[JOINT COMMITTEE PRINT]

DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2001 BUDGET PROPOSAL

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

March 6, 2000

U.S. Government Printing Office
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JOINT COMMITTEE ON TAXATION

106th CONGRESS, 2nd SESSION

CONTENTS

INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation ("Joint Committee staff"), provides a description and analysis of the revenue provisions and other provisions requiring amendment of the Internal Revenue Code (the "Code") that are contained in the President's Fiscal Year 2001 Budget Proposal, as submitted to the Congress on February 7, 2000.[2] The pamphlet generally follows the order of the proposals as included in the Department of the Treasury's explanation.[3] For these provisions, there is a description of present law and the proposal (including effective date), an analysis of issues related to the proposal, and a reference to any recent prior legislative action or budget proposal submission.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCS-2-00), March 6, 2000.

[2] See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2001: Analytical Perspectives* (H. Doc. 106-162, Vol. III), pp. 54-86.

[3] See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals,* February 2000.

I. PROVISIONS REDUCING REVENUES

A. Education Provisions

1. College opportunity tax cut

Present Law

General tax treatment of education expenses

Individual taxpayers generally may not deduct their education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above-described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous deductions, exceed two percent of the taxpayer's adjusted gross income ("AGI").

HOPE credit

Individual taxpayers are allowed to claim a nonrefundable credit, the "HOPE" credit, against Federal income taxes up to $1,500 per student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program.[4] The HOPE credit rate is 100 percent on the first $1,000 of qualified tuition and related expenses, and 50 percent on the next $1,000 of qualified tuition and related expenses.[5] The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The HOPE credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year. The

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[4] For taxable years beginning in 2000 and 2001, nonrefundable personal credits, including the HOPE credit and the Lifetime Learning credit (discussed below), may offset both regular tax and alternative minimum tax liability.

[5] Thus, an eligible student who incurs $1,000 of qualified tuition and related expenses is eligible (subject to the AGI phaseout) for a $1,000 HOPE credit. If an eligible student incurs $2,000 of qualified tuition and related expenses, then he or she is eligible for a $1,500 HOPE credit.

HOPE credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). For taxable years beginning after 2001, the $1,500 maximum HOPE credit amount and the AGI phase-out range will be indexed for inflation. The HOPE credit is not available for a year if an exclusion is allowed for distributions from an Education IRA for that year.

The HOPE credit is available in the taxable year the expenses are paid, for academic periods beginning during that year or the first three months of the next year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the HOPE credit. The repayment of a loan itself is not a qualified tuition or related expense.

A taxpayer may claim the HOPE credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is not entitled to claim a HOPE credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may elect either the HOPE credit or the “Lifetime Learning” credit (described below) with respect to an eligible student.

The HOPE credit is available for “qualified tuition and related expenses,” which include tuition and fees required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year. The HOPE credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

An eligible student for purposes of the HOPE credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one-half the normal full-time work load for the course of study the student is pursuing for at least one academic period which begins during the taxable year. To be eligible for the HOPE credit, a student must not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. In order to qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

Lifetime Learning credit

Individual taxpayers are allowed to claim a nonrefundable credit, the "Lifetime Learning" credit, against Federal income taxes equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents. For expenses paid after June 30, 1998, and prior to January 1, 2003, up to $5,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return is $1,000). For expenses paid after December 31, 2002, up to $10,000 of qualified tuition and related expenses per taxpayer return will be eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return will be $2,000). The Lifetime Learning credit is not available for a year if an exclusion is allowed for distributions from an Education IRA.

In contrast to the HOPE credit, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the HOPE credit, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return does not vary based on the number of students in the taxpayer's family -- that is, the HOPE credit is computed on a per-student basis, while the Lifetime Learning credit is computed on a family-wide basis. The Lifetime Learning credit that a taxpayer may otherwise claim is phased out ratably over the same range as the HOPE credit, i.e., for taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns).

The Lifetime Learning credit is available in the taxable year the expenses are paid, for academic periods beginning during that year or the first three months of the next year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Lifetime Learning credit (rather than repayment of the loan itself).

As with the HOPE credit, a taxpayer may claim the Lifetime Learning credit with respect to a student who is not the taxpayer or the taxpayer's spouse (e.g., in cases where the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent by the parent or other taxpayer, the student may not claim the Lifetime Learning credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of the provision.

A taxpayer may claim the Lifetime Learning credit for a taxable year with respect to one or more students, even though the taxpayer also claims a HOPE credit for that same taxable year with respect to other students. If, for a taxable year, a taxpayer claims a HOPE credit with respect to a student, then the Lifetime Learning credit is not available with respect to that same student for that year (although the Lifetime Learning credit may be available with respect to that same student for other taxable years).

The Lifetime Learning credit is available for "qualified tuition and related expenses," which include tuition and fees required to be paid to an eligible educational institution as a condition of enrollment or attendance of a student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition expenses unless this education is part of the student's degree program.

In contrast to the HOPE credit, qualified tuition and related expenses for purposes of the Lifetime Learning credit include tuition and fees incurred with respect to undergraduate or graduate-level (and professional degree) courses.[6]

As with the HOPE credit, qualified tuition and fees generally include only out-of-pocket expenses. Qualified tuition and fees do not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and fees are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student during the taxable year (such as employer-provided educational assistance excludable under section 127). The Lifetime Learning credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

In addition to allowing a credit for the tuition and related expenses of a student who attends classes on at least a half-time basis as part of a degree or certificate program, the Lifetime Learning credit also is available with respect to any course of instruction at an eligible educational institution (whether enrolled in by the student on a full-time, half-time, or less than

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[6] The HOPE credit is available only with respect to the first two years of a student's undergraduate education.

half-time basis) to acquire or improve job skills of the student.[7] Undergraduate and graduate students are eligible for the Lifetime Learning credit. Moreover, in contrast to the HOPE credit, the eligibility of a student for the Lifetime Learning credit does not depend on whether or not the student has been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Description of Proposal

The proposal would expand the Lifetime Learning credit by increasing the credit rate of 20 percent of qualified tuition and related expenses to 28 percent. The proposal also would increase the beginning points of the income phase-out ranges for the credit. Thus, the credit would be phased out ratably for individual taxpayers with modified AGI of $50,000 to $60,000 and for taxpayers filing joint returns with modified AGI of $100,000 to $120,000. These phase-out ranges would be adjusted for inflation after 2000.

In lieu of the Lifetime Learning credit, the proposal would permit taxpayers to claim a deduction for qualified tuition and related expenses. The deduction would be limited to up to $10,000 of qualified tuition and related expenses per taxpayer return ($5,000 for expenses paid prior to January 1, 2003). The deduction would be above-the-line; i.e., the deduction could be claimed by taxpayers whether or not they otherwise itemize deductions.[8] The deduction would be phased out over the same AGI ranges as the Lifetime Learning credit.

The deduction, like the Lifetime Learning credit, would be computed on a family-wide basis for qualified expenses incurred on behalf of the taxpayer, the taxpayer's spouse, and one or more claimed dependents. In addition, like the credit, the deduction would not be available with respect to expenses incurred on behalf of any student with respect to whom a HOPE credit is claimed for the same taxable year. The proposal would provide that, if a taxpayer claims a HOPE credit for one student and also claims a deduction in lieu of the Lifetime Learning credit with respect to qualified expenses incurred on behalf of other students, the definition of modified AGI for purposes of the HOPE credit would reflect the deduction.

Effective date.--The proposal would be effective for qualified tuition and related expenses paid on or after January 1, 2001.

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[7] Eligible higher educational institutions are defined in the same manner for purposes of both the HOPE and Lifetime Learning credits.

[8] Because the deduction would be above-the-line, it would not be subject to the two-percent floor on itemized deductions.

Analysis

Overview of the goals of subsidies for education

Economists attempt to analyze subsidies in terms of their efficiency, equity, and administrability. Subsidies to education have been argued to improve both economic efficiency and to promote economic equity.

Efficiency as a goal of subsidies to education

Economists generally favor the outcomes of the free market and argue that taxes or subsidies generally lead to inefficient outcomes. That is, taxes or subsidies distort choices and divert resources from their highest and best use. However, economists also recognize that sometimes markets do not work efficiently. Economists observe that the consumption or acquisition of certain goods may create spillover, or external, effects that benefit society at large as well as the individual consumer who purchases the good. A good example of such a good is a vaccination. The individual who is vaccinated benefits by not contracting an infectious disease, but the rest of society benefits as well, because by not contracting the disease the vaccinated individual also slows the spread of the disease to those who are not vaccinated. Economists call such a spillover effect a "positive externality."[9] On his own, the individual would weigh only his own reduced probability of contracting the disease against the cost of the vaccination. He would not account for the additional benefit he produces for society. As a result, he might choose not to be vaccinated, even though from society's perspective total reduction in the rate of infection throughout the population would be more than worth the cost of the vaccination. In this sense, the private market might produce too little of the good. The private market outcome is inefficiently small. Economists have suggested that the existence of positive externalities provides a rationale for the government to subsidize the acquisition of the good that produces the positive externalities. The subsidy will increase the acquisition of the good to its more efficient level.

While much evidence suggests that job skill acquisition and education benefit the private individual in terms of higher market wages, many people have long believed that education also produces positive externalities. Commentators argue that the democracy functions better with an educated populace and that markets function better with educated consumers. They observe that education promotes innovation and that, because ideas and innovations are easily copied in the market place, the market return (wage or profit) from ideas and innovations may not reflect the full value to society from the idea or innovation. Just as the single individual does not appreciate

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[9] For a more complete discussion of the notion of "positive externality" see, Harvey S. Rosen, *Public Finance* (Homewood, Illinois: Irwin), 1988, 142-146. Rosen discusses the notion of positive externality as applied to education. Rosen notes (144-145), "That college increases productivity may be true, but <u>as long as the earnings of college graduates reflect their higher productivity, there is no externality</u> [Rosen's emphasis]."

the full benefit of a vaccination, a single individual may not be able to reap the full benefit of an idea or innovation. Thus, it is argued, subsidies for education are needed to improve the efficiency of society.

On the other hand, recognizing that a subsidy might be justified does not identify the magnitude of the subsidy necessary to promote efficiency nor the best method for delivery of the subsidy. It is possible to create inefficient outcomes by over-subsidizing a good that produces positive externalities. Given that the United States already provides substantial subsidies to education[10], without some empirical analysis of the social benefits that would arise from creating new subsidies, it is not possible to say whether such subsidies would increase or decrease economic efficiency.

Some observers note that, aside from potential spillover effects that education might create, the market for financing education may be inefficient. They observe that while investors in housing or other tangible assets have property that can be pledged to secure financing to procure the asset, an individual cannot pledge his or her future earnings as security for a loan to obtain education or training designed to increase the individual's future earning potential. This inability to provide security for education loans constrains borrowing as an alternative to finance education for some taxpayers. Taxpayers who cannot borrow to finance education or training may forgo the education or training even though it would produce a high return for the investor. This inefficiency in the market for education finance may offer a justification for public subsidies. The inefficiency in the market for financing likely is most acute among lower-income taxpayers who generally do not have other assets that could be pledged as security for an education loan. This suggests that this potential source of market inefficiency also relates to the considerations of equity as a rationale for subsidies of education (discussed below).

Equity as a goal of subsidies for education

As noted above, there is evidence indicating that education and training are rewarded in the market place. Recognizing this market outcome, some argue that it is appropriate to subsidize education to ensure that educational opportunities are widely available, including to those less well off in society. Commentators argue that education can play an important role in reducing poverty and income inequality. They observe that, even if there were no positive externalities from education, promoting economic equity within a market economy provides a basis for subsidizing education.[11] If equity is the goal of expanded subsidies to education, the

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[10] For a more complete discussion of federal tax subsidies for education, see Joint Committee on Taxation, *Overview of Present Law and Issues Relating to Tax and Savings Incentives for Education* (JCX-12-99), March 2, 1999.

[11] For a cautionary note on the importance of the subsidy given see Dennis Zimmerman, "Expenditure-Tax Incidence Studies, Public Higher Education, and Equity", National Tax Journal, 26, March 1973. Zimmerman finds that the subsidy structure can just as easily promote a

cost of the subsidies should be weighed in terms of the private benefits received by the target groups, rather than the social benefits that might be generated by any possible spillovers.

Beneficiaries of tax incentives for education

The immediate beneficiaries of the proposed tax incentive for education provided by the tax credit or deduction are taxpayers who incur education expenses. The recipients of education who would otherwise not have received such education also could benefit, because generally additional education or training increases an individual's earning potential. As discussed previously, to the extent that there are positive spillover effects from education, the public at large could benefit. However, the benefit the parents may expect to receive from the tax credit or deduction might induce parents to save less money for their children's education than they otherwise would. If so, this inducement could decrease the national saving rate, possibly leading to slower economic growth. It also could mean the student's burden of debt upon graduation is not markedly different than the burden he or she otherwise would have incurred.

Some of the benefit of the incentives may accrue to educational institutions and their employees, rather than to taxpayers and their children. As discussed above, the effect of the credit or deduction is to reduce the price of education for a large number of potential students. Some believe that such incentives, by increasing the demand for post-secondary education, would drive up the prices that educational institutions and their employees charge for their services.[12] Higher prices for educational services could transfer the benefit from the taxpayer to the educational institution. Whether, or by how much, the prices charged by educational institutions might increase would depend on the supply of such education. In the short run, the number of qualifying institutions is fixed. These institutions could increase enrollments, although in the short run many may not have the physical facilities or personnel to do so. An increase in demand with no change in supply usually results in higher prices for a product (higher tuition), in which case some of the benefits of the credit and deduction may be transferred to the educational institution. Even if tuition does not increase, some of the benefits of the credit and deduction may be transferred to the educational institution because increasing enrollments with little or no change in facilities or personnel may lead to a reduced quality of the education product. On the other hand, over time post-secondary educational institutions have demonstrated

less equal distribution of lifetime income.

[12] See Michael Rothschild and Lawrence J. White, "The University in the Marketplace: Some Insights and Some Puzzles," in Charles T. Clotfelter and Michael Rothschild (eds.), *Studies of Supply and Demand in Higher Education*, (Chicago: The University of Chicago Press), 1993. Rothschild and White observe that universities compete in the marketplace, but may not set prices as high as the market can bear. Instead, they charge what might otherwise be termed "below market tuition" and selectively choose students permitted to enroll.

an ability to accommodate additional students. For example, college enrollments in 1996 were 16 percent greater than they were in 1981 and nearly 50 percent greater than in 1973.[13]

Whether, or to what extent, tuition charges will increase in response to the increase in demand will determine the effect of the proposals on enrollment. Empirical studies show that both tuition levels and financial aid can affect the enrollment in higher education. The evidence suggests the effects are larger among students who attend low-cost schools or who come from lower income families.[14] To the extent increases in tuition do not fully offset the tax savings, enrollment at these institutions and by these students may increase. On the other hand, some research suggests that tuition changes may have more of an effect than net cost changes.[15] That is, enrollment is subject to "sticker shock" and a one dollar increase in tuition does more to discourage enrollment than a one dollar increase in financial aid (or tax reduction) does to encourage enrollment.

<u>Specific issues related to the college opportunity tax cut</u>

The President's proposed expanded Lifetime Learning credit would provide a 28-percent credit for qualified tuition and related expenses. As under present law, the maximum annual expenses that could be taken into account for purposes of the credit would be $10,000 ($5,000 for 2001 and 2002). Thus, for example, a taxpayer with $5,000 of qualified tuition and related expenses in 2000 would be able to claim a credit of up to $1,400 under the proposal, compared to a maximum credit of $1,000 under present law. As under present law, the credit could be claimed by the student or the student's parents (subject to a phase-out of the credit based on AGI). As an alternative to claiming the credit, the President's proposal would permit an above-the-line deduction of up to $10,000 per year ($5,000 for 2001 and 2002) for qualified tuition and related expenses paid by the student or the student's parents.

Generally, the value of a deduction can be equated to a credit at a rate equivalent to the taxpayer's marginal tax rate. Thus, for example, if a taxpayer in the 28-percent marginal tax bracket is permitted to deduct $1,000 of educational expenses, the taxpayer's income tax liability falls by $280. This would be equivalent to permitting the same taxpayer to claim a 28-percent credit against his or her tax liability for the $1,000 of expenses. The effect under either a

[13] U.S. Department of Education, Office of Educational Research and Improvement, National Center for Education Statistics, *The Condition of Education 1999*, NCES 1999022 (Washington, D. C.: U.S. Government Printing Office), 1999. The figures reported are for all institutions.

[14] Bob Lyke, *Tuition Tax Credit and Deduction: Issues Raised by the President's Proposals*, CRS Report for Congress, 96-607 EPW, July 3, 1996, provides a brief review of this literature.

[15] *Id.*

deduction or a credit is that the taxpayer's out-of-pocket expenditure is reduced to $720; although the individual paid out $1,000, his or her income tax liability fell by $280. Thus, economists sometimes say that the deduction or credit reduces the "price" of education. In this example, the price of education is reduced to 72 cents per dollar of educational expenditure.[16]

A taxpayer will generally prefer a deduction to a credit if his or her marginal tax rate exceeds the credit rate, and will generally prefer the credit to the deduction if his or her marginal tax rate is less than the credit rate. Taxpayers with marginal tax rates in excess of 28 percent would thus prefer a deduction to a 28-percent credit. However, the proposed income phaseout of the Lifetime Learning deduction and credit effectively precludes anyone with a regular marginal income tax rate in excess of 28 percent from claiming the credit or deduction. Taxpayers with marginal tax rates of 15 percent or less will generally prefer the credit to the deduction, while those in the 28 percent bracket would generally be indifferent. For individuals whose returns are affected by the alternative minimum tax ("AMT"), the deduction would be preferred because nonrefundable credits may not reduce net tax liability below the amount of the tentative minimum tax. For these taxpayers, a deduction would reduce tax liability by an amount equal to the amount of the deduction multiplied by the effective minimum tax marginal rate (generally 26 or 28 percent). For taxable years beginning in 2000 and 2001, personal credits are not limited by the AMT provisions, and for these years the credit option would be preferable for individuals whose income is taxed at the 15 percent rate.

The expansion of the phase-out ranges for the credit or deduction preserves the basic structure whereby the phase-out rate for married taxpayers filing jointly remains at twice the levels for singles or head of households. This structure assures that no marriage penalties exist from the phaseout, though it preserves and may enhance marriage bonuses related to the Lifetime Learning credit. Some might question the relevance of marriage penalty considerations in setting the phaseout ranges for a benefit for post-secondary education that generally accrues to parents of college-age dependents, who will generally have made their marriage decision years earlier. Such observers would argue that the proposal would inappropriately deny any tax benefit to a head of household filer with AGI of $60,000 and three children in college, while granting the full benefit to a married couple with AGI of $100,000 and only one child in college. They would argue that any expansion of the phase-out range for the credit or deduction should be aimed at increasing the range for single and head of household filers to that of the level for married filing jointly. They might further argue that the credit should vary based on the number of individuals incurring educational expenses. This would help reduce an inequity in the present law structure of the Lifetime Learning credit which tends to provide more tax-based assistance to families whose children are further apart in age than to families whose children are closer in age, though the educational expenses of such families may be identical over time.

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[16] The foregoing ignores the proposal's potential interaction with Pell Grants or other public or private financial aid. Changes in other financial aid would alter the effective "price" of educational expenditures calculated in this and subsequent examples.

The proposal may increase complexity for taxpayers with education expenses. Present law contains a variety of different education tax incentives, each with differing requirements. In order to take full advantage of the tax benefits offered under present law, taxpayers must determine which of the available incentives provides the greatest benefit. For many taxpayers, such an analysis will be difficult and cumbersome. By adding another option for taxpayers with educational expenses (i.e., the proposed deduction) and modifying the present-law Lifetime Learning credit, the proposal may make it more difficult for taxpayers to determine which education tax incentive is best for them.

Prior Action

The proposal for a deduction for qualified tuition and related expenses is similar to proposals contained in the President's Fiscal Year 1997 and 1998 Budget Proposals.

2. Extend authority to issue qualified zone academy bonds and expand to include authority to issue qualified school modernization bonds

Present Law

Tax-exempt bonds

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units, including the financing of public schools (sec. 103).

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue "qualified zone academy bonds." A total of $400 million of qualified zone academy bonds is authorized to be issued in each of 1998, 1999, 2000, and 2001. The $400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit within the State.

Certain financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond (sec. 1397E). A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includible in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond issued is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond.

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

A school is a "qualified zone academy" if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in one of the 31 designated empowerment zones or one of the 95 designated enterprise communities, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

Description of Proposal

In general

The proposal would authorize the issuance of additional qualified zone academy bonds and of qualified school modernization bonds. It also would establish new requirements applicable to qualified zone academy bonds and qualified school modernization bonds ("tax credit bonds"). The new requirements would apply to tax credit bonds issued after December 31, 2000.

Qualified zone academy bonds

The proposal would authorize the issuance of an additional $1 billion of qualified zone academy bonds in calendar year 2001 and of $1.4 billion in 2002. As under present law, the aggregate volume limit would be allocated to States according to their respective populations of individuals below the poverty line. The list of permissible uses of proceeds of qualified zone academy bonds would be expanded to include school construction. Property financed with the sale of qualified zone academy bonds would be required to be owned by a State of local government.

Qualified school modernization bonds

Under the proposal, States and local governments also would be able to issue "qualified school modernization bonds" to fund the construction, rehabilitation, or repair of public elementary and secondary schools.[17] Property financed with the sale proceeds of qualified school modernization bonds would be required to be owned by a State or local government.

A total of $11 billion of qualified school modernization bonds could be issued in each of 2001 and 2002, with this amount to be allocated among the States and qualifying school districts. One half of this annual $11 billion 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 determined to be in particular need of assistance.[18] The remaining half of the annual cap would be divided among the States and Puerto Rico.[19]

An additional $200 million of bonds in each of 2001 and 2002 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.

Under the proposal, a bond would be treated as a qualified school modernization bond only if the following three requirements were satisfied: (1) the Department of Education approved the modernization plan of the State or eligible school district, which plan must (a) demonstrate that a comprehensive survey had been undertaken of the construction and renovation needs in the jurisdiction, and (b) describe how the jurisdiction would assure that bond proceeds were used as proposed;[20] (2) the State or local governmental entity issuing the bond received an allocation for the bond from the appropriate entity; and (3) at least 95 percent of the bond proceeds were used to construct, rehabilitate, or repair elementary or secondary school facilities.

Unlike qualified zone academy bonds, the proposed qualified school modernization bonds would not be conditioned on contributions from private businesses.

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[17] For this purpose, the term construction includes land upon which a school facility is to be constructed.

[18] The bond authority would be allocated among the school districts and among States 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 would not be restricted to using the Title I Basic Grant Formula to allocate the cap among school districts, but could use any appropriate mechanism.

[19] 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.

[20] Modernization plans for Bureau of Indian Affairs-funded schools would be approved by the Department of the Interior.

Rules generally applicable to tax credit bonds generally

The proposal sets forth certain rules that would apply to all tax credit bonds. As with present-law qualified zone academy bonds, the "credit rate" for tax credit bonds would be set daily by the Treasury Department so that, on average, such bonds would be issued without interest, discount, or premium. The maximum term of the bonds would be 15 years. Credits would accrue quarterly.

Unlike under present law, 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. Ownership of the bonds and credits could be separated, or "stripped;" that is, rights to future credits could be sold separately from rights to repayment of principal. Credits could also be transferred through repurchase agreements. Unused credits could not be carried back, but could be carried forward.

Under the proposal, at least 95 percent of the tax credit bond proceeds would have to be used for qualifying purposes for the entire term of the bonds. Any investment earnings on the bonds would be treated as bond proceeds. As of the date of issue, issuers would have to reasonably expect to spend at least 95 percent of bond proceeds for qualifying purposes within three years. In addition, the issuer would have reasonably expect to incur a binding obligation with a third party to spend at least 10 percent of proceeds of the issue within 6 months of the date of issue. To the extent 95 percent of the proceeds was not spent for qualifying purposes within three years, the unexpended proceeds would have to be used to retire bonds within 90 days.

If the issuer established a sinking fund for the repayment of the principal, all sinking fund assets would be required to be held in State and Local Government Securities ("SLGS") issued by the Treasury. Both school modernization bonds and qualified zone academy bonds could be issued using a pooled financing structure as long as each loan satisfied the applicable requirements for bonds issued on a per-project basis.

Any property financed with tax credit bond proceeds would be required to be used for a qualifying purpose for at least a 15-year period after the date of issuance. If the use of a bond-financed facility changed to a non-qualifying use within that 15-year period, the bonds would cease to be qualifying bonds and would accrue no further tax credits. Further, the issuer would be required to reimburse the Treasury for all tax credits (including interest) which accrued within three years of the date of noncompliance. If the issuer failed to make a full and timely reimbursement of tax credits, holders of the bonds would be liable for any remaining amounts. Similar recapture rules would apply in the case of violations of other tax-related requirements of tax credit bonds.

Effective date.--The proposal would be effective for bonds issued on or after January 1, 2001.

Analysis

The proposals to expand the allocation for (and permissible uses of) zone academy bonds and to establish school modernization bonds would subsidize a portion of the costs of new investment in public school infrastructure and, in certain qualified areas, equipment and teacher training. By subsidizing such costs, it is possible that additional investment will take place relative to investment that would take place in the absence of the subsidy. If no additional investment takes place than would otherwise, the subsidy would merely represent a transfer of funds from the Federal Government to States and local governments. This would enable States and local governments to spend the savings on other government functions or to reduce taxes.[21] In this event, the stated objective of the proposals would not be achieved.

Though called a tax credit, the Federal subsidy for tax credit bonds is equivalent to the Federal Government directly paying the interest on a taxable bond issue on behalf of the State or local government that benefits from the bond proceeds.[22] To see this, consider any taxable bond that bears an interest rate of 10 percent. A thousand dollar bond would thus produce an interest payment of $100 annually. The owner of the bond that receives this payment would receive a net payment of $100 less the taxes owed on that interest. If the taxpayer were in the 28-percent Federal tax bracket, such taxpayer would receive $72 after Federal taxes. Regardless of whether the State government or the Federal Government pays the interest, the taxpayer receives the same net of tax return of $72. In the case of tax credit bonds, no formal interest is paid by the Federal Government. Rather, a tax credit of $100 is allowed to be taken by the holder of the bond. In general, a $100 tax credit would be worth $100 to a taxpayer, provided that the taxpayer had at least $100 in tax liability. However, for tax credit bonds, the $100 credit also has to be claimed as income. Claiming an additional $100 in income costs a taxpayer in the 28-percent tax bracket an additional $28 in income taxes, payable to the Federal Government. With the $100 tax credit that is ultimately claimed, the taxpayer nets $72 on the bond. The Federal Government loses $100 on the credit, but recoups $28 of that by the requirement that it be included in income, for a net cost of $72, which is exactly the net return to the taxpayer. If the Federal Government had simply agreed to pay the interest on behalf of the State or local government, both the Federal Government and the bondholder/taxpayer would be in the same situation. The Federal

[21] Most economic studies have found that when additional funding is made available to localities from outside sources, there is indeed an increase in public spending (this is known as the "fly-paper" effect, as the funding tends to "stick" where it is applied). The additional spending is not dollar for dollar, however, implying that there is some reduction of local taxes to offset the outside funding. See Harvey Rosen, Public Finance, Second Ed., 1988, p. 530 for a discussion of this issue.

[22] This is true provided that the taxpayer faces tax liability of at least the amount of the credit. Without sufficient tax liability, the proposed tax credit arrangement would not be as advantageous. Presumably, only taxpayers who anticipate having sufficient tax liability to be offset by the proposed credit would hold these bonds.

Government would make outlays of $100 in interest payments, but would recoup $28 of that in tax receipts, for a net budgetary cost of $72, as before. Similarly, the bondholder/taxpayer would receive a taxable $100 in interest, and would owe $28 in taxes, for a net gain of $72, as before. The State or local government also would be in the same situation in both cases.

The proposed tax credit regime to subsidize public school investment raises some questions of administrative efficiencies and tax complexity. Because potential purchasers of the zone academy bonds and school modernization bonds must educate themselves as to whether the bonds qualify for the credit, certain "information costs" are imposed on the buyer. Additionally, since the determination as to whether the bond is qualified for the credit ultimately rests with the Federal Government, further risk is imposed on the investor. These information costs and other risks serve to increase the credit rate and hence the costs to the Federal Government for a given level of support to the zone academies or school modernization efforts. For these reasons, and the fact that tax credit bonds will be less liquid than Treasury Securities, the bonds would bear a credit rate that is equal to a measure of the yield on outstanding corporate bonds.[23]

The direct payment of interest by the Federal Government on behalf of States or localities, which was discussed above as being economically the equivalent of the credit proposal, would involve less complexity in administering the income tax, as the interest could simply be reported as any other taxable interest. Additionally, the tax credit approach implies that non-taxable entities would only be able to invest in the bonds to assist school investment through repurchase agreements or by acquiring rights to repayment of principal if a tax credit bond is stripped. In the case of a direct payment of interest, by contrast, tax-exempt organizations would be able to enjoy such benefits.

Prior Action

A similar proposal was included in the President's Fiscal Year 1999 and 2000 Budget Proposals.

In 1999, legislation authorizing an additional $400 million per year of qualified zone academy bond issuance during calendar years 2000 and 2001 was enacted.

[23] The proposed school modernization bonds credit rate would be set by the Secretary of the Treasury so that, on average, the bonds could be issued without interest, discount, or premium.

3. Expand exclusion for employer-provided educational assistance to include graduate education

Present Law

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

Employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under a section 127 educational assistance plan or if the expenses qualify as a working condition fringe benefit under section 132. Section 127 provides an exclusion of $5,250 annually for employer-provided educational assistance. The exclusion does not apply to graduate courses beginning after June 30, 1996. The exclusion for employer-provided educational assistance expires with respect to undergraduate courses beginning on or after January 1, 2002.

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

Educational expenses that do not qualify for the section 127 exclusion may be excludable from income as a working condition fringe benefit.[24] In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.[25]

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

[25] In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's AGI. The 2-percent floor limitation is disregarded in determining whether an item is excludable as a working condition fringe benefit.

Description of Proposal

The proposal would extend the present-law exclusion for employer-provided educational assistance to apply to graduate courses, effective for courses beginning after July 1, 2000, and before January 1, 2002.

Effective date.--The proposal would be effective for graduate-level courses beginning after July 1, 2000, before June 1, 2002.

Analysis

The exclusion for employer-provided educational assistance programs is aimed at increasing the levels of education and training in the workforce. The exclusion also reduces complexity in the tax laws.

Present-law section 127 reduces the after-tax cost of employer-provided education to the employee. This cost reduction could lead to larger expenditures on education for workers than would otherwise occur. This extra incentive for education may be desirable if some of the benefits of an individual's education accrue to society at large through the creation of a better-educated populace or workforce, i.e., assuming that education creates “positive externalities.” In that case, absent the subsidy, individuals would underinvest in education (relative to the socially desirable level) because they would not take into account the benefits that others indirectly receive. To the extent that expenditures on education represent purely personal consumption, a subsidy would lead to over consumption of education.[26]

Proponents of extending and expanding the benefits provided by section 127 observe that more education generally leads to higher future wages for the individuals who receive the education. Thus, proponents argue that higher future tax payments by these individuals will compensate for the tax expenditure today. While empirical evidence does indicate that more education leads to higher wages, whether the government is made whole on the tax expenditure depends upon to which alternative uses the forgone government funds may have been put. For example, proponents of increased government expenditures on research and development point to evidence that such expenditures earn rates of return far in excess of those on most private investments. If such returns exceed the financial returns to education, reducing such expenditures to fund education benefits may reduce future tax revenues.

Because present-law section 127 provides an exclusion from gross income for certain employer-provided education benefits, the value of this exclusion in terms of tax savings is greater for those taxpayers with higher marginal tax rates. Thus, higher-paid individuals,

[26] Economic issues regarding tax subsides for education are discussed further in Part I.A.1., above and also in Joint Committee on Taxation, *Analysis of Proposed Tax Incentives for Higher Education* (JCS-3-97), March 4, 1997, 19-23.

individuals with working spouses, or individuals with other sources of income may be able to receive larger tax benefits than their fellow workers. Section 127 does not apply, however, to programs under which educational benefits are provided only to highly compensated employees.

In general, in the absence of section 127, the value of employer-provided education is excludable from income only if the education relates directly to the taxpayer's current job. If the education would qualify the taxpayer for a new trade or business, however, then the value of the education generally would be treated as part of the employee's taxable compensation. Under this rule, higher-income, higher-skilled individuals may be more able to justify education as related to their current job because of the breadth of their current training and responsibilities. For example, a lawyer or professor may find more courses of study directly related to his or her current job and not qualifying him or her for a new trade than would a clerk.

The section 127 exclusion for employer-provided educational assistance may counteract this effect by making the exclusion widely available regardless of the employee's current job status or job description. Proponents argue that the exclusion is primarily useful to nonhighly compensated employees to improve their competitive position in the work force. In practice, however, the scant evidence available seems to indicate that those individuals receiving employer-provided educational assistance are somewhat more likely to be higher-paid workers, particularly if the exclusion is extended to graduate level courses.[27] The amount of the education benefits provided by an employer also appears to be positively correlated with the income of the recipient worker. Such evidence is consistent with the observation that, in practice, the exclusion is more valuable to those individuals in higher marginal tax brackets. A reformulation of the incentive as an inclusion of the value of benefits into income in conjunction with a tax credit could make the value of the benefit more even across recipients subject to different marginal tax brackets.[28]

Reinstating the exclusion for graduate-level employer-provided educational assistance may enable more individuals to seek higher education. Some argue that greater levels of higher education are important to having a highly trained and competitive workforce, and may be important in retraining workers who seek new employment. Others argue that the tax benefits from extending the exclusion to graduate-level education will accrue mainly to higher-paid workers. Others would argue that it would be desirable to extend the exclusion to graduate-level

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[27] See, for example, The National Association of Independent Colleges and Universities, "Who Benefits from Section 127," December 1995; Coopers & Lybrand, "Section 127 Employee Educational Assistance: Who Benefits? At What Cost?," June 1989, 15; and Steven R. Aleman, "Employer Education Assistance: A Profile of Recipients, Their Educational Pursuits, and Employers," CRS Report, 89-33 EPW, January 10, 1989, 9.

[28] If the credit were nonrefundable, then to the extent that a taxpayer reduces his or her tax liability to zero, he or she might not be able to receive the full value of the credit.

education, but that limiting the exclusion in this manner is appropriate given budgetary constraints.

In addition to furthering education objectives, the exclusion for employer-provided educational assistance may reduce tax-law complexity. In the absence of the exclusion, employers and employees must make a determination of whether the exclusion is job-related. This determination is highly factual in nature, and can lead to disputes between taxpayers and the Internal Revenue Service ("IRS"), who may come to different conclusions based on the same facts. The exclusion eliminates the need to make this determination.

Prior Action

A similar proposal to extend the exclusion to graduate-level courses was included in the President's Fiscal Year 1997, 1999, and 2000 Budget Proposals. An extension of the exclusion to graduate-level courses also was included in the Taxpayer Relief Act of 1997, the Education Savings and School Excellence Act of 1998 (105th Cong.), and the Taxpayer Refund Act of 1999, all as passed by the Senate.

4. Eliminate 60-month limit on student loan interest deduction

Present Law

Present law provides an above-the-line deduction for certain interest paid on qualified education loans. The deduction is limited to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Months during which the qualified education loan is in deferral or forbearance do not count against the 60-month period.

The maximum allowable deduction is $2,000 in 2000, and $2,500 in 2001 and thereafter.[29] The deduction is phased out ratably for individual taxpayers with modified adjusted gross income ("AGI") of $40,000-$55,000 and $60,000-$75,000 for joint returns. The income ranges will be indexed for inflation after 2002.

Description of Proposal

The proposal would eliminate the limit on the number of months during which interest paid on a qualified education loan is deductible.

Effective date.--The proposal would generally be effective for interest paid on qualified education loans after December 31, 2000.

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[29] The maximum allowable deduction for 1998 was $1,000 and for 1999 was $1,500.

Analysis

The 60-month rule serves as an overall limit on the amount of interest that may be deducted with respect to qualified education loans. Lengthening the time period over which taxpayers may deduct student loan interest expense would lead to a lower after-tax cost of financing education for those who have used large loans to finance their education or who do not repay the loans within five years (e.g., because of insufficient resources). As a consequence, lowering the after-tax cost of financing education could encourage those students that need large loans in order to finance their education to pursue more education than they would have otherwise. On the other hand, lengthening the time period over which taxpayers may deduct student loan interest expense could encourage some taxpayers to take on more debt for a given level of education expenses in order to finance a greater level of current consumption. This additional debt assumed would not be associated with a greater educational attainment, but rather, because of the fungibility of money, could serve as a way to make some consumer interest expense deductible.

The 60-month rule creates administrative burdens and complexities for individuals. For example, an individual with more than one student loan may have to keep track of different 60-month periods for each loan. Issues may arise as to the proper application of the 60-month rule in the event that an individual consolidates student loans. Special rules are needed to apply the 60-month rule in common situations, such as periods of loan deferment or forbearance and refinancings. Eliminating the 60-month rule would simplify the student loan interest deduction.

Other rules could be adopted to serve the purpose of the 60-month rule, but such rules also would be likely to add complexity. For example, some have suggested that the 60-month rule be replaced with a lifetime limit on the amount of deductible interest. Such a rule would require individuals to keep track of the total amount of interest they have deducted. Such records would need to be kept longer than under the 60-month rule as interest payments may be made over a longer period of time. Additional complexities would have to be addressed, such as how the lifetime limit would be allocated when there is a change in status of the taxpayer, such as through marriage or divorce. A lifetime limit would could also alter the class of taxpayers who benefit from the deduction and could create winners and losers relative to present law.

Some have argued that the 60-month rule (or an alternative) is unnecessary, particularly given its complexity, because of the annual limit on the deduction. In addition, the AGI limits may serve to limit the number of years over which an individual can deduct student loan interest, because AGI may increase to a level in excess of the threshold as the individual works.

In addition to simplifying the student loan interest deduction, the proposal would eliminate possible inconsistent treatment of taxpayers based on how a lender structures the interest payments on a qualified loan and when a taxpayer chooses to make payments. For example, a taxpayer who elects to capitalize interest that accrues on a 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 because the 60-month rule is suspended during the deferment, but would continue to elapse in the latter case while payments are being made.

Prior Action

The proposal is similar to a proposal contained in the President's Fiscal Year 2000 Budget Proposal. A similar proposal was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President, except that under that proposal the beginning point of the income phaseout for individual taxpayers was increased to $45,000 and for taxpayers filing joint returns to $90,000.

5. Eliminate tax on forgiveness of direct student loans subject to income contingent repayment

Present Law

Tax treatment of student loan forgiveness

In the case of an individual, gross income subject to Federal income tax does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers (sec. 108(f)).

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses (in contrast to tax free scholarships under section 117, which are limited to tuition and required fees).

The loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation. In addition, an individual's gross income does not include amounts from the forgiveness of loans made by educational organizations (and certain tax-exempt organizations in the case of refinancing loans) out of private, nongovernmental funds if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance any outstanding student loans (not just loans made by educational organizations) and the student is not employed by the lender organization. In the case of loans made or refinanced by educational organizations (as well as refinancing loans made by certain tax-exempt organizations) out of private funds, the student's work must fulfill a public service requirement. The student must work in an occupation or area with unmet needs and such work must be performed for or under the direction of a tax-exempt charitable organization or a governmental entity.

Federal Direct Loan Program; income-contingent repayment option

A major change in the delivery of Federal student loans occurred in 1993. The Student Loan Reform Act ("SLRA"), part of the Omnibus Budget Reconciliation Act of 1993, converted the Federal Family Education Loans ("FFEL"), which were made by private lenders and guaranteed by the Federal government, into direct loans made by the Federal government to students through their schools (the William D. Ford Direct Loan Program).[30] The Direct Loan Program began in academic year 1994-95 and was to be phased in, with at least 60 percent of all student loan volume to be direct loans by the 1998-1999 academic year.

Federal Direct Loans include Federal Direct Stafford/Ford Loans (subsidized and unsubsidized), Federal Direct PLUS loans, and Federal Direct Consolidation loans. The SLRA requires that the Secretary of Education offer four alternative repayment options for direct loan borrowers: standard, graduated, extended, and income-contingent. However, the income-contingent option is not available to Direct PLUS borrowers. If the borrower does not choose a repayment plan, the Secretary may choose one, but may not choose the income-contingent repayment option.[31] Borrowers are allowed to change repayment plans at any time.

Under the income-contingent repayment option, a borrower must make annual payments for a period of up to 25 years based on the amount of the borrower's Direct Loan (or Direct Consolidated Loan), adjusted gross income (AGI) during the repayment period, and family size.[32] Generally, a borrower's monthly loan payment is capped at 20 percent of discretionary income (AGI minus the poverty level adjusted for family size).[33] If the loan is not repaid in full at the

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[30] For a comprehensive description of the Federal Direct Loan program, see U.S. Library of Congress, Congressional Research Service, *The Federal Direct Student Loan Program*, CRS Report for Congress No. 95-110 EPW, by Margot A. Schenet (Washington, D.C.), updated October 16, 1996.

[31] Defaulted borrowers of direct or guaranteed loans may also be required to repay through an income-contingent plan for a minimum period.

[32] The Department of Education revised the regulations governing the income-contingent repayment option, effective July 1, 1996. See *Federal Register*, December 1, 1995, pp. 61819-61828.

[33] If the monthly amount paid by a borrower does not equal the accrued interest on the loan, the unpaid interest is added to the principal amount. This is called "negative amortization." Under the income-contingent repayment plan, the principal amount cannot increase to more than 110 percent of the original loan; additional unpaid interest continues to accrue, but is not

end of a 25-year period, the remaining debt is canceled by the Secretary of Education. There is no community or public service requirement.

Description of Proposal

The exclusion from income for amounts from forgiveness of certain student loans would be expanded to cover forgiveness of direct student loans made through the William D. Ford Federal Direct Loan Program, if loan repayment and forgiveness are contingent on the borrower's income level.

Effective date.--The proposal would be effective for loan cancellations after December 31, 2000.

Analysis

There are three types of expenditures incurred by students in connection with their education: (1) direct payment of tuition and other education-related expenses; (2) payment via implicit transfers received from governments or private persons; and (3) forgone wages. The present-law income tax generally treats direct payments of tuition as consumption, neither deductible nor amortizable. By not including the implicit transfers from governments or private persons in the income of the student, present law offers the equivalent of expensing of those expenditures undertaken on behalf of the student by governments and private persons. This expensing-like treatment also is provided for direct transfers to students in the form of qualified scholarships excludable from income. Similarly, because forgone wages are never earned, the implicit expenditure incurred by students forgoing present earnings also receives expensing-like treatment under the present-law income tax.[34]

The Federal government could help a student finance his or her tuition and fees by making a loan to the student or granting a scholarship to the student. In neither case are the funds received by the student includible in taxable income. Economically, a subsequent forgiveness of the loan converts the original loan into a scholarship. Thus, as noted above, excluding a scholarship from income or not including a forgiven loan in income is equivalent to permitting a deduction for tuition paid.

While present-law section 117 generally excludes scholarships from income, regardless of the recipient's income level, to the extent they are used for qualified tuition and related

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capitalized.

[34] For a more complete discussion of education expenses under a theoretical income tax and the present-law income tax prior to changes made in the 1997 Act, see Joint Committee on Taxation, *Analysis of Proposed Tax Incentives for Higher Education* (JCS-3-97), March 4, 1997, pp.19-23.

expenses, certain other education tax benefits are subject to expenditure and income limitations. For example, the HOPE credit limits expenditures that qualify for tax benefit to $2,000 annually (indexed for inflation after the year 2000) and the Lifetime Learning credit limits expenditures that qualify for tax benefit to $5,000 annually ($10,000 beginning in 2003).[35] In addition, the HOPE and Lifetime Learning credits are limited to taxpayers with modified adjusted gross incomes of $50,000 ($100,000 for joint filers) or less. No comparable expenditure or income limitations would apply to individuals who benefit from loan forgiveness under the proposal. For example, the expenditure limitation contained in section 117 would not apply; thus, the provision could permit students to exclude from income amounts in excess of the qualified tuition and related expenses that would have been excludable under section 117 had the loan constituted a scholarship when initially made. However, it could be argued that expenditure limits are not necessary because the Federal Direct Loan program includes restrictions on the annual amount that a student may borrow, and that income limitations are unnecessary because an individual who has not repaid an income contingent loan in full after 25 years generally would be a lower-income individual throughout most of that 25-year period.

In addition, it could be argued that expanding section 108(f) to cover forgiveness of Federal Direct Loans for which the income-contingent repayment option is elected is inconsistent with the conceptual framework of 108(f). There is no explicit or implicit public service requirement for cancellation of a Federal Direct Loan under the income-contingent repayment option. Rather, the only preconditions are a low AGI and the passage of 25 years.

As of May 1, 1996, 15 percent of the Direct Loan borrowers in repayment had selected the income-contingent option.[36] Among those who choose the income-contingent repayment option, the Department of Education has estimated that slightly less than 12 percent of borrowers will fail to repay their loans in full within 25 years and, consequently, will have the unpaid amount of their loans discharged at the end of the 25-year period.[37] Thus, the primary revenue effects associated with this provision would not commence until 2019 -- 25 years after the program originated in 1994.

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[35] For a more complete description of the HOPE and Lifetime Learning credits, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, pp. 11-20.

[36] *The Federal Direct Student Loan Program*, p.12. The Department of Education estimates that approximately 60 percent of borrowers will be in a repayment plan other than the standard 10-year repayment plan.

[37] See *Federal Register*, September 20, 1995, p. 48849.

Prior Action

The proposal was included in the President's Fiscal Year 1998, 1999, and 2000 Budget Proposals, as well as in the House and Senate versions of the Taxpayer Relief Act of 1997. The proposal was, however, not included in the conference report.

6. Tax treatment of education awards under certain Federal programs

a. Eliminate tax on awards under National Health Corps Scholarship Program and F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program

Present Law

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations.

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

Section 134 provides that any "qualified military benefit," which includes any allowance, is excluded from gross income if received by a member or former member of the uniformed services if such benefit was excludable from gross income on September 9, 1986.

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

Description of Proposal

The proposal would provide that amounts received by an individual under the NHSC Scholarship Program or the Armed Forces Scholarship Program are eligible for tax-free treatment as qualified scholarships under section 117, without regard to any service obligation by the recipient.

Effective date.--The proposal would be effective for education awards received after December 31, 2000.

b. 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

Present Law

In the case of an individual, gross income subject to Federal income tax does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.[38]

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses (in contrast to tax free scholarships under section 117, which are limited to tuition and required fees).

The loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation. In addition, an individual's gross income does not include amounts from the forgiveness of loans made by educational organizations (and certain tax-exempt organizations in the case of refinancing loans) out of private, nongovernmental funds if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance any outstanding student loans (not just loans made by educational organizations) and

[38] Section 108(f).

the student is not employed by the lender organization. In the case of loans made or refinanced by educational organizations (as well as refinancing loans made by certain tax-exempt organizations) out of private funds, the student's work must fulfill a public service requirement. The student must work in an occupation or area with unmet needs and such work must be performed for or under the direction of a tax-exempt charitable organization or a governmental entity.

The 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), because the repayment or cancellation of student loans in some instances is not contingent on the participant's working for any of a broad class of employers.

Description of 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.[39]

Effective date.--The proposal would be effective for repayments or cancellations of student loans received after December 31, 2000.

Analysis for a. and b.

Proponents of the proposed exclusions assert that the current imposition of tax liability on awards, repayments, or cancellations under the NHSC Scholarship Program, the Armed Forces Scholarship and Loan Repayment Programs, and the Americorps Education Award Program undermines the objective of providing incentives for individuals to serve as health professionals and teachers in underserved areas or as health professionals in the Armed Forces. There are, however, a number of similar federal (e.g., National Institutes of Health Undergraduate Scholarship Program) and state (e.g., Illinois Department of Public Health State Scholarships) programs that are in the same position as the programs that would be assisted by the proposal. Consequently, the proposals would result in unequal treatment of similarly situated taxpayers under various education award programs.

[39] 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.

While the Department of Defense takes the position that section 134 applies to awards made under the Armed Forces Health Professions Scholarship and Loan Repayment Programs, it has requested that the programs be included in the proposals.

Prior Action

A provision similar to the proposal to eliminate tax on awards under National Health Corps Scholarship Program and F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program was included in the Education Savings and School Excellence Act of 1998 as passed by Congress and vetoed by the President and in the Taxpayer Refund and Relief Act of 1999 as passed by the Congress and vetoed by the President. There has been no prior action on the proposal to 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.

B. Provisions for Poverty Relief and Community Revitalization

1. Expand and simplify the EIC

Present Law

In general

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

The parameters of the credit for taxable years beginning in 2000 are provided in Table 1, below.

Table 1.--Earned Income Credit Parameters (Taxable Years Beginning in 2000)

	Two or more qualifying children	One qualifying child	No qualifying children
Credit rate (percent)	40.00%	34.00%	7.65%
Earned income amount	$9,720	$6,920	$4,610
Maximum credit	$3,888	$2,353	$353
Phase-out begins	$12,690	$12,690	$5,770
Phase-out rate (percent)	21.06%	15.98%	7.65%
Phase-out ends	$31,152	$27,413	$10,380

Earned income

For purposes of the EIC, earned income has been determined to include both taxable earned income (e.g., taxable wages, salaries, tips and net earnings from self-employment) and some nontaxable earned income (e.g., U.S. military combat pay, certain employer-provided dependent care assistance benefits, and certain housing allowances or the rental value of provided housing for the clergy).

Taxpayer identification number "TIN" requirement for individuals with qualifying children

Generally, an individual must have a principal place of abode for more than one-half of the taxable year in the United States and either have a qualifying child(ren) or meet other requirements to be eligible for the EIC. Each qualifying child must meet a relationship test, a residency test and an age test. If an individual with a one qualifying child or two or more qualifying children meets the requirements of the EIC, then the individual is allowed the EIC for individuals with a qualifying child or two or more qualifying children, respectively. However, generally, the EIC available for individuals with a qualifying child (or two or more qualifying children) is denied unless the individual includes the name, age and TIN of each qualifying child on the individual's Federal income tax return for the taxable year.

To qualify for the EIC available to individuals with no qualifying children, an individual (and spouse, if any) must satisfy an age test and may not be a dependent of any other taxpayer for the taxable year. Further, neither the EIC for individuals with a qualifying child (or two or more qualifying children) nor the EIC for individuals with no qualifying children is available for individuals with one or more qualifying children if the TIN reporting requirement is not satisfied for any qualifying children.

Description of Proposal

In general

There are three proposed changes to the general present-law rules for the EIC. The first proposal would create a new credit rate for individuals with three or more qualifying children by increasing the currently applicable credit rate from 40 percent to 45 percent. Because the beginning point of the phase-out range for individuals with three or more qualifying children would be the same as the present-law beginning point for other individuals with qualifying children, the larger maximum credit amount would increase the length of the phase-out range for individuals with three or more qualifying children. The maximum increase in the end-point of the phase-out range attributable to this proposal alone would be $2,307 in 2000.[40] The second proposal would increase the beginning point of the phase-out range of the EIC for certain married

[40] Source: Joint Committee on Taxation staff projection.

couples filing a joint return by $1,450. This proposal would also increase the end-point of the phase-out range by $1,450 for affected individuals and such increase would be in addition to: (1) any increase in the end-point of the phase-out range required by the larger EIC for individuals with three or more qualifying children described above; or (2) any increase attributable to the lower phase-out rate for individuals described below. The third proposal would reduce the phase-out rate of the EIC for families with two or more children from 21.06 percent to 19.06 percent. The maximum increase in the end-point of the phase-out range attributable to the third proposal would be $1,937 in 2000.[41] In combination the three proposals would increase the end-point of the EIC phase out range by a maximum of $5,937 in 2000.[42] The phase-out range of the EIC (including the $1,450 increase for joint returns) will continue to be indexed for inflation, as under present law.

Earned income

The proposal would provide for purposes of the EIC that earned income would not include nontaxable earned income (e.g., 401(k) contributions).

Taxpayer identification number "TIN" requirement for individuals with qualifying children

The proposals would make two changes. First, it would provide that an individual who meets the requirements for an EIC with no qualifying children may claim the EIC for an individual with no qualifying children where the individual has qualifying children for whom the TIN requirement is not satisfied. Second, it would clarify the operation of the AGI tiebreaker test but the specifics of the proposal are unclear.

Effective date

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

Analysis

In general

Proponents of the proposals may argue that they are logical extensions of a program that has already been previously expanded several times. Such proponents argue that the history of the EIC is a series of successful expansions delivering a combination of both tax relief and direct outlay monies (the refundable portion of the EIC) to working individuals and families with

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[41] Source: Joint Committee on Taxation staff projection.

[42] Source: Joint Committee on Taxation staff projection. (Note: Projections do not add to totals due to interaction.)

relatively low incomes. They argue that the EIC has delivered benefits to millions of working poor. Others note that concerns have been expressed about the size and efficacy of the EIC in recent years. By its nature as a refundable credit with general applicability, the EIC has placed significant administrative demands on the IRS. As the size and complexity of the EIC have grown, the IRS has had to expand the level of resources devoted to the credit's administration. In recent years, numerous administrative and legislative initiatives have been implemented to attempt to reduce error rates in the claiming of the credit. Given the recentness of these efforts, some may argue that a comprehensive review of the EIC and its operation is necessary before another significant expansion is implemented.

The first EIC proposal would expand the EIC for families with three or more qualifying children. It would accomplish this by increasing the credit rate applicable to those families from 40 percent to 45 percent. Thus the maximum EIC for families with three or more qualifying children would be increased from \$3,888 to \$4,374 in 2000.[43] Proponents of this proposal argue that increasing the size of the EIC to poor working families with three of more children will lift many such families out of poverty. They point out that the poverty rate for families with three of more related children is more than twice the poverty rate for smaller families, and that more than 60 percent of all poor children are in families with three or more children.

Opponents of this expansion might express the concern that this proposal would provide an incentive for poor working families to have more children. They might argue that a logical extension of this proposal would be to provide ever larger credits for families with four children, five children, etc. In addition, opponents might state that help for families of working poor should not be delivered through the EIC, but rather requires a broader approach (e.g., better education or a higher minimum wage). Proponents of this expansion may respond that, in itself, the increased size of the expanded credit is not adequate to compensate for the costs of an additional child and will not act as an incentive for that reason. They may continue that this EIC expansion is very targeted relief for large working poor families, which is necessary even in the context of additional, perhaps broader, initiatives to address the issue of the working poor.

The second proposal would increase the beginning point of the phase out range by \$1,450 for married couples where each spouse has at least \$725 of earned income. The effect of this proposed increase in the beginning of the phase-out range would be to increase the EIC for married two-earner couples in the phase-out range by an amount up to \$1,450 times the phase-out rate. For example, for couples with two or more qualifying children, the maximum increase in the EIC as a result of this provision would be \$1,450 multiplied by 21.06 percent, or \$305.37.[44] This proposal would also expand the number of married couples eligible for the EIC.

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[43] Source: Joint Committee on Taxation staff projection.

[44] If the related proposal to reduce the EIC phase out rate from 21.06 percent to 19.06 percent for individuals with two or more children is enacted the maximum benefit from this proposal would also be reduced to \$276.37 (\$1,450 times 19.06 percent).

Specifically, the $1,450 increase in the end point of the phase-out range would make married couples with earnings up to $1,450 beyond the present-law phase-out range eligible for the credit. The other EIC proposals may also increase the end point of the phase-out range in addition to any increase attributable to this proposal.

Proponents of this second proposal would argue that it reduces the marriage penalty applicable to certain two-earner married couples without creating new marriage bonuses. Some opponents may express concern about the cliff effect of conditioning this relief on each spouse having at least $725 of earned income. They point out that an additional refundable credit amount of $305.37 is dependent on the addition of one dollar of earned income (from $724 to $725) to the lesser earning spouse. Notwithstanding this cliff effect, other commentators might argue that the proposal does not go far enough in relieving the marriage penalty related to the EIC. For example, an unmarried individual with $12,000 of earned income and two qualifying children who marries another individual with $24,000 of earned income and no qualifying children would lose the entire EIC ($3,888) under present law and would get no relief under this proposal.

The third proposal would reduce the phase-out rate of the EIC for families with two or more children from 21.06 percent to 19.06 percent. Proponents of this proposal argue that high phase-out rates result in high marginal tax rates which can be a disincentive for workers in the phase-out range. They argue that reducing the phase-out rate of the EIC for children with two or more qualifying children will reduce such disincentives to work. Opponents respond that any phase-out rate creates a disincentive to work and the more a phase-out rate is lowered, the longer will be the phase-out range and the greater the likelihood that some individuals who do not need the EIC will become eligible for it.

Earned income

Proponents advance three arguments for the proposal that earned income not include nontaxable earned income. First, they argue that it would ease administration of the EIC for the IRS. The IRS, they argue, would need to track only taxable income which is easier to track than nontaxable income because of the present-law third party reporting requirements. Second, they argue that the proposal would alleviate taxpayer confusion regarding what constitutes taxable and nontaxable income. Others respond that the proposal does not separately define taxable income for these purposes so that no significant simplification would be achieved. Third, since 401(k) contributions would no longer be treated as earned income for purposes of the EIC, it is argued that this provision would provide savings incentives for the working poor. Others respond that the EIC is not the reason why working poor have low savings rates and that this change is unlikely to result in increased savings by affected individuals.

Another concern about this proposal is that affected individuals will have the amount of their EIC changed even though their economic income is unchanged. Approximately one million EIC filers currently in the phase-out range will be treated as having less earned income and therefore will receive a larger EIC as a result of the proposal even though their economic income is unchanged. Similarly, approximately 50,000 filers who currently have less earned income than necessary to receive the maximum EIC or to be subject to the EIC phase-out will have their total EIC decreased even though their economic income is also unchanged.

Taxpayer identification number "TIN" requirement for individuals with qualifying children

This proposal is based on the argument that a technical correction is necessary to satisfy prior legislative intent to extend the EIC for individuals with no qualifying children to certain individuals who are currently ineligible. Proponents argue that the EIC for individuals with no qualifying children should be allowed to individuals who fail to satisfy the TIN reporting requirements with respect to one or more qualifying children. Opponents counter that individuals should be encouraged to obtain a TIN for qualifying children.

Prior Action

No prior action.

2. Increase low-income housing tax credit annual volume limit

Present Law

A tax credit, claimed over a 10-year period is allowed for the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not otherwise Federally subsidized (with limited exceptions) is adjusted monthly by the IRS so that the 10 annual installments have a present value of 70 percent of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that also receives other Federal subsidies and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent qualified expenditures.

The aggregate credit authority provided annually to each State is $1.25 per resident. Credits that remain unallocated by States after prescribed periods are reallocated to other States through a "national pool." Credits for low-income rental housing projects financed with the proceeds of tax-exempt bonds issued under the annual State private activity bond volume limits are not subject to the credit volume limit.

Description of Proposal

The State $1.25 per resident low-income housing credit limits would be increased to $1.75 per resident beginning in calendar year 2001. The $1.75 amount would be indexed for inflation beginning on calendar year 2002.

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

Analysis

Demand subsidies versus supply subsidies

As is the case with direct expenditures, the tax system may be used to improve housing opportunities for low-income families either by subsidizing rental payments (increasing demand) or by subsidizing construction and rehabilitation of low-income housing units (increasing supply).

The provision of Federal Section 8 housing vouchers is an example of a demand subsidy. The exclusion of the value of such vouchers from taxable income is an example of a demand subsidy in the Internal Revenue Code. By subsidizing a portion of rent payments, these vouchers may enable beneficiaries to rent more or better housing than they might otherwise be able to afford. The low-income housing credit is an example of a supply subsidy. By offering a subsidy worth 70 percent (in present value) of construction costs, the credit is designed to induce investors to provide housing to low-income tenants, or a better quality of housing, than otherwise would be available.

A demand subsidy can improve the housing opportunities of a low-income family by increasing the family's ability to pay for more or higher quality housing. In the short run, an increase in the demand for housing, however, may increase rents as families bid against one another for available housing. Consequently, while a family who receives the subsidy may benefit by being able to afford more or better housing, the resulting increase in market rents may reduce the well-being of other families. In the long run, investors should supply additional housing because higher rents increase the income of owners of existing rental housing, and therefore may be expected to make rental housing a more attractive investment. This should ameliorate the short-term increase in market rents and expand availability of low-income housing.

A supply subsidy can improve the housing opportunities of a low-income family by increasing the available supply of housing from which the family may choose. Generally, a supply subsidy increases the investor's return to investment in rental housing. An increased after-tax return should induce investors to provide more rental housing. As the supply of rental housing increases, the market rents investors charge should decline as investors compete to attract tenants to their properties. Consequently, not only could qualifying low-income families benefit from an increased supply of housing, but other renters could also benefit. In addition, owners of existing housing may experience declines in income or declines in property values as rents fall.

Efficiency of demand and supply subsidies

In principle, demand and supply subsidies of equal size should lead to equal changes in improved housing opportunities. There is debate as to the accuracy of this theory in practice. Some argue that both direct expenditures and tax subsidies for rental payments may not increase housing consumption dollar for dollar. One study of the Federal Section 8 Existing Housing Program suggests that, for every $100 of rent subsidy, a typical family increases its expenditure on housing by $22 and increases its expenditure on other goods by $78.[45] While the additional $78 spent on other goods certainly benefits the family receiving the voucher, the $100 rent subsidy does not increase their housing expenditures by $100.

Also, one study of government-subsidized housing starts between 1961 and 1977 suggests that as many as 85 percent of the government-subsidized housing starts may have merely displaced unsubsidized housing starts.[46] This figure is based on both moderate- and low-income housing starts, and therefore may overstate the potential inefficiency of tax subsidies solely for low-income housing. Displacement is more likely to occur when the subsidy is directed at projects the private market would have produced anyway. Thus, if relatively small private market activity exists for low-income housing, a supply subsidy is more likely to produce a net gain in available low-income housing units because the subsidy is less likely to displace otherwise planned activity.

The theory of subsidizing demand assumes that, by providing low-income families with more spending power, their increase in demand for housing will ultimately lead to more or better housing being available in the market. However, if the supply of housing to these families does not respond to the higher market prices that rent subsidies ultimately cause, the result will be that all existing housing costs more, the low-income tenants will have no better living conditions than before, and other tenants will face higher rents.[47] The benefit of the subsidy will accrue primarily to the property owners because of the higher rents.

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[45] See, W. Reeder, "The Benefits and Costs of the Section 8 Existing Housing Program," *Journal of Public Economics*, 26, 1985.

[46] M. Murray, "Subsidized and Unsubsidized Housing Starts: 1961-1977," *The Review of Economics and Statistics,* 65, November 1983.

[47] For example, supply may not respond to price changes if there exist construction, zoning, or other restrictions on the creation of additional housing units.

Supply subsidy programs can suffer from similar inefficiencies. For example, some developers who built low-income rental units before enactment of the low-income housing credit, may now find that the projects qualify for the credit. That is, the subsidized project may displace what otherwise would have been an unsubsidized project with no net gain in number of low-income housing units. If this is the case, the tax expenditure of the credit will result in little or no benefit except to the extent that the credit's targeting rules may force the developer to serve lower-income individuals than otherwise would have been the case. In addition, by depressing rents the supply subsidy may displace privately supplied housing.

Efficiency of tax subsidies

Some believe that tax-based supply subsidies do not produce significant displacement within the low-income housing market because low-income housing is unprofitable and the private market would not otherwise build new housing for low-income individuals. In this view, tax-subsidized low-income housing starts would not displace unsubsidized low-income housing starts. However, the bulk of the stock of low-income housing consists of older, physically depreciated properties which once may have served a different clientele. Subsidies to new construction could make it no longer economic to convert some of these older properties to low-income use, thereby displacing potential low-income units.

The tax subsidy for low-income housing construction also could displace construction of other housing. Constructing rental housing requires specialized resources. A tax subsidy may induce these resources to be devoted to the construction of low-income housing rather than other housing. If most of the existing low-income housing stock had originally been built to serve non-low-income individuals, a tax subsidy to newly constructed low-income housing could displace some privately supplied low-income housing in the long run.

Supply subsidies for low-income housing may be subject to some additional inefficiencies. Much of the low-income housing stock consists of older structures. Subsidies to new construction may provide for units with more amenities or units of a higher quality than low-income individuals would be willing to pay for if given an equivalent amount of funds. That is, rather than have $100 spent on a newly constructed apartment, a low-income family may prefer to have consumed part of that $100 in increased food and clothing. In this sense, the supply subsidy may provide an inefficiently large quantity of housing services from the point of view of how consumers would choose to allocate their resources. However, to the extent that maintenance of a certain standard of housing provides benefits to the community, the subsidy may enhance efficiency. If the supply subsidy involves fixed costs, such as the cost of obtaining a credit allocation under the low-income housing credit, a bias may be created towards large projects in order to amortize the fixed cost across a larger number of units. This may create an inefficient bias in favor of large projects. On the other hand, the construction and rehabilitation costs per unit may be less for large projects than for small projects. Lastly, unlike demand subsidies which permit the beneficiary to seek housing in any geographic location, supply subsidies may lead to housing being located in areas which, for example, are farther from places of employment than the beneficiary would otherwise choose. In this example, some of benefit of the supply subsidy may be dissipated through increased transportation cost.

Targeting the benefits of tax subsidies

A supply subsidy to housing will be spent on housing; although, as discussed above, it may not result in a dollar-for-dollar increase in total housing spending. To insure that the housing, once built, serves low-income families, income and rent limitations for tenants must be imposed as is the case for demand subsidies. While an income limit may be more effective in targeting the benefit of the housing to lower income levels than would an unrestricted market, it may best serve only those families at or near the income limit.

If, as with the low-income housing credit, rents are restricted to a percentage of targeted income, the benefits of the subsidy may not accrue equally to all low-income families. Those with incomes beneath the target level may pay a greater proportion of their income in rent than does a family with a greater income. On the other hand, to the extent that any new, subsidy-induced housing draws in only the targeted low-income families with the highest qualifying incomes it should open units in the privately provided low-income housing stock for others.

Even though the subsidy may be directly spent on housing, targeting the supply subsidy, unlike a demand subsidy, does not necessarily result in targeting the benefit of the subsidy to recipient tenants. Not all of the subsidy will result in net additions to the housing stock. The principle of a supply subsidy is to induce the producer to provide something he or she otherwise would not. Thus, to induce the producer to provide the benefit of improved housing to low-income families, the subsidy must provide benefit to the producer.

Targeting tax incentives according to income can result in creating high implicit marginal tax rates. For example, if rent subsidies are limited to families below the poverty line, when a family is able to increase its income to the point of crossing the poverty threshold the family may lose its rent subsidy. The loss of rent subsidy is not unlike a high rate of taxation on the family's additional income. The same may occur with supply subsidies. With the low-income housing credit, the percentage of units serving low-income families is the criteria for receiving the credit. Again, the marginal tax rate on a dollar of income at the low-income threshold may be very high for prospective tenants.

Data relating to the low-income housing credit

Comprehensive data from tax returns concerning the low-income housing tax credit currently are unavailable. However, Table 2, below, presents data from a survey of State credit allocating agencies.

Table 2.--Allocation of the Low-Income Housing Credit, 1987-1997

Years	Authority (millions)	Allocated (millions)	Percentage allocated (percent)
1987	$313.1	$62.9	20.1%
1988	311.5	209.8	67.4
1989	314.2	307.2	97.8
1990	317.7	213.1	67.0
1991[1]	497.3	400.6	80.6
1992[1]	488.5	337.0	69.0
1993[1]	546.4	424.7	78.0
1994[1]	523.7	494.9	95.5
1995[1]	432.6	420.9	97.0
1996[1]	391.6	378.9	97.0
1997[1]	387.3	382.9	99.0
1998[1]	376.8	373.8	99.2

[1] Increased authority includes credits unallocated from prior years carried over to the current year.

Source: Survey of State allocating agencies conducted by National Council of State Housing Associations.

Table 2 does not reflect actual units of low-income housing placed in service, but rather only allocations of the credit to proposed projects. Some of these allocations will be carried forward to projects placed in service in future years. As such, these data do not necessarily reflect the magnitude of the Federal tax expenditure from the low-income housing credit. The staff of the Joint Committee on Taxation ("Joint Committee staff") estimates that the calendar year 2000 tax expenditure resulting from the low-income credit will total $3.8 billion.[48] This estimate would include revenue lost to the Federal Government from buildings placed in service in the 10 years prior to 1999. Table 2 shows a high rate of credit allocations in recent years.

A Department of Housing and Urban Development study has attempted to measure the costs and benefits of the low-income housing credit compared to that of the Federal Section 8 housing voucher program.[49] This study attempts to compare the costs of providing a family with an identical unit of housing, using either a voucher or the low-income housing credit. The study concludes that on average the low-income housing credit provides the same unit of housing as

[48] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2000-2004* (JCS-13-99), December 22, 1999, p. 18.

[49] U.S. Department of Housing and Urban Development, *Evaluation of the Low-Income Housing Tax Credit: Final Report*, February 1991.

would the voucher at two and one half times greater cost than the voucher program. However, this study does not attempt to measure the effect of the voucher on raising the general level of rents, nor the effect of the low-income housing credit on lowering the general level of rents. The preceding analysis has suggested that both of these effects may be important. In addition, as utilization of the credit has risen, the capital raised per credit dollar has increased. This, too, would reduce the measured cost of providing housing using the low-income credit.

<u>Increasing State credit allocations</u>

The dollar value of the State allocation of $1.25 per capita was set in the 1986 Act and has not been revised. Low-income housing advocates observe that because the credit amount is not indexed, inflation has reduced its real value since the dollar amounts were set in 1986. The Gross Domestic Product ("GDP") price deflator for residential fixed investment measures 47.6 percent price inflation between 1986 and the fourth quarter of 1999. Had the per capita credit allocation been indexed for inflation, using this index to reflect increased construction costs, the value of the credit today would be approximately $1.84.[50] While not indexing for inflation, present law does provide for annual adjustments to the State credit allocation authority based on current population estimates. Because the need for low-income housing can be expected to correlate with population, the annual credit limitation already is adjusted to reflect changing needs.

The revenue consequences estimated by the Joint Committee staff of increasing the per capita limitation understate the long-run revenue cost to the Federal Government. This occurs because the Joint Committee staff reports revenue effects only for the 10-year budget period. Because the credit for a project may be claimed for 10 years, only the total revenue loss related to those projects placed in service in the first year are reflected fully in the Joint Committee staff's 10-year estimate. The revenue loss increases geometrically throughout the budget period as additional credit authority is granted by the States and all projects placed in service after the first year of the budget period produce revenue losses in years beyond the 10-year budget period.

<u>Prior Action</u>

A similar proposal was included in the President's Fiscal Year 1999 and 2000 Budget Proposals.

A similar proposal was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President, and in the Wage and Employment Growth Act of 1999, as passed by the House.

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[50] Many Code provisions are indexed to the Consumer Price Index ("CPI"). Over this same period, cumulative inflation as measured by the CPI was approximately 53.6 percent. Indexing the $1.25 to the CPI would have produced a value of approximately $1.92 today.

3. Provide new markets tax credit

Present Law

A number of tax incentives are available for investments and loans in low-income communities. For example, tax incentives are available to taxpayers that invest in specialized small business investment companies licensed by the Small Business Administration ("SBA") to make loans to, or equity investments in, small businesses owned by persons who are socially or economically disadvantaged. A tax credit is allowed over a 10-year period for qualified contributions to selected community development corporations that provide assistance in economically distressed areas. A tax credit is allowed over a 10-year period for rental housing occupied by tenants having incomes below specified levels. Certain businesses that are located in empowerment zones and enterprise communities designated by HUD and the Secretary of the Department of Agriculture also qualify for Federal tax incentives.

Description of Proposal

The proposal would create a new tax credit for qualified investments made to acquire stock (or other equity interests) in a selected community development entity ("CDE"). The credits would be allocated to CDEs pursuant to Treasury Department regulations. During the period 2001-2005, the maximum amount of investments that would qualify for the credit would be capped at an aggregate annual amount of $3 billion (a maximum of $15 billion for the entire period of the tax credit). If a CDE 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 could authorize another CDE to issue equity interests for the unused portion.[51]

The credit allowed to the investor (either the original purchaser or a subsequent holder) would be a six-percent credit for the year in which the equity interest is purchased from the CDE and each anniversary date (for four years) after the qualified equity interest is purchased from the CDE. 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.

A "qualified equity investment" refers to common stock or a similar equity interest acquired directly from a CDE in exchange for cash.[52] The stock or equity interest must not be

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[51] In making credit allocations, the Treasury Department would give priority to entities with records of having successfully provided capital or technical assistance to disadvantaged businesses or communities.

[52] To ensure that credits are available only for new equity investments in CDEs, the term "qualified equity investment" would not include any stock or other equity interest acquired from a CDE which made a substantial stock redemption or distribution (determined under rules similar

redeemed (or otherwise cashed out) by the CDE for at least five years. Substantially all of the investment proceeds must be used by the CDE to make "qualified low-income community investments," meaning equity investments in, or loans to, qualified active businesses located in low-income communities, certain financial counseling and other services provided to businesses and residents in low-income communities.[53] Qualified low-income community investments could be made directly by a CDE, or could be made indirectly through another CDE.[54]

A CDE 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 CDE's primary mission must be serving or providing investment capital for low-income communities or low-income persons. The CDE also must maintain accountability to residents of low-income communities through representation on governing or advisory boards, or otherwise.

As part of the credit allocation process, the Treasury Department would certify entities as eligible CDEs. Certified entities would be required to file annual reports demonstrating that they continue to meet the requirements for initial certification. The certified entities also 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 CDE 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 (with interest) and no further credits would be allowed.

A "low-income community" 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 the greater of metropolitan area income or statewide median

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to current-law section 1202(c)(3)). As with the low-income housing tax credit, section 183 would not bar a taxpayer from claiming a loss with respect to a qualified equity investment.

[53] If at least 85 percent of the aggregate gross assets of the CDE 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.

[54] A CDE would be treated as indirectly making "qualified low-income community investment" when it purchases loans previously made by another CDE which, in turn, uses the proceeds to provide additional capital (or financial or other services) to qualified active businesses located in low-income communities.

family income (or for a non-metropolitan census tract, 80 percent of non-metropolitan statewide median family income). In addition, any area that is part of an "empowerment zone" or "enterprise community" designated by section 1391 would be treated as a low-income community for purposes of the proposal.

A "qualified active businesses" generally would be defined as a business[55] which satisfies 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 is performed in low-income communities; and (4) less than 5 percent of the average aggregate of 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 CDE 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); 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 CDE.

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), regulations preventing abuse of the credit through the use of related parties and regulations which apply the provisions to newly formed entities. The Treasury Department would issue regulations describing the certification process for CDEs, and annual reporting requirements for selected entities.

Effective date.--The proposal would be effective for qualified investments made after December 31, 2000.

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[55] As under present-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.

Analysis

The proposal would create a new incentive for taxpayers that make capital available for use in inner cities and isolated rural communities, in the form of a guaranteed return on an equity investment. Generally, a non-preferred equity investment carries few or no guarantees of return. The incentive provided under the proposal is in effect a guaranteed return in the form of a tax credit. Hence, for taxpayers who can claim the new markets tax credit, their equity investment in the CDE is similar to owning preferred stock in the CDE which converts to common stock after five years, except that the preferred dividend (the tax credit) is guaranteed by the Federal government rather than backed by the revenue of the CDE. By guaranteeing a return, the proposal both reduces the aggregate return the CDE must hope to earn in order to attract investors to the CDE and reduces the risk of an investment in a CDE. Thus, the proposal should reduce the cost of raising capital to the CDE. The proposal requires the CDE to use substantially all of the new capital to make qualified low-income community investments.

There may be a loss of efficiency from funneling a tax benefit to qualified low-income community businesses through CDEs. If the pool of potential qualifying investments is large relative to the pool of CDE funds, the competing businesses would bid up the returns they promise the CDE and, thereby, the tax benefit would remain with the CDE rather than the businesses. On the other hand, if the pool of potential qualifying investments is small relative to the pool of CDE funds, the CDEs would compete among themselves for qualifying investments and the businesses would receive the benefits of a lower cost of capital.

Proponents would argue that capital markets are not fully efficient. In particular, a bias may exist against funding business ventures in low-income communities, with investors demanding a higher rate of return on such ventures than the proponents believe is justified by market conditions. The proposal attempts to influence investment decisions by increasing the net, after-tax, return to qualified low-income investments compared to other investments in order to reverse the effects of this bias. By reducing the cost of capital, the proposal could make location in a qualifying low-income community profitable.

Opponents would argue that a higher cost of capital[56] does not imply that markets are inefficient. The cost of capital reflects investors' perceptions of risk. Where a business locates may increase the probability of its failure and thereby increase its cost of capital. Artificially diverting investment funds in one direction results in certain investments that offer a lower rate of return being funded in lieu of other investments that offer a higher rate of return. Moreover, the proposal does not limit the CDE’s investments to those investments that otherwise have a higher cost of capital. Loans to a Fortune 500 company would be permissible under the proposal. However, a CDE’s plans to make such loans presumably would be a factor taken into account when the CDE applies for a credit allocation.

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[56] A higher cost of capital may take the form of higher interest rates charged on business loans or a larger percentage of equity ownership per dollar invested.

Proponents would argue that, even if the higher cost of capital to such businesses is not the result of inefficiency of the capital market, an important social goal can be achieved by helping target investment to low-income communities. Opponents would argue that this objective could be addressed through existing programs, such as the community development corporations, the empowerment zone and empowerment communities, and by requirements of the Community Redevelopment Act and other similar legislation.[57] They also would question whether the proposal is the most efficient means of achieving this objective. It will take time and resources to implement this proposal. By contrast, the SBA already has programs in place that are designed to achieve similar objectives.[58]

The proposal is expected to result in the imposition of new recordkeeping and other administrative burdens on CDEs. Each CDE presumably would have to establish extensive procedures by which it evaluates, selects and monitors the businesses in which it invests (and with its community accountability requirements) on an ongoing basis to ensure its continued qualification as a CDE. For example, a CDE that makes a loan to a qualified active business in the low-income community would need to verify that the business satisfies the requirements of a "qualified active business" throughout the term of the loan. Each CDE also would need to develop a process by which it allocates the tax credit to investors, and keep sufficient records concerning its investors (and former investors) in the event it fails to maintain its CDE status (which would result in a recapture of any credits claimed by investors within the previous five years). The CDEs also would have additional reporting requirements for the IRS.

The proposal provides that the Treasury Department allocate the tax credits among CDEs. The description of the proposal notes that the Treasury Department would give priority to entities with records of having successfully provided capital or technical assistance to disadvantaged business or communities. However, it should be expected that many of the entities seeking CDE status will be new entities and, as such, would not have a proven record upon which the Treasury

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[57] For purposes of the proposal, empowerment zones and empowerment communities would be treated as a low-income communities. The proposal does not specify any rule for coordination of tax benefits under the new markets tax credit with empowerment zone tax benefits, nor does it specify coordination with any appropriated funds that the taxpayer may receive as a result of undertaking a qualified investment. The proposal does state that the Treasury Department would have authority to issue regulations limiting the benefit of the proposed tax credit for circumstances in which investments are directly or indirectly being subsidized by other Federal programs (such as the low-income housing credit and tax-exempt bonds). Department of the Treasury, *General Explanations of the Administration's Revenue Proposals,* February 2000 at 17.

[58] Small Business Investment Companies ("SBIC") are similar in structure to the proposed CDEs. An SBIC receives a reduction in its cost of capital from the Federal government through loans from the SBA. The SBIC, in turn, uses this capital to make equity and debt investments in qualified enterprises.

Department could rely. In the absence of legislative criteria providing qualifications for the allocation of the credits among CDEs, some also might question whether the proposal raises concerns regarding the delegation of such taxing power by the Congress to the Executive Branch.

Prior Action

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal.[59]

4. Extend and expand empowerment zone incentives

Present Law

Pursuant to the Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993"), the Secretaries of the Department of Housing and Urban Development and the Department of Agriculture designated a total of nine empowerment zones (and 95 enterprise communities). Of the nine empowerment zones, six are located in urban areas and three are located in rural areas.[60] The Taxpayer Relief Act of 1997 ("1997 Act") authorized the designation of two additional urban empowerment zones[61] (collectively, the "11 Round I empowerment zones"), with respect to which the same tax benefits generally are available for businesses located in the nine original empowerment zones.

Businesses located in the 11 Round I empowerment zones qualify for the following tax incentives: (1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the empowerment zone (the "wage credit");[62] (2) an additional $20,000 of section

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[59] Similar tax credit proposals have been introduced in the 106th Congress by Mr. Rangel and others (H.R. 2713), by Mr. Watts and others (H.R. 2848), and, in the Senate, by Mr. Rockefeller and others (S. 1526).

[60] The six urban empowerment zones are located in New York City, Chicago, Atlanta, Detroit, Baltimore, and Philadelphia-Camden (New Jersey). The three rural empowerment zones are located in the Kentucky Highlands (Clinton, Jackson and Wayne counties, Kentucky), Mid-Delta Mississippi (Bolivar, Holmes, Humphreys, Leflore counties, Mississippi), and Rio Grande Valley Texas (Cameron, Hidalgo, Starr, and Willacy counties, Texas).

[61] The two additional urban empowerment zones are located in Los Angeles, California and Cleveland, Ohio.

[62] For wages paid in calendar years during the period 1994 through 2001, the credit rate is 20 percent. The credit rate is reduced to 15 percent for calendar year 2002, 10 percent for calendar year 2003, and 5 percent for calendar year 2004. No wage credit is available after 2004. The wage credit for businesses located in Los Angeles and Cleveland empowerment zones is phased down beginning in 2005 and expires after 2007. Thus, their wage credit rate is 20 percent

179 expensing for "qualified zone property" placed in service by an enterprise zone business; (3) special tax-exempt financing for certain zone facilities and (4) "brownfields" expensing for certain environmental remediation expenditures.[63] The tax incentives with respect to the nine empowerment zones designated by OBRA 1993 are generally available during the 10-year period of 1995 through 2004. The tax incentives with respect to the two additional urban empowerment zones are generally available during the 10-year period of 2000 through 2009 (except for the wage credit, which begins to phase down in 2005 and expires after 2007).

The 1997 Act also authorized the designation of 20 additional empowerment zones ("Round II empowerment zones"), of which 15 are located in urban areas and five are located in rural areas.[64] Businesses in the Round II empowerment zones are not eligible for the wage credit (but are eligible to receive up to $20,000 of additional section 179 expensing, to utilize brownfields expensing, and to utilize the special tax-exempt financing benefits). The tax incentives with respect to the Round II empowerment zones are generally available during the 10-year period of 1999 through 2008.

Description of Proposal

The proposal would expand the tax incentives available to the existing empowerment zones and provide for the designation of ten new empowerment zones.

First, the designation of empowerment zone status for Round I and II empowerment zones would be extended through December 31, 2009.

Second, the 20-percent wage credit would be made available in all Round I and II empowerment zones. The credit rate would remain at 20 percent (rather than being phased down) through December 31, 2009, in all empowerment zones.

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during the period 2000 to 2004, 15 percent for calendar year 2005, 10 percent for calendar year 2006, and 5 percent for calendar year 2007.

[63] Businesses located in enterprise communities are eligible for the special tax-exempt financing benefits and brownfields expensing but not the other tax incentives available in the empowerment zones.

[64] The 15 Round II urban empowerment zones are located in Boston; Columbia/Sumter, South Carolina; Cumberland County, New Jersey; Gary/East Chicago, Indiana; Knoxville; Minneapolis; Norfolk/Portsmouth, Virginia; St. Louis/East St. Louis; Cincinnati; Columbus, Ohio; El Paso, Texas; Huntington, West Virginia/Ironton, Ohio; Miami; New Haven, Connecticut; and Santa Ana, California. The five Round II rural empowerment zones are located in Riverside County, California; Cordele, Georgia; Ullin, Illinois; Lake Agassiz, North Dakota; and Ogala Sioux Reservation, South Dakota.

Third, an additional $35,000 (rather than $20,000) of section 179 expensing would be available for qualified zone property placed in service after December 31, 2000, and prior to December 31, 2009, by a qualified business in any of the empowerment zones.[65]

Fourth, the Secretaries of the Department of Housing and Urban Development and the Department of Agriculture would be authorized to designate 10 additional empowerment zones (the "Round III empowerment zones"). Eight of these Round III empowerment zones would be located in urban areas, and two would be located in rural areas. The eligibility and selection criteria for the 10 Round III empowerment zones would be the same as the criteria that applied to the Round II empowerment zones authorized by the 1997 Act. During the period 2002 through 2009, businesses located in the Round III empowerment zones would be eligible for the 20-percent wage credit, an additional $35,000 of section 179 expensing, special tax-exempt financing benefits[66], and brownfields expensing.

Effective date.--The proposal would be effective after December 31, 2000.

Analysis

Extension of scheduled expiration date

The proposal would extend the empowerment zone designation for all presently existing empowerment zones through December 31, 2009. Extending the program beyond its scheduled expiration would allow these communities additional time to further promote economic development. Some would argue that extension would assist in attracting new businesses and help retain current ones because of the certainty that the tax incentives will be available through

[65] The additional $35,000 of section 179 expensing would be available throughout all areas that are part of a designated empowerment zone, including the non-contiguous "developable sites" that were allowed to be part of the designated Round II empowerment zones under the 1997 Act. The President's Fiscal Year 2001 Budget Proposal includes a separate proposal to enhance section 179 expensing for small businesses. That proposal would increase the amount of investment that can be expensed to $25,000, starting in 2001, and would permit the section 179 deduction to be claimed at the entity level for pass-through businesses. The proposal would treat off-the-shelf computer software under 167(f) as property eligible for section 179 expensing. The proposal would also limit eligibility for section 179 expensing to small businesses, defined as those averaging no more than $10 million in gross receipts over the three preceding taxable years.

[66] The Round III empowerment zones would be eligible for the same tax-exempt financing benefits that are available with respect to the Round I empowerment zones.

2009. On the other hand, evidence is limited and mixed regarding the extent to which empowerment zone tax incentives help attract new business or retain current business.[67]

Expansion of wage credit and section 179 expensing

The proposal expands two tax incentives for empowerment zones. First, the proposal makes the 20-percent wage credit available to all empowerment zones. Currently, the Round II empowerment zones are not eligible for the wage credit, and the wage credit for the Los Angeles and Cleveland zones are scheduled to phase down in 2005 and expire after 2007. Second, the proposal increases the amount of additional section 179 expensing from $20,000 to $35,000 for qualified zone property.

The effect of the tax incentives on the success of the empowerment zone program is unclear. A recent GAO report analyzed the use of empowerment zone tax incentives.[68] The GAO identified 13,590 business operating in the original nine empowerment zones. It surveyed 2,400 of these businesses on their usage of the empowerment zone tax incentives. The report highlights a general lack of knowledge among the survey respondents about the availability of the incentives.

The GAO report found that the wage credit was the most frequently used tax incentive. According to the responses to the GAO survey, 42 percent of large urban businesses, 6 percent of small urban businesses and 32 percent of the rural businesses used the wage credit. The most frequently cited reasons for not claiming the credit were (1) that the business did not qualify for the credit because its employees lived outside the zone and (2) that the businesses did not know about the credit.

Extending the wage credit, as recommended by the proposal, would provide uniformity among the various empowerment zones and could increase use of the credit. It would provide all empowerment zones with the same length of wage credit benefit. In addition, the GAO reported

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[67] In a recent study based on a survey of businesses located in Round I empowerment zones in 1997, the GAO found that most businesses had been in those locations prior to zone designation. Ninety percent of urban businesses and 78 percent of rural businesses told the GAO that they had been in business in their present location prior to zone designation. General Accounting Office, *Community Development: Business Use of Empowerment Zone Tax Incentives*, (GAO/RCED-99-253, September 1999) at 31. At the same time, the Department of Housing and Urban Development has reported that more than $2 billion of new private sector investment has been made, or committed, in the six urban Round I empowerment zones. *See*, Department of Housing and Urban Development, *New York Empowerment Zone Executive Summary, Empowerment Zone Performance Report 1995-1996.*

[68] General Accounting Office, *Community Development: Business Use of Empowerment Zone Tax Incentives*, (GAO/RCED-99-253, September 1999).

that the number of employees working in empowerment zones has increased for the survey respondents present in the zone since its designation. The survey respondents stated that the wage credit was at least "somewhat important" to making decisions about hiring employees who live in the zones. Expanding the availability of the wage credit could assist in increasing employment of those persons living inside the empowerment zones.

According to the GAO, the increased section 179 expensing deduction was used less than the wage credit. The GAO reported that of the businesses surveyed, 9 percent of large urban businesses, 4 percent of small urban businesses, and 8 percent of rural businesses used the increased expensing deduction. The four most frequently cited reasons for not claiming the deduction were (1) a lack of knowledge about the increased deduction, (2) a lack of investment in "qualified zone property," (3) insufficient business investments to use the deductions and (4) insufficient income to use the deduction.[69]

Some would argue that, given the lack of knowledge suggested by the GAO report, instead of increasing the expensing deduction, emphasis should be placed on educating the public about its current availability. The other reasons given for not using the deduction suggest that increasing the amount of the deduction would not increase its use. The businesses not using the deduction reported that they did not invest in qualified zone property, had insufficient business investments to use the deduction, or had insufficient income to use the deduction. An increase in the amount of the deduction would not remove these obstacles. Nonetheless, an increased public awareness effort in combination with the increased amount may make the deduction more attractive to businesses, therefore, triggering investment and resulting in increased economic activity within the zone.

Round III empowerment zones

The proposal would authorize the Secretaries of Housing and Urban Development and Agriculture to designate 10 additional empowerment zones, eight in urban areas and two in rural areas. During the period 2002 to 2009, these empowerment zones would be eligible for the 20 percent wage credit, an additional $35,000 in section 179 expensing, tax-exempt financing, and brownfields expensing.

Some would argue that it is difficult to gauge the success of the empowerment zone program. The proposal seeks to extend the expiration date for the original empowerment zones to allow them to reach the desired level of economic development. In light of this proposed extension, some would argue against expanding the program further without an empirical analysis of the current program. On the other hand, each empowerment zone, while sharing characteristics of poverty and distress, is still unique in its composition and environment.

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[69] GAO also noted that few businesses have used the tax-exempt bond financing. The predominant reason for not using these bonds was that the businesses did not know of their existence.

Therefore, the degree of success in any particular zone, is not necessarily an indicator of the success that could be achieved in future zones. Extension of the empowerment zone designation may assist additional communities in their effort to address their economic distress.

Prior Action

A proposal in the President's Fiscal Year 2000 Budget Proposal would have made the wage credit available to businesses located in the two additional urban empowerment zones.

5. Tax credit for contributions to qualified zone academies and technology centers

Present Law

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue "qualified zone academy bonds." A total of $400 million of qualified zone academy bonds is authorized to be issued in each of 1998, 1999, 2000, and 2001. The $400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit within the State.

Certain financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond (sec. 1397E). A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includible in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond issued is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond.

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

A school is a "qualified zone academy" if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in one of the 31 designated empowerment zones or one of the 95 designated enterprise communities, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

Rules applicable to corporate contributions

The maximum charitable contribution deduction that may be claimed by a corporation for any one taxable year is limited to 10 percent of the corporation's taxable income for that year (disregarding charitable contributions and with certain other modifications) (sec. 170(b)(2)). Corporations also are subject to certain limitations based on the type of property contributed. In the case of a charitable contribution of short-term gain property, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis (generally, cost) in the property. However, special rules in the Code provide augmented deductions for certain corporate[70] contributions of specific types of property. Under these special rules, the amount of the augmented deduction available to a corporation making a qualified contribution generally is equal to its basis in the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold. However, the augmented deduction cannot exceed twice the basis of the donated property.

Description of Proposal

A credit against Federal income taxes would be allowed for corporate sponsorship payments made to a qualified zone academy, public library, or community technology center located in a designated empowerment zone or enterprise community. The credit would equal 50 percent of cash contributions. For purposes of the credit, a qualified zone academy located outside of a designated empowerment zone or enterprise community would be treated as located within such a zone or community if a significant percentage of the academy's students reside in the zone or community. A public library or community technology center located outside of a designated empowerment zone or enterprise community would be treated as located within such a zone or community if it is adjacent to such a zone or community.

For this purpose, a community technology center generally would refer to any nonprofit organization that is eligible to receive deductible charitable contributions (including a governmental instrumentality) and whose principal purpose is to provide disadvantaged residents of economically distressed communities with access to information technology and related training.

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[70] S corporations are not eligible donors for purposes of section 170(e)(3), section 170(e)(4), or section 170(e)(6).

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). The local governmental agency for each of the empowerment zones (including the 10 new empowerment zones proposed under the President's Fiscal Year 2001 Budget) would be allowed to designate up to $16 million of sponsorship payments to qualified zone academies, public libraries, and community technology centers as eligible for the 50-percent credit (that is, up to $8 million of credits). The local governmental agency for each of the enterprise communities would be allowed to designate up to $4 million of contributions to qualified zone academies, public libraries, and community technology centers as eligible for the 50-percent credit (that is, up to $2 million of credits). There is no limit on the amount of allocated credits that could be claimed by any one corporate sponsor; thus one sponsor could claim all the credits available in a particular zone or community. 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.

Effective date.--The proposal would be effective for corporate sponsorship payments made after December 31, 2000.

Analysis

The proposal's objective is to encourage private sector support of and participation in educational programs conducted at certain qualified zone academies, public libraries, and community technology centers located in empowerment zones and enterprise communities. By offering a tax credit to participating corporations, the proposal would lower the after-tax cost of a corporate contribution beyond that currently provided by the deduction for charitable contributions. Specifically, under present law, a corporate taxpayer in the 35-percent bracket faces an after-tax cost of only 65 cents for each dollar of charitable contributions, since the dollar deduction yields a tax saving of 35 cents. With the proposed 50-percent credit, this same taxpayer would have more than half of its contribution, in effect, subsidized by the federal government. In addition to the 50-cent credit per dollar of contribution, the taxpayer would still be permitted to deduct from taxable income 50 cents of that dollar (the contribution amount minus the credit). Such 50-cent deduction would be worth 17.5 cents to a corporate taxpayer in the 35-percent tax bracket. Thus, the total after-tax cost of a dollar contribution under the proposal is only 32.5 cents (1 dollar less the 50-cent credit less the 17.5-cent value of the 50-cent deduction), as compared to 65 cents under present-law rules. The effect of the credit cuts the taxpayer's cost of giving in half compared to present law.[71]

The purpose of the present-law charitable deduction, and the proposed credit, is to encourage charitable giving by making giving less expensive. Economic studies have generally

[71] This same result follows regardless of the effective tax rate of the corporate donor.

found that, at least with respect to individual donors, the charitable contribution deduction[72] has both encouraged giving, and done so efficiently in that the additional charitable contributions that the deduction encourages exceed the revenue cost to the federal government of the deduction. Thus, to the extent that the charitable contribution serves a useful public service, it is argued that the deduction is cheaper than appropriating the funds that would be necessary to achieve the same public service. At the same time, it is also argued that private organizations can in many instances perform a charitable function more efficiently than a government agency. Others argue that not all activities subsidized by the deduction serve a truly public purpose, and thus would prefer to see the deduction eliminated and replaced with greater direct public spending. However, since the proposed credit is restricted to certain purposes, the latter objection is not relevant provided a true public service is promoted by the credit.

The proposal defines qualified zone academies for purposes of the proposed tax credit differently than under current law. Specifically, the proposal would limit eligible qualified zone academies to those schools that are located in an empowerment zone or enterprise community, or that have a "significant" percentage of their students residing in an empowerment zone or enterprise community. The proposal does not define the term "significant" for purposes of the residency requirement. In contrast to present law, the proposal would exclude from the definition of qualified zone academy those schools located outside a zone or community at which at least 35 percent of the students are eligible for free or reduced-cost lunches, but which do not meet the proposal's student residency requirement. In addition, under the proposal's definition, those schools located outside a zone or community that fail the present-law subsidized lunch qualification, but that meet the proposal's student residency requirement, would qualify as qualified zone academies for purposes of the proposed tax credit, although they are not qualified zone academies under present law. Presumably, the objective of the proposal's different definition of qualified zone academy is to ensure that allocated tax credits reach only those schools with a relatively high percentage of students who are residents of an empowerment zone or enterprise community. However, the differing definitions of qualified zone academies for purposes of the proposed tax credit and for other purposes may cause some confusion on the part of affected schools.

The proposal also would permit corporations to receive a tax credit for contributions to public libraries and community technology centers, which are not located in an empowerment zone or enterprise community, but which are "adjacent" to such a zone or community. The proposal does not define what areas are considered to be adjacent to a zone or community; however, presumably the local governmental agencies that are responsible for making the credit allocations for sponsorship payments would have an interest in ensuring that such allocations are appropriate.

[72] The proposed credit has an effect similar to the effect of a deduction in lowering the cost of giving, and thus the economic studies focusing on the deduction are thus relevant to the credit as well.

Prior Action

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal.

6. Enhanced deduction for corporate contributions of computers

Present Law

The maximum charitable contribution deduction that may be claimed by a corporation for any one taxable year is limited to 10 percent of the corporation's taxable income for that year (disregarding charitable contributions and with certain other modifications) (sec. 170(b)(2)). Corporations also are subject to certain limitations based on the type of property contributed. In the case of a charitable contribution of short-term gain property, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis (generally, cost) in the property. However, special rules in the Code provide an augmented deduction for certain corporate contributions. Under these special rules, the amount of the augmented deduction is equal to the lesser of (1) the basis of the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold, or (2) twice the basis of the donated property.

Section 170(e)(6) allows corporate taxpayers an augmented deduction for qualified contributions of computer technology and equipment (i.e., computer software, computer or peripheral equipment, and fiber optic cable related to computer use) to be used within the United States for educational purposes in grades K-12. Eligible donees are: (1) any educational organization that normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on; and (2) tax-exempt charitable organizations that are organized primarily for purposes of supporting elementary and secondary education. A private foundation also is an eligible donee, provided that, within 30 days after receipt of the contribution, the private foundation contributes the property to an eligible donee described above.

Qualified contributions are limited to gifts made no later than two years after the date the taxpayer acquired or substantially completed the construction of the donated property. In addition, the original use of the donated property must commence with the donor or the donee. Accordingly, qualified contributions generally are limited to property that is no more than two years old. Such donated property could be computer technology or equipment that is inventory or depreciable trade or business property in the hands of the donor.

Donee organizations are not permitted to transfer the donated property for money or services (e.g., a donee organization cannot sell the computers). However, a donee organization may transfer the donated property in furtherance of its exempt purposes and be reimbursed for shipping, installation, and transfer costs. For example, if a corporation contributes computers to a charity that subsequently distributes the computers to several elementary schools in a given area, the charity could be reimbursed by the elementary schools for shipping, transfer, and installation costs.

The special treatment applies only to donations made by C corporations. S corporations, personal holding companies, and service organizations are not eligible donors.

The provision is scheduled to expire for contributions made in taxable years beginning after December 31, 2000.

Description of Proposal

The proposal would extend the current enhanced deduction for donations of computer technology and equipment through June 30, 2004. The proposal also would expand the deduction to apply to contributions of computer equipment to a public library or community technology center located in a designated empowerment zone or enterprise community, or in a census tract with a poverty rate of 20 percent of more (currently defined by the 1990 census). For this purpose, a community technology center generally would refer to any nonprofit organization that is eligible to receive deductible charitable contributions (including a governmental instrumentality) and whose principal purpose is to provide disadvantaged residents of economically distressed communities with access to information technology and related training.

Effective date.--The proposal would be effective for contributions made after December 31, 2000 and before July 1, 2004.

Analysis

The enhanced deduction for charitable contributions of computer technology and equipment is intended to provide an incentive for businesses to contribute computer equipment and software for the benefit of primary and secondary school students in order to provide schools with the technological resources necessary to prepare both teachers and students for an increasingly technologically advanced society. The proposed expansion of this provision to include public libraries or community technology centers located in a designated empowerment zone or enterprise community, or in a census tract with a poverty rate of 20 percent of more is generally consistent with these original purposes, although it is not clear that simply making computers available without providing computer education programs is effective in providing persons in the targeted low-income areas with basic computer skills.

The proposal also would extend the enhanced deduction for charitable contributions of computer technology and equipment for an additional three and one-half years. Extension of the provision for a limited period of time would allow additional time to assess the efficacy of the law, which was adopted as part of the Taxpayer Relief Act of 1997. Some critics of the enhanced deduction contend that the provision has failed to increase significantly the number of computer donations. Various proposals have been introduced in the last two years in an effort to increase use of the enhanced deduction, including proposals to expand the deduction by increasing the age of eligible computers, to offer a credit rather than an enhanced deduction, and to expand the class of eligible donors to include S corporations.

Prior Action

A similar proposal was included in the Taxpayer Refund and Relief Act of 1999 as passed by the Senate, but was not included in the conference agreement.

7. Tax credit for employer-provided workplace literacy and basic education programs

Present Law

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

Employer-paid educational expenses are excludable from the gross income of an employee if provided under a section 127 educational assistance plan or if the expenses qualify as a working condition fringe benefit under section 132. Section 127 provides an exclusion of $5,250 annually for employer-provided educational assistance. The exclusion does not apply to graduate courses. The exclusion for employer-provided educational assistance expires with respect to courses beginning on or after January 1, 2002.

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

Educational expenses that do not qualify for the section 127 exclusion may be excludable from income as a working condition fringe benefit.[73] In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain

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

minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.[74]

Description of Proposal

Employers who provide certain 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 20 percent of the employer's eligible expenses incurred with respect to qualified education programs, with a maximum credit of $1,050 in a taxable year per eligible 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; (2) basic, entry-level computer skills of broad applicability; and (3) English literacy instruction. In general, the credit could not be claimed with respect to an employee who has received a high school degree or its equivalent. 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. With respect to English literacy instruction, eligible employees would be employees with limited English proficiency. 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. The terms qualified education and eligible employees would be further defined in Treasury regulations.

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 present-law section 127. Expenses eligible for the credit (up to $5,250) would be excludable from income and wages as a working condition fringe benefit if not otherwise excludable under section 127.[75]

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 education

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[74] In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's AGI. The 2-percent floor limitation is disregarded in determining whether an item is excludable as a working condition fringe benefit.

[75] Present-law rules would apply in determining whether expenses in excess of this amount are excludable from income and wages.

programs would not be eligible for the credit. The amount of the credit claimed would reduce, dollar for dollar, the amount of education expenses that the employer could otherwise deduct in computing its taxable income.

Unless the employer provides the 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 would include local education agencies, certain community-based or volunteer literacy organizations, institutions of higher education, and other public or private nonprofit agencies.

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

Analysis

The proposal is intended to provide employers with an additional incentive to provide basic education programs to their employees. The proposal focuses on this type of education due to concern that low-skilled workers may not undertake needed education because they lack resources to overcome barriers such as cost, child care, and transportation. It is argued that present law (i.e., the section 127 exclusion) does not provide sufficient incentive because employers of low-skilled workers may hesitate to provide general education; the benefits of basic skills and literacy education may be more difficult for employers to capture through increased productivity than the benefits of more job-specific education.

Providing additional tax benefits for certain educational expenses could lead to larger expenditures on education for workers than would otherwise occur. This extra incentive for education may be desirable if some of the benefits of an individual's education accrue to society at large (through the creation of a better-educated populace or workforce). In that case, absent the subsidy, individuals would under invest in education (relative to the socially desirable level) because they would not take into account the benefits that others indirectly receive. To the extent that expenditures on education represent purely personal consumption, a subsidy would lead to over-consumption of education. Some argue that concerns about over-consumption of education are reduced under the proposal because it targets basic skills and literacy training for individuals who, for the most part, lack a high school degree.

The requirements with respect to eligible providers may increase the cost of education that would otherwise be provided under the proposal. On the other hand, providing the credit without limitations on the provider or curriculum could create potentially difficult issues of expense allocation, compliance, and tax administration.

Prior Action

A similar provision was included in the President's Fiscal Year 2000 Budget Proposal, except that the prior proposal did not include a credit for basic computer training. In addition, the prior proposal was limited to 10 percent of eligible expenses, with a maximum per employee credit of $525.

8. Authorize issuance of tax-credit "Better America Bonds"

Present Law

Tax-exempt bonds

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds ("governmental bonds"). These bonds may include bonds used to finance the acquisition of land (or interests in land) and buildings. Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person ("private activity bonds") is taxable unless the purpose of the borrowing is approved specifically in the Code or in another provision of a revenue Act. These specified purposes include, but are not limited to, privately owned and/or operated: (1) sewage facilities; (2) solid waste disposal facilities; (3) water systems; and (4) activities of section 501(c)(3) organizations. Issuance of most qualified private activity bonds (other than qualified 501(c)(3) bonds) is subject to annual state volume limits, currently the greater of $50 per resident, or $150 million. A phased increase in the volume limits to the greater of $75 per resident or $225 million is scheduled to begin in calendar year 2003, with the new levels being fully effective in calendar year 2007.

Tax credits for interest on qualified zone academy bonds

A nonrefundable income tax credit in an amount equal to a credit rate (set by the Treasury Department) multiplied by the face amount of certain qualified zone academy bonds is allowed to certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money). A taxpayer holding a qualified zone academy bond on the credit allowance date (i.e., the annual anniversary of the bond's issuance) is entitled to a credit. The credit is includible in gross income (as if it were an interest payment on the bond), and may be claimed against regular income tax liability and alternative minimum tax liability. A qualified zone academy bond is defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy" and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

Expensing of certain environmental remediation expenses

Taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred (sec. 198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. A qualified contaminated site generally is any property that: (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within certain targeted areas; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). In the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any qualified environmental remediation expenditure deductions are subject to recapture as ordinary income upon sale or other disposition of the property (sec. 1245). The provision applies only to eligible expenditures paid or incurred in taxable years ending after August 5, 1997, and before January 1, 2002.

Description of Proposal

In general

The proposal would authorize issuance of a new category of tax-credit bonds, Better America Bonds,[76] by States and local governments for certain specified purposes. The amount of the credit would be set to equal interest that otherwise would accrue on the taxable bonds. Bondholders would accrue credits quarterly. The maximum maturity of the bonds would be 15 years. The credit would be includible in gross income (as if it were an interest payment on the bond), and could be claimed against regular income tax liability and alternative minimum tax liability.

Authority to issue bonds

The Administrator of the Environmental Protection Agency ("EPA") would be given authority to allocate up to $2.1 billion of Better America Bond authority to eligible issuers (i.e., States and local governments, including tribal governments and U.S. Possessions) annually for five years beginning in calendar year 2001. Any amounts unallocated for a year could be allocated in the following year. Any amounts allocated to an eligible issuer in any year could be

[76] The structure of Better America Bonds would be identical to the structure of qualified school modernization bonds and qualified zone academy bonds, as included in the President's Fiscal Year 2001 Budget Proposal.

used for bond issuance in that year or in any of the following three years. After the third year, unused allocation would be available for reallocation by the EPA.

The EPA would be directed to publish guidelines, before January 1, 2001, establishing the criteria to be used in an annual competition for authority to issue the bonds. Eligible issuers would apply for an allocation of authority to issue the bonds, and the EPA, in consultation with other Federal agencies, would review these applications and allocate authority to issue Better America Bonds in conjunction with the Community Empowerment Board.

An additional $50 million of Better America Bonds would be authorized for each of the five years beginning in 2001 for environmental assessment and remediation of property damaged by anthracite coal mining. Special rules would be provided for these bonds.

Qualifying purposes for bonds

Except in the case of certain brownfields remediation activities, acquisition, construction, remediation or use of land and facilities would be a qualifying purpose only if the property was available for use by the public. Any agreement, other than a management contract that would be a qualified management contract for property financed with tax-exempt bonds would be treated as violating the public use requirement. Further, in general, repayment of principal could not be secured or paid with monies derived from private persons in any capacity other than that of the general public.

Better America Bonds could be issued by eligible issuers for: (1) acquisition of land for open space, wetlands, public parks or green ways to be owned by the State or local government or 501(c)(3) entity whose exempt purpose includes environmental preservation; (2) construction of visitors' facilities related to such land and owned by the State or local government or 501(c)(3) entity whose exempt purpose includes environmental preservation; (3) remediation of land, in order to improve water quality, acquired under (1) above, or of publicly owned open space, wetlands, or parks, by undertaking reasonable measures to control erosion and remediating conditions caused by prior disposal of toxic or other waste; (4) acquisition of easements on privately owned open land that prevent commercial development and any substantial change in the use or character of the land; (5) environmental assessment and remediation of contaminated property owned by State or local governments if the property was acquired before January 1, 2000 or by reason of abandonment by the prior owner;[77] or (6) environmental assessment and remediation of certain property damaged by anthracite coal mining if the property is owned by a State or local government or a 501(c)(3) organization.

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[77] The restrictions on private use of bond-financed property would be waived for this category of property.

Other rules

For a discussion of additional requirements governing issuance and use of the proceeds of these tax-credit bonds, see the discussion of the rules governing issuance of qualified zone academy bonds and school modernization bonds, above.

Effective date

The proposal would apply to bonds issued on or after January 1, 2001.

Analysis

The proposal would subsidize a portion of the cost of new investment in "green space" land and facilities, as well as certain environmental remediation expenditures. Subsidizing such costs, it is argued, increases the level of investment in socially desirable assets over the level of investment that would take place in the absence of the subsidy. It is argued that significant public benefits will result, in the form of more public green space and a cleaner environment.

Though called a tax credit, the Federal subsidy for Better America Bonds would be economically equivalent to a direct payment by the Federal government of interest on taxable bonds, on behalf of the eligible issuers that benefit from the bond proceeds.[78] To illustrate, consider any taxable bond that bears an interest rate of 10 percent. A $1,000 bond would produce an interest payment of $100 annually. The bondholder receiving this payment would have $100, less the tax owed on the interest income. If the taxpayer were in the 28-percent Federal tax bracket, taxpayer would have $72 after Federal tax. Regardless of whether the eligible issuer or the Federal Government pays the interest, the taxpayer receives the same net-of-tax return of $72. In the case of Better America Bonds, interest is not actually paid by the Federal Government, but rather, a tax credit of $100 is allowed to the holder of the bond. In general, a $100 tax credit would be worth $100 to a taxpayer, provided that the taxpayer had at least $100 in tax liability. However, the Better America Bonds proposal requires the amount of the $100 credit to be included in the taxpayer's income. The taxpayer in the 28-percent tax bracket nets $72 after Federal tax, just as on the bond. Similarly, the Federal Government would be in the same position under the Better America Bonds proposal as if it had paid the $100 interest on the bond. The Federal Government loses $100 on the credit, but recoups $28 of that by the requirement that it be included in income, for a net cost of $72. The State and local government would also be in the same situation in both cases.

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[78] This is true provided that the taxpayer faces tax liability of at least the amount of the credit. Without sufficient tax liability, the proposed tax credit arrangement would not be as advantageous. Presumably, only taxpayers who anticipate having sufficient tax liability to be offset by the proposed credit would hold these bonds.

The proposed tax credit arrangement to subsidize environmental preservation and remediation raises some questions of administrative efficiency and tax complexity. An alternative, direct expenditure program under the direct control of the EPA would avoid the involvement of the IRS in the administration of a program outside its traditional area of expertise. Because potential purchasers of the bonds must educate themselves as to whether the bonds qualify for the credit, certain "information costs" are imposed on the buyer. Additionally, since the determination as to whether the bond is qualified for the credit ultimately rests with the Federal Government, further risk is imposed on the investor. These information costs and other risks serve to increase the credit rate and hence the costs to the Federal Government for a given level of support for environmental improvements. For these reasons, and the fact that tax credit bonds will be less liquid than Treasury securities, the bonds would bear a credit rate that is equal to a measure of the yield on outstanding corporate bonds. The direct payment of interest by the Federal Government on behalf of eligible issuers, which was discussed above as being economically the equivalent of the credit proposal, would be less complex, both as to the substantive tax law, and as to the administration of the tax law, because the interest could simply be reported like any other taxable interest.

Prior Action

A similar provision was included in the President's Fiscal Year 2000 Budget Proposal.

9. Make permanent the expensing of brownfields remediation costs

Present Law

Code section 162 allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Treasury regulations provide that the cost of incidental repairs which neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury regulations define "capital expenditures" as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Under Code section 198, taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property, which would otherwise be allocated to the site under the principles set forth in Commissioner v. Idaho Power Co.[79] and section 263A, are treated as qualified environmental remediation expenditures.

A "qualified contaminated site" generally is any property that: (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas are defined as: (1) empowerment zones and enterprise communities as designated under present law and under the Act[80] (including any supplemental empowerment zone designated on December 21, 1994); (2) sites announced before February 1997, as being subject to an Environmental Protection Agency ("EPA") Brownfields Pilot; (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.

Both urban and rural sites qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA") cannot qualify as targeted areas. The chief executive officer of a State, in consultation with the Administrator of the EPA, was authorized to designate an appropriate State environmental agency. If no State environmental agency was so designated within 60 days of the date of enactment, the Administrator of the EPA was authorized to designate the appropriate environmental agency for such State. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use.

In the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under the Act is treated as a depreciation deduction and the property is treated as section 1245 property. Thus, deductions for qualified environmental remediation expenditures are subject to recapture as ordinary income upon sale or other disposition of the property. In addition, sections 280B (demolition of structures) and 468 (special rules for mining and solid waste reclamation and closing costs) do not apply to amounts which are treated as expenses under this provision.

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[79] Commissioner v. Idaho Power Co., 418 U.S. 1 (1974) (holding that equipment depreciation allocable to the taxpayer's construction of capital facilities must be capitalized under section 263(a)(1)).

[80] Thus, the 22 additional empowerment zones authorized to be designated under the Taxpayer Relief Act of 1997, as well as the D.C. Enterprise Zone, are "targeted areas" for purposes of this provision.

The provision applies only to eligible expenditures paid or incurred before January 1, 2002.

Description of Proposal

The proposal would eliminate the requirement that expenditures must be paid or incurred before January 1, 2002, to be deductible as eligible environmental remediation expenditures. Thus, the provision would become permanent.

Effective date.--The proposal would be effective on the date of enactment.

Analysis

The proposal to make permanent the expensing of brownfields remediation costs would promote the goal of environmental remediation and remove doubt as to the future deductibility of remediation expenses. Removing the doubt about deductibility may be desirable if the present-law expiration date is currently affecting investment planning. For example, the temporary nature of relief under present law may discourage projects that require a significant ongoing investment, such as groundwater clean-up projects. On the other hand, extension of the provision for a limited period of time would allow additional time to assess the efficacy of the law, adopted only recently as part of the Taxpayer Relief act of 1997, prior to any decision as to its permanency.

The proposal is intended to encourage environmental remediation, and general business investment, in sites located in enterprise communities and empowerment zones, the original EPA Brownfields Pilots, or in census tracts with poverty rates of 20 percent or more, or certain adjacent tracts. With respect to environmental remediation, it is not clear that the restriction to certain areas will lead to the most socially desirable distribution of environmental remediation. It is possible that the same dollar amount of expenditures for remediation in other areas could produce a greater net social good, and thus the restriction to specific areas diminishes overall efficiency. On the other hand, property located in a nonqualifying area may have sufficient intrinsic value so that environmental remediation will be undertaken absent a special tax break. With respect to environmental remediation tax benefits as an incentive for general business investment, it is possible that the incentive may have the effect of distorting the location of new investment, rather than increasing investment overall.[81] If the new investments are offset by less investment in neighboring, but not qualifying, areas, the neighboring communities could suffer. On the other hand, the increased investment in the qualifying areas could have spillover effects that are beneficial to the neighboring communities.

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[81] For a discussion of the economic effects of enterprise zones, see Leslie E. Papke, "What Do We Know About Enterprise Zones," in Jim Poterba, ed., *Tax Policy and the Economy* (Cambridge, MA: The MIT Press), 1993.

Further, permanently extending the brownfields provision raises administrative issues. For example, it is unclear whether currently qualified zone sites will continue to qualify after such designation expires, by law, after 10 years. Similarly, it is unclear whether the application to census tracts (currently defined by the 1990 census) with poverty rates of 20 percent or more (or certain adjacent tracts) applies to tracts that meet such qualifications on (1) August 5, 1997 (the effective date of the original brownfields legislation), (2) the effective date of this proposal, or (3) the date of the expenditure.

Prior Action

The special expensing for environmental remediation expenditures was enacted as part of the Taxpayer Relief Act of 1997. Identical proposals were included in the President's Fiscal Year 1999 and Fiscal Year 2000 Budget Proposals.

10. Specialized small business investment company tax incentives

Present Law

Under present law, a taxpayer may elect to roll over without payment of tax any capital gain realized upon the sale of publicly-traded securities where the taxpayer uses the proceeds from the sale to purchase common stock in a specialized small business investment company ("SSBIC") within 60 days of the sale of the securities. The maximum amount of gain that an individual may roll over under this provision for a taxable year is limited to the lesser of (1) $50,000 or (2) $500,000 reduced by any gain previously excluded under this provision. For corporations, these limits are $250,000 and $1 million.

In addition, under present law, an individual may exclude 50 percent of the gain[82] from the sale of qualifying small business stock held more than five years. An SSBIC is automatically deemed to satisfy the active business requirement which a corporation must satisfy to qualify its stock for the exclusion.

Regulated investment companies ("RICs") are entitled to deduct dividends paid to shareholders. To qualify for the deduction, 90 percent of the company's income must be derived from dividends, interest and other specified passive income, the company must distribute 90 percent of its investment income, and at least 50 percent of the value of its assets must be invested in certain diversified investments.

For purposes of these provisions, an SSBIC means any partnership or corporation that 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). SSBICs make long-term loans to, or

[82] The portion of the capital gain included in income is subject to a maximum regular tax rate of 28 percent, and 42 percent of the excluded gain is a minimum tax preference.

equity investments in, small businesses owned by persons who are socially or economically disadvantaged.

Description of Proposal

Under the proposal, the tax-free rollover provision would be expanded by (1) extending the 60-day period to 180 days, (2) making preferred stock (as well as common stock) in an SSBIC an eligible investment, and (3) increasing the lifetime caps to $750,000 in the case of an individual and to $2 million in the case of a corporation, and repealing the annual caps.

The proposal also would provide that an SSBIC that is organized as a corporation may convert to a partnership without imposition of a tax to either the corporation or its shareholders, by transferring its assets to a partnership in which it holds at least an 80-percent interest and then liquidating. The corporation would be required to distribute all its earnings and profits before liquidating. The transaction must take place within 180 days of enactment of the proposal. The partnership would be liable for a tax on any "built-in" gain in the assets transferred by the corporation at the time of the conversion.

The 50-percent exclusion for gain on the sale of qualifying small business stock would be increased to 60 percent where the taxpayer, or a pass-through entity in which the taxpayer holds an interest, sells qualifying stock of an SSBIC.

For purposes of determining status as a RIC eligible for the dividends received deduction, the proposal would treat income derived by a SSBIC from its limited partner interest in a partnership whose business operations the SSBIC does not actively manage as income qualifying for the 90-percent test; would deem the SSBIC to satisfy the 90-percent distribution requirement if it distributes all its income that it is permitted to distribute under the Small Business Investment Act of 1958; and would deem the RIC diversification of assets requirement to be met to the extent the SSBIC's investments are permitted under that Act.

Effective date.--The rollover and small business stock provisions of the proposal would be effective for sales after date of enactment. The RIC provisions would be effective for taxable years beginning after date of enactment.

Analysis

The proposal would make investments in SSBICs more attractive by providing tax advantages of deferral and lower capital gains taxes. Present law, and the proposal, attempt to distort taxpayer investment decisions by increasing the net, after-tax, return to investments in SSBICs compared to other assets. Economists argue that distortions in capital markets lead to reduced economic growth. In an efficient capital market, relative market values indicate sectors of the economy where investment funds are most needed. Artificially diverting investment funds may cause capital to be diverted to investments that offer a lower rate of return and away from investments that offer a higher rate of return. The net outcome is a reduction in national income below that which would otherwise be achieved. Proponents of the proposal argue that capital markets are not fully efficient. In particular, they argue that a bias exists against funding business ventures undertaken by persons who are socially or economically disadvantaged.

Generally, the cost of capital is greater for small businesses than for larger businesses. That is, investors demand a greater rate of return on their investment in smaller businesses than in larger businesses. The higher cost of capital may take the form of higher interest rates charged on business loans or a larger percentage of equity ownership per dollar invested. A higher cost of capital does not imply that capital markets are inefficient. The cost of capital reflects investors' perceptions of greater risk and the higher failure rates among small business ventures. There has been little study of whether the cost of capital to small businesses, regardless of the economic or social background of the entrepreneur, is "too high" when the risk of business failure is taken into account.

Proponents of the proposal argue that, even if the higher cost of capital to small businesses is not the result of inefficiency of the capital market, investors in small businesses can achieve an important social goal by helping more persons who are socially or economically disadvantaged gain entrepreneurial experience. Opponents observe that, under present law, that objective is addressed by the Small Business Administration's subsidized loan program and present-law Code sections 1045 and 1202. They note that the proposal would not lower the cost of capital for all small businesses or for all small businesses organized by persons who are socially or economically disadvantaged, only those businesses that receive some of their financing through an SSBIC. Other investors do not receive these tax benefits even if they make substantial investments in business ventures organized by persons who are socially or economically disadvantaged. They argue there is a loss of efficiency from funneling a tax benefit to entrepreneurs through only one type of investment fund pool. In the near term, some of the tax benefit may accrue to current owners of SSBICs rather than to entrepreneurs as taxpayers seeking to take advantage of the proposal bid up the price of shares of existing SSBICs. Proponents note that over the longer term, as more funds flow into SSBICs and as new SSBICs are formed, there will be a larger pool of funds available to qualified entrepreneurs, and those entrepreneurs will receive the benefits of a lower cost of capital.

Prior Action

Similar proposals were included in the President's Fiscal Year 1999 and 2000 Budget Proposals, and in The Financial Freedom Act of 1999 as passed by the House.

C. Health Care Provisions

1. Assisting taxpayers with long-term care needs

Present Law

Present law provides special rules for taxpayers with a disabled family member or with long-term care needs. A child and dependent care tax credit is provided for expenses incurred to care for a disabled spouse or dependent so the taxpayer can work. A low-income working taxpayer may qualify for the earned income tax credit if he or she resides with a disabled child (of any age). An itemized deduction is provided for expenses for qualified long-term care services or insurance if the taxpayer is chronically ill, or such expenses were incurred on behalf of a chronically ill spouse or dependent, provided that such expenses, together with other medical expenses of the taxpayer, exceed 7.5 percent of adjusted gross income ("AGI"). An additional standard deduction is provided to a taxpayer who does not itemize deductions if the taxpayer (or spouse) is over age 65 or blind. A credit is provided to certain low income taxpayers who are elderly or disabled. The impairment-related work expenses of a handicapped individual are classified as a miscellaneous itemized deduction not subject to the 2-percent floor.

To qualify as a dependent under present law, 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 ($2,900 in 2001)[83] if not the taxpayer's child; and (5) receive over half of his or her support from the taxpayer. If no one person contributes over half the support of an individual, the taxpayer is treated as meeting the support requirement if: (1) 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; (2) the taxpayer contributes over 10 percent of such support; and (3) other caregivers who provide over 10 percent of the support file written declarations stating that they will not claim the individual as a dependent.

Description of Proposal

A credit of up to $3,000 would be provided to an individual taxpayer, if the individual, the spouse of the individual, or a qualifying dependent of the taxpayer has long-term care needs. The credit (aggregated with the child credit and the proposed disabled worker credit) would be phased out for taxpayers with modified AGI above certain thresholds. Under the proposal, the sum of the otherwise allowable present-law child credit, the proposed disabled workers credit, and the proposed long-term care credit would be phased out at a rate of $50 for each $1,000 (or fraction thereof) of modified AGI above the threshold amount. Modified AGI and the threshold amounts would be the same as under the present-law phaseout rules for the child tax credit.

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[83] Source: Joint Committee on Taxation staff projection.

Thus, modified AGI would be AGI plus the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively). The threshold modified AGI amount would be $110,000 for married individuals filing a joint return, $75,000 for unmarried taxpayers, and $55,000 for married taxpayers filing separate returns. These threshold amounts would not be indexed for inflation. An individual may be eligible for both this proposed credit and the proposed disabled workers tax credit.

For purposes of the proposed credit only, the definition of a dependent would be modified in two ways. First, the gross income threshold would be increased to the sum of the personal exemption amount, the standard deduction, and the additional deduction for the elderly and blind (if applicable). In 2001, the gross income threshold would generally be $7,400 for a non-elderly single dependent and $8,500 for an elderly single dependent.[84]

Second, the present-law support test would be deemed to be met, for purposes of the proposed credit, 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 specified period would be 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 only the taxpayer with the highest AGI would be eligible for the credit.

An individual age 6 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 6 months to perform at least 3 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).[85] As under the present-law rules relating to long-term care, 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).

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[84] Source: Joint Committee on Taxation staff projections.

[85] A portion of the period certified by the physician would have to occur within the taxable year for which the credit is claimed. After the initial certification, individuals would have to be recertified by their physician within 3 years or such other period as the Secretary prescribes.

As an alternative to the 3-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 (1) requiring substantial supervision for at least 6 months to be protected from threats to health and safety due to severe cognitive impairment and (2) being unable for at least 6 months to perform at least one or more ADLs or to engage in age-appropriate activities as determined under regulations prescribed by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services.

A child between the ages of 2 and 6 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 6 months with at least 2 of the following activities: eating, transferring, and mobility. A child under the age of 2 would be considered to have long-term care needs if he or she were certified by a licensed doctor as requiring for at least 6 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. The Department of the Treasury and the Department of Health and Human Services would be directed to report to Congress within 5 years of the date of enactment 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 the mathematical error rule. Under that rule, the IRS may summarily assess additional tax due without sending the individual a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. 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 long-term care credit would generally be nonrefundable, which means that the credit generally would be allowed only to the extent that the individual's regular tax liability exceeds the individual's tentative minimum tax, determined without regard to the alternative minimum tax foreign tax credit (the “tax liability limitation”). However, the credit would be coordinated with the present-law child credit and the proposed disabled workers credit so that the credits would be refundable for a taxpayer claiming three or more credit amounts under the credits. 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 two children under age 17, one of whom has long-term care needs, would have three credit amounts: two child credit amounts and one long-term care credit amount. As under the present-law child credit, the amount of refundable credit would be the amount that the nonrefundable personal credits would increase if the tax liability limitation were increased by the excess of the taxpayer's social security taxes over the taxpayer's earned income credit (if any).

The credit would be phased in as illustrated in the following table.

Taxable Year	**Maximum Long-Term Care Credit**
2001	$1,000
2002	$1,500
2003	$2,000
2004	$2,500
2005 and thereafter	$3,000

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

Analysis

The proposal is intended to provide assistance to individuals who have long-term care needs or who care for others with such needs. Those in favor of the proposal argue that the credit is appropriate because such individuals have additional costs and do not have the same ability to pay as other taxpayers. Some also argue that the present-law favorable tax treatment for long-term care services and expenses is not sufficient to provide relief to all individuals with long-term care needs. For example, present law does not provide relief for family members who provide care for an individual with long-term care needs because they cannot afford to hire assistance. Present law also provides relief only to individuals with substantial expenses (i.e., in excess of the 7.5 percent of AGI threshold).

Some argue that the proposal should be expanded to apply to long-term care insurance expenses, even if the taxpayer currently does not have long-term care needs, in order to make more long-term care insurance more affordable.

On the other hand, some argue that the proposal is unfair to taxpayers not eligible for the credit who also might have reduced ability to pay. For example, the credit would not be available for individuals who have significant medical expenses during a year due to an illness that does not qualify the individual for the credit. As another example, the credit would not apply to individuals with extraordinary losses, such as the destruction of a home. Some argue that the present-law tax benefits for long-term care expenses and insurance already provide sufficient benefits for individuals with long-term care needs.

The proposal could be criticized because it would create new complexities in the Code. Taxpayers would need to keep records to demonstrate eligibility for the credit. In addition, the proposal could cause confusion among some taxpayers because it modifies for credit purposes only the dependency tests used elsewhere in the Code.

It could further be argued that phaseouts are inequitable because they increase marginal tax rates for taxpayers in the phaseout range.[86] On the other hand, it could be argued that a phaseout is needed if the proposal is to be targeted to individuals with limited ability to pay.

Prior Action

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal.

2. Encourage COBRA continuation coverage

Present Law

Under present law, the tax treatment of health insurance expenses depends on whether a taxpayer is covered under a health plan paid for by an employer, whether an individual has self-employment income, or whether an individual itemizes deductions and has medical expenses that exceed a certain threshold.

An employer's contribution to a plan providing health benefits coverage for an employee, and his or her spouse and dependents, is excludable from the employee's income for both income and payroll tax purposes. In addition, active employees participating in a cafeteria plan may pay their employee share of premiums on a pre-tax basis.

Self-employed individuals may deduct a portion of health insurance expenses for themselves and their spouse and dependents. The deductible percentage is 60 percent for taxable years beginning in 1999 to 2001, 70 in 2002, and 100 percent in 2003 and thereafter. The deduction is not available for any month in which the self-employed individual is eligible to participate in an employer-subsidized health plan. The deduction may not exceed the individual's self-employment income.

Other individuals who pay for their own health insurance may claim an itemized deduction for their health insurance premiums only to the extent that premiums, when combined with other unreimbursed medical expenses, exceed 7.5 percent of adjusted gross income.

Under the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), qualified beneficiaries are eligible to purchase continuation coverage under an employer-sponsored plan upon the occurrence of certain events that would otherwise result in loss of coverage, such as termination of employment. The employer may charge up to 102 percent of the average cost of the employer's health plan for continuation coverage. Depending on the

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[86] For a more complete discussion of these issues, see Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98), February 3, 1998.

circumstances, former employees and their dependents can elect to continue COBRA coverage for up to 18 to 36 months.

Description of Proposal

The proposal would provide that retired employees whose employers eliminate retiree health benefits after retirement would be eligible to purchase COBRA continuation coverage under the former employer's plan until reaching age 65. Unless the retired employee is otherwise eligible to purchase continuation coverage, the employer would be permitted to charge up to 125 percent of the average cost of the employer's group health plan for the coverage.

Under the proposal, individuals would be eligible for a 25 percent nonrefundable tax credit for their COBRA continuation coverage premiums (including the premiums for the proposed retiree continuation coverage). For individuals who purchase COBRA continuation coverage under the proposal regarding extended retiree continuation coverage, eligibility for the tax credit would continue until the retiree reaches age 65. For all others, eligibility for the credit would be limited to the present-law COBRA continuation period applicable to the individual. The Secretary of the Treasury would be directed to issue regulations regarding reporting requirements for employers needed to administer the credit.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2001.

Analysis

Expansion of COBRA continuation coverage to retirees who lose retiree health coverage

The COBRA health care continuation rules were designed to help eliminate or reduce gaps in health coverage due to the occurrence of certain events, such as termination of employment, by making it possible for individuals to continue to be covered under an employer-sponsored plan. In order to balance concerns of employers regarding the cost of such coverage and making coverage affordable, COBRA included a limit on the premium that could be charged to those electing continuation coverage. While the COBRA health care continuation rules may increase health insurance coverage, they also impose administrative burdens on employers.

The proposal to expand COBRA continuation coverage is designed to provide retirees with a health coverage option until they are eligible for Medicare. The proposal is limited to retirees whose employer eliminates retiree health coverage, and thus is limited to those employers who have plans that cover (or have covered) retirees. The proposal recognizes that an older population may be more costly to insure by allowing a greater premium to be charged for such individuals than the regular COBRA premium. If this maximum premium understates the cost of such coverage, then some portion of the cost would be borne by persons other than those purchasing the coverage. It is not clear who would bear the burden of the additional cost in that case, for example, the employer (who would nominally pay the additional cost) could pass the cost along to customers of the employer in the form of higher prices or to current employees in the form of lower total wages.

Tax credit for COBRA premiums

As discussed above, present law provides different tax benefits for the purchase of health insurance depending on the manner in which the health insurance is purchased (e.g., by an employer or self-employed individual). Individuals covered under an employer-subsidized health plan receive the greatest tax benefits, because employer contributions for such coverage are excludable from income. In addition, if the individual purchases the coverage through a cafeteria plan, the individual's premium may also be paid on a pre-tax basis.

This favorable tax treatment does not generally extend to individuals who elect COBRA continuation coverage for two reasons. First, employer contributions toward the purchase of health coverage typically decline after termination of employment. In other words, many employers do not contribute toward the premium for COBRA continuation coverage or provide a lower subsidy for such coverage than for coverage for active employees. In addition, the individual's share of COBRA premiums are paid on an after-tax basis.

The proposal is designed to encourage more individuals to purchase continuation coverage by lowering the cost of such coverage for those that have a tax liability to offset by the credit. Like all tax benefits for health coverage, the proposed tax credit may lead to larger expenditures on health insurance than might otherwise be the case. This extra incentive for health insurance may be desirable if some of the benefits of an individual's having health insurance accrue to society at large (e.g., through a healthier, more productive workforce, or a reduction in health expenditures for uninsured individuals). In that case, absent the subsidy, individuals would underinvest in health insurance (relative to the socially desirable level) because they would not take into account the benefits that others receive. To the extent that expenditures on health insurance represent purely personal consumption, a subsidy would lead to over consumption of health insurance.

By providing a credit rather than a deduction for the cost of health insurance, the proposal would provide the same tax benefits for all individuals who have the same health insurance costs. In contrast, if the tax benefit were provided in the form of a deduction, a greater benefit would be provided to individuals in higher marginal tax brackets.

Some argue that, because the objective of the proposal is to increase health insurance coverage, it would be more efficient to provide a tax benefit to individuals for the purchase of any health insurance, rather than just COBRA continuation coverage. This would allow individuals more health coverage options.

The proposal addresses some of the present-law inequity of tax treatment between employer-subsidized health insurance and insurance purchased by individuals. However, the proposal does not eliminate this inequity; it provides tax benefits only for the purchase of employer-sponsored insurance. Some argue that any new subsidy for the purchase of health insurance should more directly address the inequity in tax treatment of health insurance coverage.

Prior Action

No prior action.

3. Provide tax credit for Medicare buy-in program

Present Law

Under present law, the tax treatment of health insurance expenses depends on whether a taxpayer is covered under a health plan paid for by an employer, whether an individual has self-employment income, or whether an individual itemizes deductions and has medical expenses that exceed a certain threshold.

An employer's contribution to a plan providing health benefits coverage for an employee, and his or her spouse and dependents, is excludable from the employee's income for both income and payroll tax purposes. In addition, active employees participating in a cafeteria plan may pay their employee share of premiums on a pre-tax basis.

Self-employed individuals may deduct a portion of health insurance expenses for themselves and their spouse and dependents. The deductible percentage is 60 percent for taxable years beginning in 1999 to 2001, 70 in 2002, and 100 percent in 2003 and thereafter. The deduction is not available for any month in which the self-employed individual is eligible to participate in an employer-subsidized health plan. The deduction may not exceed the individual's self-employment income.

Other individuals who pay for their own health insurance may claim an itemized deduction for their health insurance premiums only to the extent that premiums, when combined with other unreimbursed medical expenses, exceed 7.5 percent of adjusted gross income.

Under the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), qualified beneficiaries are eligible to purchase continuation coverage under an employer-sponsored plan upon the occurrence of certain events that would otherwise result in loss of coverage, such as termination of employment. The employer may charge up to 102 percent of the average cost of the employer's health plan for continuation coverage. Depending on the circumstances, former employees and their dependents can elect to continue COBRA coverage for up to 18 to 36 months.

Description of Proposal

Under the proposal, taxpayers would be allowed to claim a nonrefundable tax credit for health insurance purchased through the new Medicare buy-in program proposed in the President's Fiscal Year 2001 Budget Proposal. The credit would equal 25 percent of Medicare buy-in premiums paid by a taxpayer prior to reaching age 65.

Under the Medicare buy-in proposal, individuals age 62 through 64 years of age who do not have access to employer-provided health coverage or certain other subsidized health insurance coverage would be eligible for the program. Qualifying individuals would have a one-time election to voluntarily join the Medicare buy-in program. These individuals would pay a base premium, adjusted for location, that on average equals the average cost of insuring individuals in this age range. The base premium would be paid every year prior to reaching age 65 and would be eligible for the tax credit. Once an individual turns 65 years old, the individual would no longer pay the base premium, but instead would pay an (estimated smaller) amortized amount every year the individual is enrolled in Medicare until age 85. This latter cost would be assessed to cover the above-average costs of this particular risk-pool and would not be eligible for the tax credit.

In addition, workers involuntarily separated from their jobs between 55 and 62 years of age could make a one-time election (per qualifying event) to voluntarily join the Medicare buy-in program. Eligibility would be limited to individuals who do not have access to employer-provided health coverage or certain other subsidized health insurance coverage. In addition, individuals would be required to have had health benefit coverage on their previous job for at least one year. Spouses of eligible individuals would also be eligible. Unlike the 62-64 age group, these individuals would pay a premium each year that would approximately cover the total cost of their risk-pool. Because the entire premium would be paid before reaching age 65, the entire premium would qualify for the tax credit.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2001.

Analysis

The proposal to allow certain retired individuals to buy in to Medicare is designed to address concerns regarding lack of heath care coverage for such individuals. It is argued that retirees who are not yet eligible for Medicare may have difficulty purchasing insurance in the individual market because the insurance is likely to be expensive. In addition, some individuals may have difficulty obtaining coverage for preexisting conditions. Premiums charged the individuals, plus a surcharge to the Medicare Part B premium are designed to make the buy-in program self financing.

The stated rationale for tax credit for the buy-in premiums is to encourage healthy as well as wealthy individuals to participate, creating a broad risk pool with more affordable premiums.

Like all tax benefits for health coverage, the proposed tax credit may lead to larger expenditures on health insurance than might otherwise be the case. This extra incentive for health insurance may be desirable if some of the benefits of an individual's having health insurance accrue to society at large (e.g., through a healthier, more productive workforce, or a reduction in health expenditures for uninsured individuals). In that case, absent the subsidy, individuals would underinvest in health insurance (relative to the socially desirable level) because they would not take into account the benefits that others receive. To the extent that expenditures on health insurance represent purely personal consumption, a subsidy would lead to over consumption of health insurance.

By providing a credit rather than a deduction for the cost of health insurance, the proposal would provide the same tax benefits for all individuals who have the same health insurance costs (provided they have tax liability). In contrast, if the tax benefit were provided in the form of a deduction, a greater benefit would be provided to individuals in higher marginal tax brackets. The credit may provide a subsidy for individuals who arguably do not need a subsidy, such as higher-income retirees.

Some argue that, because the objective of the proposal is to increase health insurance coverage, it would be more efficient to provide a tax benefits to individuals for the purchase of any health insurance, rather than the Medicare buy-in program. This would allow individuals more health coverage options.

The proposal addresses some of the present-law inequity of tax treatment between employer-subsidized health insurance and insurance purchased by individuals. However, the proposal does not eliminate this inequity. Some argue that any new subsidy for the purchase of health insurance should more directly address the inequity in tax treatment of health insurance coverage.

Prior Action

No prior action.

4. Provide tax relief for workers with disabilities

Present Law

Tax credit for elderly and disabled individuals

A nonrefundable income tax credit is provided under present law for certain low-income individuals who are age 65 or older. The credit also is available to an individual, regardless of age, who is retired on disability and who was permanently and totally disabled at retirement. For this purpose, an individual is considered permanently and totally disabled if he or she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death, or that has lasted or can be expected to last for a continuous period of not less than 12 months. The individual must furnish proof of disability to the IRS. The maximum credit is $750 for unmarried elderly or disabled individuals and for married couples filing a joint return if only one spouse is eligible; $1,125 for married couples filing a joint return with both spouses eligible; or $562.50 each, for married couples with both spouses eligible who are filing separate returns. The credit is phased out for individuals with middle- and higher-income levels.

Deduction for impairment-related work expenses

Under present law, the impairment-related work expenses of a handicapped individual are classified as miscellaneous itemized deductions not subject to the two-percent adjusted gross income ("AGI") floor. Impairment-related work expenses are expenses for attendant care services at an individual's place of employment and other expenses (but not depreciation expenses) in connection with such place of employment which are necessary for the individual to work and which are deductible as a necessary business expense. For purposes of this deduction, a handicapped individual is someone with a physical or mental disability which results in a functional limitation to employment, or who has any physical or mental impairment which substantially limits at least one major life activity.

Description of Proposal

In general

The proposal would provide a tax credit to disabled individuals, not to exceed the lesser of $1,000 or the individual's earned income for the taxable year. The credit (aggregated with the child credit and the proposed long-term care credit) would be phased out for taxpayers with modified AGI above certain thresholds. Under the proposal, the sum of the otherwise allowable present-law child tax credit, the proposed disabled workers credit, and the proposed long-term care credit would be phased out at a rate of $50 for every $1,000 (or fraction thereof) of modified AGI above the threshold amount. Modified AGI and the threshold amounts would be the same as under the present-law phaseout of the child tax credit. Thus, modified AGI would be AGI plus the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively). The threshold amount would be $110,000 for married individuals filing a joint return, $75,000 for unmarried taxpayers, and $55,000 for married individuals filing separately. These threshold amounts would not be indexed for inflation. An individual may be able to claim both this credit and the proposed long-term care credit.

Disability rules

An individual would qualify as a disabled individual if the individual is certified by a licensed physician as being unable for a period of at least one year to perform at least one activity of daily living ("ADL") without substantial assistance from another person, due to a loss of functional capacity. As under the present-law rules relating to long-term care, 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). The initial certification by a licensed physician would be required prior to the filing of the tax return in which the individual initially claims the disabled workers credit. A portion of the period certified by the physician would have to occur within the taxable year for which the credit is claimed. After the initial certification, the individual would have to be recertified by a licensed physician every three years or such other period as the Secretary prescribes.

The individual 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 physician making the certification. Failure to provide a correct physician identification number would be subject to the mathematical error rule (sec. 6213). Under that rule, the IRS may summarily assess additional tax due without sending the individual a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. 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.

Tax liability limitation; refundable credits

The disabled workers credit would generally be nonrefundable, which means that the credit generally would be allowed only to the extent that the individual's regular tax liability exceeds the individual's tentative minimum tax, determined without regard to the alternative minimum tax foreign tax credit (the "tax liability limitation"). However, the credit would be coordinated with the present-law child credit and the proposed long-term care credit so that the credits would be refundable for a taxpayer claiming three or more credit amounts under the credits. 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 two children under age 17, one of whom has long-term care needs, would have three credit amounts: two child care credit amounts and one long-term care credit amount. As under the present-law child credit, the amount of refundable credit would be the amount that the nonrefundable personal credits would increase if the tax liability limitation were increased by the excess of the taxpayer's social security taxes over the taxpayer's earned income credit (if any).

Effective date

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

Analysis

Proponents of the proposal argue that a disabled worker's ability to pay tax may be limited compared to an identical worker who is not disabled, because the disabled worker incurs additional costs in order to work and earn income. The proposal, however, allows disabled workers to claim the credit regardless of whether they actually incur any such additional expenses. If the purpose of the proposal is to subsidize these additional expenses, it may be more efficient to condition the credit on the worker actually incurring the expenses. This, however, would entail more record keeping.

Proponents of the proposed credit argue that it is intended to provide a tax benefit for lower and middle income disabled taxpayers. While present law provides some relief to such taxpayers, it is argued that some disabled taxpayers may not benefit from the present-law provisions because they have insufficient expenses to benefit from itemizing deductions, have expenses that do not qualify under present law, or rely on unpaid assistance. Opponents respond that the present-law benefits are sufficient. They also argue that the proposal is poorly targeted. For example, it does not provide relief to other individuals who have reduced ability to pay, such as individuals with significant medical expenses.

Some argue that it is appropriate to extend the credit to all disabled taxpayers, irrespective of their earned income or AGI. A taxpayer's ability to pay tax is reduced by the costs of being disabled regardless of the taxpayer's income level. Nevertheless, it could be said that additional costs associated with disability reduce a higher-income taxpayer's ability to pay tax proportionately less than the same amount of costs reduce a lower-income taxpayer's ability to pay.

The proposal also may be criticized for increasing the effective marginal tax rates with their inherent efficiency, equity, and complexity questions for taxpayers in the phase-out ranges.[87] Proponents may respond, however, that phase-outs are necessary to appropriately target the benefits of the proposal to lower- and middle-income taxpayers. Others may argue that the proposal is inequitable, because it gives a $1,000 tax credit to a disabled worker with a modified AGI of $100,000 who files a joint return, but no tax credit to an unmarried worker who also has an AGI of $100,000.

Another issue presented by the proposal is its efficiency. For example, a direct expenditure program could be designed to subsidize all disabled workers, even if the disabled workers had no tax liability. Such an approach would provide a benefit to a broader category of disabled workers than the tax credit structure of the proposal, because some workers are not eligible for the refundable credit under the proposal. It could also be argued that the refundable

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[87] For a more complete discussion of these issues, see Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98), February 3, 1998.

aspect of the credit adds complexity to the tax law. One response to this criticism is that the present-law child tax credit has similar rules, which may already be familiar to taxpayers and tax practitioners. Finally, some might question whether the IRS is the government agency best suited to the responsibility for verifying the disability of each worker and the identification numbers of each physician making disability certifications.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

5. Provide tax relief for small business health plans

Present Law

Under present law, the tax treatment of health insurance expenses depends on the individual circumstances. Employer contributions toward employee accident or health insurance are generally deductible by employers and excludable from income and wages by employees. An individual who itemizes may deduct his or her health insurance premiums to the extent that such premiums, together with the individual's other medical expenses exceed 7.5 percent of the individual's AGI.

A self-employed individual may deduct a percentage of premiums for health insurance covering the individual and his or her spouse and dependents, but only if the individual is not eligible to participate in a subsidized health plan maintained by any employer of the individual or the individual's spouse. The deduction is limited by the self-employed individual's earned income derived from the relevant trade or business. The deduction is equal to 60 percent of health insurance expenses for 1999-2000, 70 percent for 2002, and 100 percent for 2003 and thereafter.

A multiple employer welfare arrangement ("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 other Federal laws. MEWAs (whether or not funded through insurance) are also regulated under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") with respect to reporting, disclosure, fiduciary, and claims procedures.

Private foundation grants (including loans) must be used by the recipient 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 noncharitable 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.

Description of Proposal

In general

The proposal has two parts. First, it would provide that a grant or loan made by a private foundation to a qualified health purchasing coalition ("qualified coalition") would be treated as a grant or loan made for charitable purposes. Second, it would create a new income tax credit for the purchase of certain health insurance through a qualified coalition by small businesses that currently do not provide health insurance to their employees. Both provisions would be temporary.

Foundation grants to qualified health benefit purchasing coalitions

Under the proposal, any grant or loan made by a private foundation to a 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 noncharitable organization for exclusively charitable purposes, private foundations would be required to comply with the "expenditure responsibility" recordkeeping and reporting requirements under present 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 qualified coalition.

Small business health plan tax credit

The proposal also would create a temporary tax credit for small businesses that purchase employee health insurance through qualified 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 1998 or 1999. The credit would be available only with respect to insurance purchased through a qualified coalition. The credit would equal 20 percent of employer contributions to the cost of employee health insurance purchased through a qualified coalition. The maximum credit amount per policy would be $400 per year for individual coverage and $1,00 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. This 24-month limit would not include months beginning before January 1, 2001. As a condition of qualifying for the credit, employers would need to cover at least 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 by another employer health plan.[88] A self-employed individual who is eligible to take a deduction for health insurance premiums would not be allowed to include any of the premiums eligible for the deduction 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. The amount of the credit would reduce the employer's deduction for employee health care expenses.

Requirements imposed on qualified health benefit purchasing coalitions

A qualified coalition would be required to operate on a nonprofit 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 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 HIPPA (generally, businesses that employ an average of at least two, but not more than 50, employees).

Qualified coalitions would be subject to HIPAA and other 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.

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[88] This rule applies whether or not the other health plan is subsidized by the employer.

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.

Effective date

The proposal would be effective for taxable years beginning after December 31, 2000. The special foundation rule would apply to grants and loans made prior to January 1, 2009, for initial operating expenses incurred prior to January 1, 2011. The small business tax credit would be available only for health plans established before January 1, 2009. No carrybacks of the credit would be allowed to taxable years beginning before January 1, 2001.

Analysis

Health insurance coverage of employees of small businesses is significantly lower than that of larger employers. One possible reason for this lower coverage is that the costs of setting up and operating health plans in the current small business insurance market can be higher than those for larger employers. Consequently, small employers may 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. Most small businesses that offer health insurance benefits do not provide their workers with a choice of health plans.

The proposal is intended to increase health care coverage by reducing the cost of such coverage to small businesses in two ways. First, the proposal is intended to facilitate the establishment of health benefit purchasing coalitions. Proponents of the proposal argue that such coalitions will reduce the cost of health coverage for small businesses. It is anticipated that such coalitions will 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. Proponents of the provision believe that, if the proposal were enacted, health care purchasing coalitions would be established and the additional tax incentives under the proposal would not be necessary on a permanent basis to help make health insurance more affordable and available to employees of small businesses. It is unclear whether coalitions will operate as intended. Under present law, in some cases MEWAs have proved unsuccessful in reducing costs, and have in some cases failed to provide the promised coverage. In some cases this has been due to fraud, while in other cases simply to mismanagement. The requirements imposed on purchasing coalitions under the proposal may reduce the likelihood of such occurrences under the proposal.

The second way the proposal intends to decrease health insurance costs is by providing a tax credit for the purchase of health insurance through the health benefit purchasing coalitions. While the credit is in effect, it will directly reduce the cost of health care coverage purchased by small businesses through a health benefit purchasing coalition. By reducing the effective price of health insurance, providing a tax credit for the purchase of health insurance may lead to larger expenditures on health insurance than might otherwise be the case. This extra incentive for health insurance may be desirable if some of the benefits of an individual's having health insurance accrue to society at large (e.g., through a healthier, more productive workforce, or a reduction in health expenditures for uninsured individuals). In that case, absent the subsidy, individuals would underinvest in health insurance (relative to the socially desirable level) because they would not take into account the benefits that others receive. To the extent that expenditures on health insurance represent purely personal consumption, a subsidy would lead to over consumption of health insurance.

The proposed credit does not target all individuals without health insurance, only those who work for small employers. Some argue that, because the objective of the proposal is to increase health insurance coverage, it would be more efficient to provide a tax benefit to individuals for the purchase of health insurance rather than to employers. For example, individuals who do not have access to subsidized employer insurance or who have been uninsured for a certain period of time could be provided a tax credit or deduction for the purchase of health insurance. Others question why the tax credit should apply only to the purchase of health care through a health benefit purchasing coalition. They argue that if such coalitions were the most economically efficient means of purchasing insurance, they would be competitive without the requirement that the tax credit is available only for insurance purchased through them. Furthermore, they would question how restricting the health care choices available to small businesses in order to qualify for the credit could help such businesses find the best insurance at the best price.

Proponents of the proposal relating to private foundations argue that the formation of health benefit purchasing coalitions has been hindered by their limited access to capital. Some private foundations have indicated a willingness to fund coalition start-up expenses; however, private foundations are prohibited under the Code from making grants for other than charitable purposes. It is unclear under present law whether 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.

The temporary nature of the provisions may result in additional complexity. Present law contains a variety of expiring tax provisions, such as the exclusion for employer provided educational assistance and the research and development credit. These provisions, initially enacted on a temporary basis, have been repeatedly extended, sometimes on a retroactive basis after the provision has expired. Such expiring provisions create uncertainty and complexity, because it is often unclear whether (or when) the provision will be extended. Enacting a new temporary provision would likely involve the same complexity and uncertainty.

Prior Action

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal, except that the small business tax credit in the prior proposal was 10 percent of eligible expenses, with per policy maximums of $200 for individual coverage and $500 for family coverage. In addition, in the prior proposal, the provisions would have been in effect for only four years.

6. Encourage the development of vaccines for targeted diseases

Present Law

In general

No credit is provided for the sale of vaccines. However, present law does have three provisions relating to the development of vaccines.

Research credit

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and generally does not apply to amounts paid or incurred after June 30, 2004.

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. The taxpayer's "fixed-base percentage" generally is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.

Taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1 percent (i.e., the base amount equals 1 percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of 2 percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2 percent. An election to be subject to this alternative incremental credit regime may be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years (in the event that the credit subsequently is extended by Congress) unless revoked with the consent of the Secretary of the Treasury.

Orphan drug credit

Taxpayers may claim a 50-percent credit for expenses related to human clinical testing of drugs for the treatment of certain rare diseases and conditions, generally those that afflict less than 200,000 persons in the United States (sec. 45C). Qualifying expenses are those paid or incurred by the taxpayer after the date on which the drug is designated as a potential treatment for a rare disease or disorder by the Food and Drug Administration ("FDA") in accordance with the section 526 of the Federal Food, Drug, and Cosmetic Act.

Vaccine excise tax

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

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund ("Vaccine Trust Fund") to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers and physicians.

Description of Proposal

The proposal would provide a credit against the taxpayer's income tax liability for the sale of a qualifying vaccine to a qualifying nonprofit organization. The credit would be equal to 100 percent of the taxpayer's receipts from a qualified sale. The total amount of credit that may be claimed annually by taxpayers is subject to an annual limitation. The credit would be a general business credit.

A qualifying vaccine is a vaccine against a specified "targeted" disease that receives Food and Drug Administration ("FDA") approval after the date of enactment. Malaria, tuberculosis, and HIV/AIDS would comprise targeted diseases. In addition, the Secretary of the Treasury, with the consultation of the Centers for Disease Control and Prevention ("CDC") and the U.S. Agency for International Development ("USAID"), could designate any infectious disease (of a single etiology) that is estimated to cause more than one million deaths annually worldwide as a targeted disease.

A qualified nonprofit organization is a nonprofit organization that purchases and distributes vaccines for developing countries. Taxpayers could claim a credit for certain sales to such organizations only if the nonprofit organization has received a credit allocation from the USAID with respect to specific purchases of qualifying vaccines.

The USAID could make up to $100 million in credit allocations for calendar years 2002 through 2006 and up to $125 million in credit allocations for calendar years 2007 through 2010. Credits unallocated in any year could be carried forward for up to ten succeeding years and made available for allocations in such succeeding year. For example, if USAID allocated $75 million in credits to qualified nonprofit organizations in 2005, all or part of the remaining $25 million could be made available for allocation in any year between 2006 through 2015. Credits unallocated after the ten-year carried forward would be canceled.

Effective date.--The proposal would be effective for sales of qualifying vaccines with respect to which a credit allocation has been made after December 31, 2001.

Analysis

Vaccines and spillover benefits

Intentional distortions to markets generally reduce overall economic efficiency. However, consumption of certain goods may yield benefits to individuals other than solely the individual who consumes the good. Such benefits are called spillover benefits or positive externalities. Because individuals make their purchase decisions based on their private benefit without accounting for the spillover benefits that others might receive, economists argue that too little of such goods are provided in the private market and that a subsidy might be warranted to produce a more socially efficient outcome. Most analysts concur that vaccines are an example of goods that provide society with spillover benefits. A vaccination provides the patient with protection against infectious disease and also reduces the probability with which other individuals become exposed to such a disease.

To be fully efficient, the magnitude of the subsidy provided for the purchase or supply of vaccines should vary with the magnitude of the external benefit the vaccine provides. The proposal would target malaria, tuberculosis, and HIV/AIDS. There may be other vaccines with substantial spillover benefits that are excluded from the subsidy provided by the credit or the spillover benefit from an effective vaccine against one disease may be greater than that of another. On the other hand, calculation of such spillover benefits is difficult in practice and may not justify making distinctions in the magnitude of subsidies for different vaccines.

Subsidy value of the proposed credit

The proposal would provide a tax credit equal to 100 percent of the revenue from a qualifying vaccine sale. With an allocation of credits, a qualified nonprofit buyer of vaccines could make a bid to the seller of vaccines to purchase the vaccines for less than the market price. Because such a sale would permit the seller to claim a tax credit for the sale, the seller might be willing to sell the vaccines for a below market price. Although the seller takes in less revenue, the seller also may claim a tax credit.

In a competitive market, a 100-percent credit on the sale of vaccine has the effect of providing a subsidy in excess of 50-percent of the market price of the vaccine. To see this consider a vaccine that would otherwise sell for $1.00 per dose. If a buyer offered the seller 50 cents for the dose, normally the seller would reject the offer. However, if the buyer's offer of 50 cents were accompanied by a tax credit entitling the seller to reduce his income tax liability then the seller would receive 50 cents from the sale and a reduction in income taxes by 50 cents for a total of $1.00 received by the seller as a result of the sale. The seller would be just as well off as if he had sold the vaccine for $1.00 in the absence of the tax credit. Thus, for an offer of 50 cents, the buyer has been able to purchase a vaccine worth $1.00. At this initial level of analysis, the tax credit would appear to be equivalent to a 50-percent subsidy to the market price of the vaccine.

The tax credit is not exactly the same as a direct subsidy to the purchase of the vaccine. A direct subsidy generally is paid on a "before tax" basis while the tax credit provides an "after tax" benefit. For example, if a direct subsidy were provided to vaccine purchases, the buyer would pay the seller 50 cents and the government would pay the seller 50 cents. The seller would receive $1.00 in revenue, from which the seller would deduct costs, compute taxable income, and pay income tax.[89] In short, 50 cents of tax credit generally is worth more than 50 cents of revenue. With the tax credit, the seller's gross revenue is 50 cents less than it otherwise would be. Hence, the seller's income tax liability is reduced by 50 cents times the seller's marginal income tax rate. In addition, the seller may claim a 50 cent income tax credit. Thus, the sale to a buyer who offers a tax credit reduces the seller's income tax liability by $50 \cdot t + 50$ cents, where t is the seller's marginal income tax rate. Thus, the effective subsidy provided by the tax credit exceeds 50 percent of the purchase price. For a corporate taxpayer subject to the top statutory marginal tax rate of 35 percent, the effective subsidy provided by the tax credit is approximately 61 percent.[90]

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[89] An example of a direct subsidy is the Food Stamp program. The buyer of food purchases food stamps from the government at a discount from the stamp's face value. The grocer redeems food stamps from the government at face value. Thus, the buyer of the food and the government have each contributed to the gross receipts, before tax, of the grocer.

[90] More generally, if the price of a dose of the vaccine is P and the cost of a dose of the vaccine is C, the seller's pre-tax profit, π, is $\pi = P - C$. If the seller's marginal income tax rate is

The credit may not be of equal value to all taxpayers. As discussed above, to the extent that different taxpayers are subject to different marginal income tax rates, the value of the subsidy will differ. In addition, the alternative minimum tax minimum tax effectively may defer when the taxpayer may claim the benefit of the credit. Deferring the credit reduces the present value of the credit.

Subsidies to supply, subsidies to demand, and the market for vaccines

A subsidy may be structured to increase the supply of a product, generally by reducing the cost of supplying the product. As the supply of a product increases, generally the price of the product declines and the quantity of the product consumed increases. The present-law research tax credit and orphan drug tax credit are examples of supply subsidies.[91] These credits reduce the cost of the research and testing necessary to bring new vaccines to market. These credits should work to increase the supply of vaccines.

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t, then the seller's after tax profit, π', from the sale of the vaccine is $\pi' = (P - C)(1 - t)$.

Assume the seller may claim a credit equal to v percent of his gross receipts. As discussed in the text, the seller may find it profitable to reduce his price by some percentage, s, so that his gross receipts from the sale fall from P to $(1 - s)P$. The seller's costs remain at C. Now the seller's pre-tax, pre-credit profit is $(1 - s)P - C$. The tax credit is worth $v \cdot (1 - s)P$, the credit rate, v, multiplied by the qualifying gross receipts, $(1 - s)P$. The after-tax, after-credit profit becomes $\pi^* = ((1 - s)P - C)(1 - t) + v(1 - s)P$.

Equating the after-tax profit in the case of no credit, π', to the after-tax, after-credit profit, π^*, permits a calculation of the discount in price, s, at which the seller could sell the vaccine and be indifferent between making a sale at market prices or by claiming the credit. Algebraic manipulation establishes that this outcome would occur for $s = v/(1-t+v)$.

The proposal would have a credit rate of 100 percent. If the seller of the vaccine is a corporate taxpayer subject to the top statutory marginal tax rate of 35 percent, the seller could discount the sales price by approximately 61 percent with no change in after-tax profit from the sale.

[91] The benefits of the orphan drug credit would not generally apply to the targeted vaccines identified by the proposal. The proposal would identify a potential targeted vaccine as a vaccine against a disease that kills at least one million people worldwide annually. The present-law orphan drug credit only may be claimed for certain expenses related to diseases afflicting 200,000 or fewer persons in the United States. HIV/AIDS afflicts more than 200,000 persons in the United States. The CDC report that through June 1999, 393,045 persons in the United States are living with HIV infection or with AIDS, Centers for Disease Control and Prevention, "HIV/AIDS Surveillance Report." midyear edition, 1999. By contrast, the CDC reported a total of 18,361 cases of tuberculosis for 1998 in the United States, Centers for Disease Control and Prevention, "Reported Tuberculosis in the United States, 1998, August 1999. The CDC reported 1,167 cases of malaria in the United States in 1995, Centers for Disease Control and Prevention, "Malaria Surveillance, United States, 1995," February 26, 1999.

Alternatively, a subsidy may be structured to increase the demand for a product, generally by reducing the net price that consumers pay for the subsidized product while not altering the gross price received by suppliers. If the demand for a product increases, generally the quantity of the product consumed increases and the price of the product increases. The proposed tax credit for vaccine sales is an example of a demand subsidy. By making it cheaper for qualified organizations to procure targeted vaccines, the demand for targeted vaccines should increase.[92] The proposal would provide a credit for the qualified sale of targeted vaccines that do not currently exist. By increasing the potential demand for a product that does not currently exist, the profit potential of such a product increases and investment may flow into research to create and market the targeted vaccines.

The discussion in the preceding section suggested that the credit may have the effect of reducing the price of a targeted vaccine sold to a qualified nonprofit buyer by 50 to 61 percent. That analysis was predicated on stringent assumptions regarding the competitiveness of the market for vaccines and the nature of supply conditions in the market for vaccines.[93] If it is assumed that the market for vaccines is competitive,[94] the extent to which prices and quantities consumed increase in response to a demand subsidy depends upon the responsiveness to supply to changes in price. If small changes in price bring forth substantial additional quantities of a product to the market, then the benefit of a subsidy will accrue primarily to consumers of the subsidized good. If a large change in price brings forth only modest increases in quantities of a

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[92] The present-law excise taxes on vaccines and the Vaccine Injury Compensation Trust Fund program affects both demand and supply. By raising the purchase price of a vaccine, the excise tax may reduce demand. A decline in demand engendered by an excise tax generally implies less of a product is consumed at a higher price than in the absence of the tax. However, the net revenues of the vaccine excise taxes fund the Vaccine Injury Compensation Program. This program provides a substitute, Federal "no fault" insurance system for the State-law tort and private liability insurance otherwise applicable to vaccine manufacturers and physicians. By reducing uncertainty regarding liability claims, and by possibly reducing the magnitude of such claims, the cost of operating as a vaccine manufacturer are reduced. As with a direct subsidy to supply, lower costs should increase the supply of vaccines and lower the price of vaccines to consumers.

However, vaccines subject to tax and Trust Fund benefits under this program are vaccines against childhood diseases and Congress must subject any new vaccine to tax to be eligible for Trust Fund benefits. The proposal does not propose amending the Vaccine Injury Compensation Trust Fund program to include the proposal's targeted vaccines.

[93] In particular, that discussion assumed that an increase in the demand for a vaccine would lead to increased production of the vaccine with no change in the market price of the vaccine.

[94] By a "competitive market," economists mean a market in which the actions of no one buyer or seller can affect the market price.

product to the market, then the benefit of a subsidy will accrue primarily to the supplier of the good. In general, by increasing demand, the proposed credit may increase market prices. While the credit would still have the effect of reducing the price of a targeted vaccine sold to a qualified nonprofit buyer by 50 to 61 percent, the new net price paid by the nonprofit buyer may be less than 50 to 61 percent below the unsubsidized market price.

The discussion of the preceding paragraph assumes the market for vaccines is competitive. In practice, developers of new vaccines patent their discovery. The patent grants the developer monopoly rights for a limited period. As the sole seller, there is no competitor providing an incentive for the seller to accept a below market bid for a vaccine from a qualified nonprofit buyer with a tax credit allocation. Some studies of oligopolistic markets have found "undershifting" of excise tax reductions and "overshifting" of excise tax increases.[95] That is, prices in the markets fell by less than the tax reduction and rose by more than the tax increase. On the other hand, the proposal would allocate credits to a limited number of nonprofit buyers. This may create bargaining power on the part of the buyers sufficient to offset the seller's position as monopolist in the vaccine.

The cost of the tax credit will be borne by U.S. taxpayers generally. Under the proposal, the subsidy to purchase would apply directly to purchases for vaccinations given overseas. If the increase in demand created by this subsidy leads to increases in prices of vaccines above those which would otherwise occur, then in addition to bearing the a tax cost of the subsidy to foreign consumption of the vaccines, U.S. persons who use the vaccines also would bear a price increase. In addition, if a premise for providing the subsidy via tax credit is that targeted vaccines provide spillover benefits, subsidizing only foreign purchases may mitigate the spillover benefits produced as most of the spillover benefits from increasing vaccinations accrue within local populations receiving vaccinations. On the other hand, given that there currently are no vaccines against these diseases, if an increase in worldwide demand leads to the discovery of vaccines, the U.S. persons will benefit. In addition, most cases of tuberculosis within the United States arrived in the United States with persons from less developed countries. Inoculations abroad may be the most efficacious method to eliminate tuberculosis within the United States.

Other issues

The proposal acts as a targeted source of foreign aid administered by USAID and the IRS. The USAID is granted authority to allocate $1 billion of tax benefits which, as discussed above, is equivalent to granting spending authority to subsidize purchases of certain vaccines for administration in certain foreign countries. Some criticize funding an explicit foreign aid

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[95] See, for example, Paul G. Barnett, Theodore E. Keeler, and The-wei Hu, "Oligopoly Structure and the Incidence of Cigarette Excise Taxes," Journal of Public Economics, 57, July 1995, 457-470, and Timothy Besley and Harvey S. Rosen, "Sales Taxes and Prices: An Empirical Analysis," National Bureau of Economic Research working paper no. 6667, July 1998.

program through the tax code and outside the normal oversight of the appropriate congressional committees. Such critics note that funding such programs through the tax code masks the true size of the USAID budget and programs.

The proposal also would grant to the Secretary of the Treasury authority to expand the scope of the tax credit, albeit subject to guidelines. Some see such authority as an inappropriate delegation of the Congress's constitutional authority to impose taxes. They argue that tax subsidies for new products should be granted only after congressional deliberation. Others respond that such authority, while it does substantially alter the tax liabilities of certain taxpayers, provides the flexibility needed to address new diseases and vaccines as they arise. Moreover, they note that because the amount of total credits that could be allocated is limited to $1 billion over the ten years 2001 through 2010, the Secretary would not be able to substantially modify the scope of the tax credit benefit.

As noted above, the proposal would target tax credits for vaccines that do not yet exist. The tax benefits would be available for years 2001 through 2010. Often pharmaceutical and biological research and product approval consume more than ten years. Some suggest that a credit of limited duration may not yield a substantial increase in research efforts due to the long lead times necessary to bring new vaccines to market.

Prior Action

No prior action.

D. Family and Work Incentive Provisions

1. Provide marriage penalty relief and increase the basic standard deduction

Present Law

Marriage tax penalty

A married couple is treated as one tax unit that must pay tax on the couple's total taxable income. This filing status is referred to as "married individuals filing joint returns." Married couples may elect to file separate returns; however, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons, to single heads of households, to surviving spouses, and to trusts and estates.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if the couple were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if the couple were not married.

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

Under present law, the size of the standard deduction and the tax bracket breakpoints follow certain customary ratios across filing statuses. The standard deduction and tax bracket breakpoints for single filers are roughly 60 percent of those for joint filers.[96] Thus, the sum of the standard deductions for two unmarried individuals exceeds the standard deduction for a married couple filing a joint return.[97]

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

[97] For a more detailed discussion of the marriage penalty, see Joint Committee on Taxation, *Present Law and Background Relating to Proposals to Reduce the Marriage Tax Penalty* (JCX-1-98), January 27, 1998.

Basic standard deduction

Taxpayers who do not itemize deductions may use the basic standard deduction[98] which is subtracted from adjusted gross income ("AGI") in arriving at taxable income. The size of the basic standard deduction varies according to filing status and is indexed for inflation. For 2000, the size of the basic standard deduction for each filing status is shown in the following table:

Table 3.–Basic Standard Deduction Amounts
Taxable Years Beginning in 2000

Filing status	Basic standard deduction[4]
Married, joint return.................	$7,350
Head of household return..........	$6,450
Single return.............................	$4,400
Married, separate return...........	$3,675

[4] These amounts are indexed for inflation annually.

For 2000, the basic standard deduction for joint returns is projected to be 1.67 times the basic standard deduction for single returns.

Description of Proposal

Marriage tax penalty relief

The proposal would increase the basic standard deduction for a two-earner married couple filing jointly to the lesser of: (1) the basic standard deduction for a one-earner married couple filing jointly plus the earned income of the lower earning spouse; or (2) twice the basic standard deduction amount for a single return. Earned income would be defined as the sum of wages, salaries, and net income from self employment less certain deductions for IRA, Keogh, SEP, and SIMPLE plan contributions, self-employed health insurance, and one-half of self-employment taxes. This increase would be phased in over five years. The maximum increase for each year is the following percentage of the difference between the basic standard deduction for joint filers and twice the basic standard for unmarried filers.

[98] Additional standard deductions are allowed with respect to any individual who is elderly (age 65 or over) or blind.

Taxable year	Maximum increase in the size of the standard deduction for two-earner joint filers
2001	20 percent
2002	40 percent
2003	60 percent
2004	80 percent
2005 and thereafter	100 percent

If the increase is not a multiple of $50 after applying the applicable percentage, the increase would be rounded to the next lowest multiple of $50.

Increase in the standard deduction

The proposal would also increase the otherwise allowable maximum basic standard deduction by $250 for single filers, $350 for heads of households, and $500 for married couples filing a joint return in 2005. Beginning in 2006, the amount of these increases would be indexed for inflation under the present-law rules for indexing of the standard deductions. These increases would be in addition to the increase, if any, in the basic standard deduction for two-earner couples filing jointly.

Effective date

The proposal relating to marriage tax penalty relief would be effective for taxable years beginning after December 31, 2000. The proposal to increase the basic standard deductions would be effective for taxable years beginning after December 31, 2004.

Analysis

Marriage tax penalty relief

A marriage penalty exists when the combined tax liability of a married couple filing a joint return is greater than the sum of their tax liabilities had each spouse filed his or her taxes as if they were not married. This measure of the marriage penalty may represent the combined effects of many provisions of the Code. In the case of taxpayers who do not itemize their deductions, at least a part of the marriage penalty is attributable to the basic standard deduction.[99] In the case of a married couple with no dependents who claim the basic standard deduction, the marriage penalty attributable to the basic standard deduction is the tax attributed to the amount by which the sum of two basic standard deductions for unmarried individuals exceeds the basic standard deduction for married couples filing jointly. If a married couple who claim the basic standard deduction has one or more dependents, the marriage penalty relating to the basic standard deduction depends on whether each spouse; if unmarried, would file as an unmarried individual or a head of household. In such a case, the marriage penalty attributable to the basic standard deduction is the amount by which the sum of the standard deductions attributable to each of the spouses exceeds the standard deduction for married couples filing jointly.

Because marriage penalties are greater the more evenly divided the spouses incomes, marriage penalties tend to be concentrated in two-earner couples. By contrast, most single-earner couples experience a marriage bonus. Proponents of this proposal argue that it is targeted to address the circumstances that are most likely to produce a marriage penalty without affecting couples with a marriage bonus. Specifically, it would limit tax relief to married couples where each spouse has earned income.[100] Opponents argue that this targeting is unduly complex and fails to address some marriage penalties. They argue that the calculations required by the proposal are more complicated than simply claiming a single larger standard deduction. Further, they argue that the proposal would not address a marriage penalty in the case where both spouses have taxable income but one spouse's taxable income is entirely unearned income. Examples include a married couple where one spouse's only source of income is unemployment compensation, Social Security and railroad retirement benefits, or taxable disability payments from a private insurance contract purchased by the individual. Advocates of this proposal argue that the level of complexity associated with this proposal is low and that it addresses the majority of cases where the present-law standard deduction results in a marriage penalty. They contend that extending tax relief to taxpayers without earned income would give more couples marriage bonuses than it would reduce the number of couples with marriage penalties.

Some argue that the proposal fails to properly address the marriage penalty in the case of married couples with dependents who claim the basic standard deduction. In that case, critics argue that the marriage penalty as it relates to the basic standard deduction can be eliminated only if the basic standard for a married couple filing jointly is increased to an amount equal to the sum of the basic standard deductions for the two spouses had one or both spouses claimed the basic standard deduction for heads of households. Proponents of the proposal respond that increasing the basic standard deduction for married couples filing a joint return to twice the basic

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[99] The calculation of the marriage penalty requires a more detailed analysis to allocate itemized deductions between spouses if the spouses individually or as a couple have itemized deductions in excess if the applicable standard deductions.

[100] The element of the proposal which limits tax relief to the extent that the lesser earning spouse has earned income is based on the prior-law two-earner deduction.

standard deduction for a head of household would create additional marriage bonuses (e.g., if only one spouse would have been eligible for head of household status had the couple filed separate returns). They also argue that any attempts to attribute head of household status to one or both spouses for purposes of computing the marriage penalty as it relates to the basic standard deduction would be imprecise and possibly subject to manipulation (i.e., absent rules regarding the allocation of children between the spouses, a couple may simply allocate the children between themselves so as to minimize the combined tax liability).

Increase in the standard deduction

Proponents of the proposal argue that increasing the basic standard deduction for each filing status is a fair and responsible form of comprehensive tax relief. In fact, most taxpayers claim the standard deduction and would therefore benefit from this proposal. The proposal would also reduce the number of taxpayers who claim itemized deductions. This should relieve those taxpayers of certain record keeping requirements and ease some of the complexity of filing their tax returns. Others may respond that the proposal is unfair because it provides no tax relief to taxpayers who do not claim the basic standard deduction (e.g., approximately one half of married couples filing jointly).

Reduction of regular tax liability and the alternative minimum tax "AMT"

Both of the proposals relating to the basic standard deduction would reduce the regular tax liability of affected taxpayers without changing their tentative minimum tax liability. This would result in an increase in the AMT liability of some taxpayers already on the AMT and would increase the number of taxpayers who have AMT liability. Other taxpayers would not experience an increase in AMT liability but would not fully benefit from the proposal because their ability to claim nonrefundable personal credits would be affected by their tentative minimum tax liability. The proposals relating to the AMT would mitigate these effects, but not completely offset them. Those proposals would: (1) allow taxpayers who use a standard deduction for regular income tax purposes to use it for AMT purposes in the years 2000 and 2001; and (2) allow dependent personal exemptions for AMT purposes.[101] The proposal to allow dependent personal exemptions for AMT purposes would be phased in over 10 years (2000-2010). Opponents of this proposal argue that if more individuals become subject to the AMT as a result of the proposal, these individuals will have to include a calculation of the tentative minimum tax and file the appropriate minimum tax forms. This increased complexity could lead to greater taxpayer confusion and tax preparation costs for affected individuals.

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[101] A more complete discussion of the proposals relating to the AMT is included in F.1., below.

Prior Action

The Marriage Tax Penalty Relief Act of 2000, as passed by the House, contains a proposal to increase the basic standard deduction for joint filers to twice the basic standard deduction for single filers.

2. Increase, expand, and simplify the dependent care credit

Present Law

Dependent care credit

A nonrefundable credit is provided under present-law for up to 30 percent of a limited amount of employment-related dependent care expenses of a taxpayer who maintains a household which includes one or more qualifying individuals (sec. 21). Eligible employment-related expenses are limited to $2,400 if there is one qualifying individual or $4,800 if there are two or more qualifying individuals. Generally, a qualifying individual is a dependent under the age of 13 or a physically or mentally incapacitated dependent or spouse. No credit is allowed for any qualifying individual unless a valid taxpayer identification number ("TIN") has been provided for that individual. A taxpayer is treated as maintaining a household for a period if the taxpayer (or the taxpayer's spouse, if married) provides more than one-half the cost of maintaining the household for that period. In the case of married taxpayers, the credit is not available unless they file a joint return.

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

Expenses that may be taken into account in computing the credit generally may not exceed an individual's earned income or, in the case of married taxpayers, the earned income of the spouse with the lesser earnings. Thus, if one spouse has no earned income, generally no credit is allowed.

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

Interaction with employer-provided dependent care assistance

The maximum amount of employment-related expenses that can be taken into account for purposes of the dependent care credit is reduced to the extent that the taxpayer has received employer- provided dependent care assistance that is excludable from gross income (sec. 129).

The exclusion for dependent care assistance is limited to $5,000 per year and does not vary with the number of children.

Additional credit for taxpayers with dependents under the age of one

There is no additional credit for taxpayers with dependents under the age of one.

Description of Proposal

The proposal would make several changes to the dependent care tax credit.

Refundability

The basic credit would be made refundable.

Expand basic dependent care credit

The credit percentage would be increased to 50 percent for taxpayers with AGI of $30,000 or less. This increase would be phased in as follows:

Phase in for Increase of Maximum Credit Percentage of Basic Credit

Taxable Year	Maximum basic credit percentage	AGI level at which maximum credit percentage is reduced to 20 percent[1]
2001	30	39,001
2002	30	39,001
2003	40	49,001
2004	40	49,001
2005 and thereafter	50	59,001

[1] These amounts are indexed for inflation annually.

The maximum credit percentage would be decreased by 1 percent for each $1,000 of AGI, or fraction thereof, in excess of $30,000. However, the credit rate would never be less than 20 percent. Therefore, when the proposal is fully phased in (2005 and thereafter), the maximum credit percentage would be phased down between $30,001 and $59,000 of AGI and the credit percentage would be 20 percent for taxpayers with AGI of $59,001 or greater. During the transition: (1) the maximum credit percentage would be phased down between $30,001 and $39,001 of AGI and the credit percentage would be 20 percent for taxpayers with AGI of $39,001 or greater for taxable years 2001-2002; and (2) the maximum credit percentage would be phased down between $30,001 and $49,001 of AGI and the credit percentage would be 20 percent for taxpayers with AGI of $49,001 or greater for taxable years 2003-2004.

Under the proposal, an otherwise qualifying taxpayer would generally qualify for the dependent care tax credit if the taxpayer resided in the same household as the qualifying individual for more than one half the year, regardless of whether the taxpayer contributed over one-half the cost of maintaining the household. The proposal would extend the credit to a qualifying spouse filing a separate return. However, in that case, the spouse claiming the dependent care tax credit would have to satisfy the present-law household maintenance test.

Finally, under the proposal, the dollar amounts of the starting point of the new phase-down range and the maximum amount of eligible employment-related expenses would be indexed for inflation beginning in 2002.

Additional credit for dependents under the age of one ("infants")

The proposal would expand the dependent care credit to provide an additional nonrefundable credit for all taxpayers with qualifying dependents under the age of one, regardless of whether or not they incur any employment-related expenses and regardless of whether both spouses work. The proposal would provide up to $250 of additional credit ($500 for two or more qualifying infants). This additional credit, would be equal to the applicable credit rate times $500 ($1,000 for two or more qualifying infants).

Effective date

Generally, the proposal would be effective for taxable years beginning after December 31, 2000. The proposal relating to the refundability of the basic credit would be effective for taxable years beginning after December 31, 2002. The starting point of the phase-down range for the credit, the maximum amounts of eligible employment-related expenses generally and the maximum amount of the additional credit for taxpayers with infants would be indexed for inflation for taxable years beginning after December 31, 2001.

Analysis

Economic analysis of tax benefits for child care

One of the many factors that may influence the decision as to whether the second parent in a two-parent household works outside the home is the tax law.[102] The basic structure of the present-law graduated income tax may act as a deterrent to work outside of the home. The reason for this is that the income tax taxes only labor the value of which is formally recognized

[102] This discussion applies to childless couples as well.

through the payment of wages.[103] Work in the home, though clearly valuable, is not taxed. One way to see the potential impact of this bias is to consider the case of a parent who could work outside the home and earn $10,000. Assume that in so doing the family would incur $10,000 in child care expenses. Thus, in this example, the value of the parent's work inside or outside the home is recognized by the market to have equal value.[104] From a purely monetary perspective (ignoring any work-related costs such as getting to work, or buying clothes for work), this individual should be indifferent between working inside or outside the home. The government also should be indifferent to the choice of where this parent expends the parent's labor effort, as the economic value is judged to be the same inside or outside the home. However, the income tax system taxes the labor of this person in the formal marketplace, but not the value of the labor if performed in the home. Thus, of the $10,000 earned in the market place, some portion would be taxed, leaving a net wage of less than $10,000.[105] From a strictly monetary perspective, this parent would be better off by staying at home and enjoying the full $10,000 value of home labor without taxation.[106]

Because labor in the home is not taxed, most economists view the income tax as being biased towards the provision of home labor, resulting in inefficient distribution of labor resources. For example, if the person in the above example could earn $12,000 in work outside the home and pay $10,000 in child care, work outside the home would be the efficient choice in the sense that the labor would be applied where its value is greatest. However, if the $12,000 in labor resulted in $2,000 or more in additional tax burden, this individual would be better off by working in the home. The government could eliminate or reduce this bias in several ways. First, it could consider taxing the value of "home production." Most would consider this unfair and not feasible for administrative reasons. The second alternative would be to eliminate or reduce the

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[103] Barter transactions involving labor services would generally be subject to income taxation as well.

[104] A neutral position is taken in this analysis as to whether parents can provide better care for their own children than can other providers. Thus, because the child care can be obtained in the marketplace for $10,000 in this example, it is assumed that this is the economic value of the parent doing the same work.

[105] The tax on "secondary" earners may be quite high, as the first dollar of their earnings are taxed at the highest Federal marginal tax rate applicable to the earnings of the "primary" earning spouse. Additionally, the earnings are subject to social security payroll taxes, and may be subject to State and local income taxes as well. For further discussion of this issue, see Joint Committee on Taxation, *Present Law and Background Relating to Proposals to Reduce the Marriage Tax Penalty* (JCX-1-98), January 27, 1998.

[106] Even taking into account the child care credit, the net wage would still be lower than $10,000 because of the social security taxes and any income taxes for which the taxpayer would be liable.

burden of taxation on "secondary" earners when they do enter the formal labor force. This approach was implemented through the two-earner deduction (from 1982-1986), which allowed a deduction for some portion of the earnings of the lesser-earning spouse.[107] Another approach, and part of present law, is to allow tax benefits for child care expenses, provided both parents (or if unmarried, a single parent) work outside the home. This latter approach is targeted to single working parents and two-earner families with children, whereas the two-earner deduction applied to all two-earner couples regardless of child care expenses.

The proposal to expand the basic dependent care credit would reduce the tax burden on families that pay for child care relative to all other taxpayers. Alternatives such as expanding the child tax credit[108] or the value of personal exemptions for dependents would target tax relief to all families with children regardless of the labor choices of the parents. However, families without sufficient income to owe taxes would not benefit.

Proponents of the proposal argue that child care costs have risen substantially, and the dependent care credit needs to be expanded to reflect this and ensure that children are given quality care. Opponents would argue that the current credit is a percentage of expenses, and thus as costs rise so does the credit. However, to the extent one has reached the cap on eligible expenses, this would not be true. Furthermore, the maximum eligible employment-related expenses and the income levels for the phaseout have not been adjusted for inflation since 1982, when the amounts of maximum eligible employment-related expenses were increased. It also could be argued that the increase is needed to lessen the income tax bias against work outside of the home. However, the increase in the number of families with two working parents might suggest that any bias against work outside of the home has been mitigated by other forces, such as increased wages available for work outside of the home. Others argue that the increasing number of two-earner couples with children is not the result of any reduction in the income tax bias against work outside of the home, but rather reflects economic necessity in many cases.

Opponents of the proposal contend that all families with children should be given any available tax breaks aimed at children, regardless of whether they qualify for the dependent care tax credit. In this regard, they may support the element of the proposal extending a tax benefit to all taxpayers with dependents under the age of one. This latter group may cite as support for their position that the size of the personal exemption for each dependent is much smaller than it would have been had it been indexed for inflation in recent decades. In their view, even with the addition of the child tax credit, the current Federal income tax does not adequately account for a family with children's decreased ability to pay taxes.

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[107] Joint Committee on Taxation, *Present Law and Background Relating to Proposals to Reduce the Marriage Tax Penalty* (JCX-1-98), January 27, 1998, p. 6.

[108] Present law provides a $500 tax credit to taxpayers with qualifying children. The child credit is phased out over certain levels of AGI.

It is not clear whether opponents of the proposal also believe that there should be biases in the income tax in favor of a parent staying at home with the children. It should be noted that two-earner married couples with children are often affected by the so-called marriage penalty.[109] Conversely, those for whom one parent stays at home generally benefit from a "marriage bonus." The proposal to increase the dependent care credit can be thought of as a proposal to decrease the marriage penalty for families with children.[110]

Complexity and marginal rate issues

Some argue that the replacement of the maintenance of household test with a residency test for purposes of the dependent care credit is a significant simplification. Others respond that taxpayers' compliance burden will not be significantly reduced because the dependency requirement which is retained under the proposal requires the application of a set of rules, including a support test, with a compliance burden similar to that of the maintenance of household test.

The proposal's modifications relating to the phase-out of the credit increase complexity for some taxpayers while reducing complexity for others. By phasing out the dependent care credit over the $30,000 to $60,000 income range, many more families are likely to be in the phase out ranges. For those families, the application of a phase-out is an increase in complexity. In contrast, families with income levels who would be subject to the present-law phase-down range but not the phase out range under the proposal would enjoy a reduction in complexity.

Additionally, the phase-out rate under the proposal is steeper than under present law. Present law has a reduction in the credit rate of 1 percent for each additional $2,000 of AGI in the phase-out range. This proposal would reduce the credit rate by 1 percent for each $1,000 of AGI in the phase-out range. The marginal tax rate implied by the phaseout is thus twice as great as the marginal tax rate under present law. Under present law, a taxpayer with maximum eligible expenses of $4,800 will thus lose $48 in credits for each $2,000 of income in the phase-out range, which is equivalent to a marginal tax rate increase of 2.4 percentage points ($48/$2,000). Under the proposal, marginal tax rates would be increased by 4.8 percentage points ($48/$1,000) for those in the phase-out range. Thus, the dependent care credit could decrease work effort for two reasons. By increasing marginal tax rates for those in the phase-out range, the benefit from working is reduced. Additionally, for most recipients of the credit, after-tax incomes will have been increased, which would enable the taxpayer to consume more of all goods, including

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[109] See Joint Committee on Taxation, *Present Law and Background Relating to Proposals to Reduce the Marriage Tax Penalty* (JCX-1-98), January 27, 1998, p. 10.

[110] Two-earner married couples with children that receive a marriage bonus would also benefit from the dependent care proposal.

leisure. A positive effect on labor supply will exist for those currently not working, for whom the increased credit might be an incentive to decide to work outside of the home.[111]

Prior Action

A substantially similar proposal (not including the proposals to make the basic credit refundable and to create the additional credit for taxpayers with qualifying dependents under the age of one) was included in the President's Fiscal Year 1999 Budget Proposal. Another substantially similar proposal (which included the additional credit for taxpayers with qualifying dependents under the age of one but not the proposal to make the basic credit refundable) was included in the President's Fiscal Year 2000 Budget Proposal. A similar proposal was included in the Taxpayer Refund and Relief Act of 1999 as passed by Congress and vetoed by the President.

3. Provide tax incentives for employer-provided child care facilities

Present Law

Generally, present law does not provide a tax credit to employers for supporting child care or child care resource and referral services.[112] An employer, however, may be able to deduct such expenses as ordinary and necessary business expenses. Alternatively, the taxpayer may be required to capitalize and amortize the expenses over time.

Description of Proposal

Employer tax credit for supporting employee child care

Under the proposal, a tax credit would be provided 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

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[111] For further discussion of the impact of this provision on marginal tax rates and labor supply, see Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98), February 3, 1998.

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

operations. Also, if the facility is owned or operated by the taxpayer, at least 30 percent of the children enrolled in the center (based on an annual average or the enrollment measured at the beginning of each month) must be children of the taxpayer's employees. If a taxpayer opens a new facility, it must meet the 30-percent employee enrollment requirement within two years of commencing operations. If a new facility failed to meet this requirement, the credit would be subject to recapture.

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

Employer tax credit for child care resource and referral services

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

Other rules

The maximum aggregate credits that a taxpayer could receive under the proposal would be $150,000 per year. Any amounts of qualified expenses that would otherwise be deductible would be reduced by the amount of these credits. Similarly, the taxpayer's basis in a facility would be reduced by the amount of the credits for expenses of acquiring, constructing, rehabilitating, or expanding the facility.

Effective date

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

Analysis

It is argued that providing these tax benefits may encourage employers to spend more money on child care services for their employees and that increased quality and quantity of these services will be the result. On the other hand, less desirable results may include a windfall tax benefit to employers who would have engaged in this behavior without provision of these tax benefits, and a competitive disadvantage in the hiring and retaining of workers for nonprofit organizations who cannot take advantage of these new tax benefits.

Opponents of the proposal argue that adding complexity to the tax law can undermine the public's confidence in the fairness of the tax law, and that the country's child care problems and other social policy concerns can be more efficiently addressed through a spending program than through a tax credit. Proponents argue that any additional complexity in the tax law is outweighed by increased fairness. They contend that present law has not taken into account the changing demographics of the American workforce and the need to provide improved child care for the ever increasing numbers of two-earner families.

Prior Action

The proposal was included in the President's Fiscal Year 1999 and 2000 Budget Proposals. Also, the Taxpayer Refund and Relief Act of 1999, as passed by the Senate, included a similar provision. Finally, the Taxpayer Relief Act of 1997, as passed by the Senate, would have provided a temporary tax credit (taxable years 1998 through 2000) equal to 50 percent of an employer's qualified child care expenses for each taxable year. The maximum credit allowable would not have exceeded $150,000 per year.

E. Savings, Retirement Security, and Portability Provisions

1. Retirement Savings Accounts

Present Law

Present law provides favorable tax treatment for a variety of retirement savings vehicles, including employer-sponsored retirement plans and individual retirement arrangements ("IRAs").

Several different types of tax-favored employer-sponsored retirement plans exist, such as section 401(a) qualified plans (including plans with a section 401(k) qualified cash-or-deferred arrangement), section 403(a) qualified annuity plans, section 403(b) annuities, section 408(k) simplified employee pensions ("SEPs"), section 408(p) SIMPLE retirement accounts, and section 457(b) eligible deferred compensation plans. In general, an employer and, in certain cases, employees, contribute to the plan. Taxation of the contributions and earnings thereon is generally deferred until benefits are distributed from the plan to participants or their beneficiaries.[113] Contributions and benefits under tax-favored employer-sponsored retirement plans are subject to specific limitations.

Coverage and nondiscrimination rules also generally apply to tax-favored employer-sponsored retirement plans to ensure that plans do not disproportionately cover higher-paid employees and that benefits provided to moderate- and lower-paid employees are generally proportional to those provided to higher-paid employees.

IRAs include both traditional IRAs and Roth IRAs. In general, an individual makes contributions to an IRA, and investment earnings on those contributions accumulate on a tax-deferred basis. Total annual IRA contributions per individual are limited to $2,000 (or the compensation of the individual or the individual's spouse, if smaller). Contributions to a traditional IRA may be deducted from gross income if an individual's adjusted gross income (AGI) is below certain levels or the individual is not an active participant in certain employer-sponsored retirement plans. Contributions to a Roth IRA are not deductible from gross income, regardless of adjusted gross income. A distribution from a traditional IRA is includible in the individual's gross income except to the extent of individual contributions made on a nondeductible basis. A qualified distribution from a Roth IRA is excludable from gross income.

Taxable distributions made from employer retirement plans and IRAs before the employee or individual has reached age 59-1/2 are subject to a 10-percent additional tax, unless an exception applies.

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[113] In the case of after-tax employee contributions, only earnings are taxed upon withdrawal.

Description of Proposal

The proposal would create Retirement Savings Accounts ("RSAs") that would provide progressive matching contributions with respect to individual contributions made by eligible taxpayers to a 401(k)-type retirement plan or an account held by a financial institution. The matching contribution would supplement any employer matching contributions.

The RSA matching contribution would be provided through employers and financial institutions that choose to participate in the program. A participating employer or financial institution would contribute an amount equal to the applicable RSA matching contribution for each participating individual and would be entitled to claim a nonrefundable tax credit equal to the same amount. Financial institutions would also be entitled to claim a $10 per account tax credit to defray the administrative costs of establishing each new RSA. These credits would be general business tax credits.

Taxpayers would receive notification of eligibility for an RSA matching contribution, including the specific rate of matching contribution for which the taxpayer would qualify. A taxpayer's eligibility would be based on the taxpayer's AGI on the prior year's tax return. The RSA matching contribution would be available for taxpayers with AGI up to $80,000 ($40,000 from 2002 to 2004) on joint returns, $60,000 ($30,000 from 2002 to 2004) on head-of-household returns, and $40,000 ($20,000 from 2002 to 2004) on single returns.

The RSA matching contribution would consist of a basic matching contribution and an additional matching contribution. The basic matching contribution would be as much as 100 percent for up to $1,000 in contributions ($500 from 2002 to 2004) and would phase down to 20 percent for taxpayers with AGI in the following ranges: between $25,000 and $50,000 ($20,000 and $40,000 from 2002 to 2004) for married taxpayers filing a joint return, $18,750 to $37,500 ($15,000 to $30,000 from 2002 to 2004) for taxpayers filing a head-of-household return, and $12,500 to $25,000 ($10,000 to $20,000 from 2002 to 2004) for single taxpayers.

The additional matching contribution would be as much as $100 for the first $100 contributed to the account. The additional match would phase out over the same income ranges as the basic match.

Eligible taxpayers would be those age 25 to 60 who have at least $5,000 in earnings (which may be joint earnings for married taxpayers filing a joint return) and who are not claimed as a dependent by another taxpayer. An otherwise eligible individual without earnings would be eligible if his or her spouse earns at least $5,000. If each spouse filing a joint return satisfies the age requirement, each spouse would be permitted to establish a separate RSA and receive up to the maximum match.

Eligible taxpayers and spouses would participate by making voluntary salary reduction contributions to a 401(k)-type employer plan in which they participate, or cash contributions to an RSA held in a qualifying and participating financial institution. The employer or financial institution would make the matching contribution to the taxpayer's or spouse's RSA upon receipt of verification of the individual's eligibility.

An eligible taxpayer's salary reduction contributions to an employer plan that receives RSA matching contributions would receive the same tax treatment and be subject to the same qualification requirements as any other salary reduction contribution (e.g., excluded from income when made, taken into account in nondiscrimination testing, and subject to the general salary reduction contribution limits). The RSA matching contributions would also be excluded from income when deposited, but would not be taken into account in nondiscrimination testing or for any other qualified plan limits.

An eligible taxpayer would be permitted to deduct the taxpayer's RSA individual contributions to an RSA held by a qualifying and participating financial institution if the taxpayer is eligible for a matching contribution. RSA matching contributions would also be excluded from income when deposited. A taxpayer's RSA individual contributions and matching contributions would offset the taxpayer's $2,000 IRA contribution limit. Like excess IRA contributions, individual RSA contributions in excess of $1,000 ($500 from 2002 to 2004) would be subject to an annual excise tax.

Earnings on contributions would accumulate on a tax-deferred basis and distributions would be taxable. Preretirement withdrawals of limited amounts to be used for the purchase of a first home, a medical emergency, or education expenses, would be permitted after 5 years. Except in the case of death or disability, distribution of all other amounts would be prohibited before the account holder reaches retirement age.

RSAs held by financial institutions would be subject to the prohibited transaction rules, including the prohibition against loans, and the investment restrictions applicable to IRAs. As with employer plan benefits and traditional IRAs, the transfer of RSA amounts upon divorce would not create immediate tax consequences to the transferor, and the transferred interest would be treated as held by the transferee.

To facilitate efficient administration of the RSA program, participation by financial institutions would be limited to Federally insured depository institutions and certain other financial institutions as specified by Treasury regulations. To assist with account administration requirements, an on-line database of eligible taxpayers and spouses and available government matching contributions would be maintained. It is anticipated that the provisions of the Code dealing with confidentiality and disclosure of returns and return information (sec. 6103) would be expanded to permit employers and financial institutions to access this database to determine if plan participants and account holders requesting a government matching contribution are eligible.

Effective date.--The proposal would be effective for taxable years beginning after 2001, with initial eligibility for government matching contributions based on 2001 individual income tax returns.

Analysis

Although the favorable tax treatment of contributions to IRAs and employer-sponsored retirement plans has helped produce expanded retirement-savings opportunities for many individuals, many lower-and moderate-income workers do not benefit from these opportunities. Some statistics indicate that only half of American workers are covered by employer-sponsored retirement plans, and that workers with lower earnings are much less likely than workers with higher earnings to be covered by such plans, to contribute to a 401(k)-type plan offered by employers, or to contribute to an IRA.

Some believe that the reasons for these low levels of participation by lower income workers are that these families, compared to higher-income workers and families (1) tend to have less access to credit and financial markets, (2) must devote a high proportion of their disposable income to necessities such as food, clothing, housing, and medical care, leaving little or no income for retirement saving, (3) are less likely to have experience with financial institutions and their investment products or the benefits of long-term saving on a tax-preferred basis, and (4) are likely to receive little or no tax subsidy on their IRA or pension contributions.

Proponents of the proposal believe that the proposal would address these impediments to savings by lower- and middle-income families by using a substantial government matching contribution to highlight the benefit of saving and, unlike the existing savings incentives provided in the form of deductions and exclusions, providing the greatest tax benefits for those workers with the most modest incomes. Others argue that the proposal would do little to assist lower-income workers, who would continue to be required to choose between paying for necessities and saving for retirement, and would create a new Federal entitlement that would be difficult and expensive to administer.

Prior Action

No prior action.

2. Small business tax credit for qualified retirement plan contributions

Present Law

The timing of an employer's deduction for compensation paid to an employee generally corresponds to the employee's recognition of the compensation. However, an employer that contributes to a qualified retirement plan is entitled to a deduction (within certain limits) for the employer's contribution to the plan on behalf of an employee even though the employee does not recognize income with respect to the contribution until the amount is distributed to the employee.

Description of Proposal

The proposal would provide a nonrefundable income tax credit for small employers equal to 50 percent of certain qualifying employer contributions made to qualified retirement plans on behalf of nonhighly compensated employees. For purposes of the proposal, a small employer would mean an employer with no more than 100 employees who received at least $5,000 of earnings in the preceding year. A nonhighly compensated employee would be defined as an employee who neither (1) was a five-percent owner of the employer at any time during the current year or the preceding year, or (2) for the preceding year, had compensation in excess of $80,000 (indexed for inflation).[114]

The proposal would require a small employer to make nonelective contributions equal to at least one percent of compensation to qualify for the credit. The credit would apply to both qualifying nonelective employer contributions or qualifying employer matching contributions, but only up to a total of three percent of the nonhighly compensated employee's compensation. The credit would be available for 50 percent of qualifying benefit accruals under a nonintegrated defined benefit plan if the benefits are equivalent, as defined in regulations, to a three-percent nonelective contribution to a defined contribution plan.

To qualify for the credit, the nonelective and matching contributions to a defined contribution plan and the benefit accruals under a defined benefit plan would be required to vest at least as rapidly as under either a three-year cliff vesting schedule or a graded schedule that provides 20-percent vesting per year for five years. Amounts contributed to qualified plans other than pension plans would be subject to the same distribution restrictions that apply to qualified nonelective employer contributions to a section 401(k) plan (*i.e.*, distribution only upon separation from service, death, disability, attainment of age 59½, plan termination without a successor plan, or acquisition of a subsidiary or substantially all the assets of a trade or business that employs the participant). Qualifying contributions to pension plans would be subject to the distribution restrictions generally applicable to those plans (*i.e.*, distribution only attainment of normal retirement age, termination of employment, disability, death, or plan termination). However, qualifying contributions to both pension and non pension plans generally would not be distributable upon separation from service or severance from employment within five years after the date of the first contribution to the plan, unless directly transferred to an account with the same distribution restrictions.

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[114] The top paid group election, which under present law permits an employer to classify an employee as a nonhighly compensated employee if the employee had compensation in excess of $80,000 during the preceding year but was not among the top 20 percent of employees of the employer when ranked on the basis of compensation paid to employees during the preceding year, would not be taken into account in determining nonhighly compensated employees for purposes of the proposal.

The plan to which the small employer makes the qualifying contributions (and any plan aggregated with that plan for nondiscrimination testing purposes) would be required to allocate any nonelective employer contributions proportionally to participants' compensation from the employer (or on a flat-dollar basis) and, accordingly, without the use of permitted disparity or cross-testing.

Forfeited nonvested qualifying contributions or accruals for which the credit was claimed generally would result in recapture of the credit at a rate of 35 percent. The Secretary of the Treasury would be authorized to issue administrative guidance, including de minimis rules, to simplify or facilitate claiming and recapturing the credit.

The credit would be a general business credit. The 50 percent of qualifying contributions that are effectively offset by the tax credit would not be deductible; the other 50 percent of the qualifying contributions (and other contributions) would be deductible to the extent permitted under present law.

Effective date.--The credit would be effective for taxable years beginning after December 31, 2001. An employer would not be permitted to claim the credit for more than three taxable years. The credit generally would not be effective for taxable years beginning after December 31, 2009, but an employer that claims the credit for the first time in 2008 or 2009 would be permitted to claim the credit for the remaining one or two taxable years.

Analysis

Small employers may be hesitant or unable to establish a qualified retirement plan that provides nonelective or matching contributions to all employees. Plans that offer only salary reduction contributions often do not benefit many lower- and moderate-income employees. Providing a tax credit for a portion of nonelective contributions and matching contribution may encourage small employers to adopt plans that provide such contributions. On the other hand, it is unclear whether the magnitude of the cost saving provided by the proposed tax credit will provide sufficient additional incentive for small businesses to establish plans. In some cases the credit may be inefficient because it may be claimed by employers who would have established a plan in any event.

Prior Action

No prior action.

3. Small business tax credit for new retirement plan expenses

Present Law

The costs incurred by an employer related to the establishment and maintenance of a retirement plan (*e.g.*, payroll system changes, investment vehicle set-up fees, consulting fees) generally are deductible by the employer as ordinary and necessary expenses in carrying on a trade or business.

Description of Proposal

The proposal would provide a three-year tax credit 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 plan, simplified employee pension ("SEP"), or payroll deduction IRA arrangement. The credit would apply to 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 an employer 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 retirement plan or payroll deduction IRA arrangement during any part of 1998. In order for an employer to be eligible for the credit, the plan would have to cover at least one nonhighly compensated employee. 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 a general business credit. The 50 percent of qualifying expenses that are effectively offset by the tax credit would not be deductible; the other 50 percent of the qualifying expenses (and other expenses) would be deductible to the extent permitted under present law.

Effective date.--The credit would be effective beginning in the year of enactment and would be available only for plans established after 1998 and on or before December 31, 2009. For example, if an eligible employer adopted a plan in the year 2009, the credit would be available for the years 2009, 2010, and 2011.

Analysis

Establishing and maintaining a qualified plan involves employer administrative costs both for initial start-up of the plan and for on-going operation of the plan. These expenses generally are deductible to the employer as a cost of doing business. The cost of these expenses to the employer is reduced by the tax deduction. By reducing costs, providing a tax credit for the costs associated with establishing a retirement plan may promote the adoption of such plans by small businesses. On the other hand, it is unclear whether the magnitude of the cost saving provided by the proposed tax credit will provide sufficient additional incentive for small businesses to establish plans. In some cases the credit may be inefficient because it may be claimed by employers who would have established a plan in any event.

Prior Action

The proposal is similar to proposals contained in the President's Fiscal Year 1999 and 2000 Budget Proposals.

4. Promote Individual Retirement Account contributions through payroll deduction

Present Law

Under present law, an employer may establish a payroll deduction program to help employees save for retirement through individual retirement arrangements ("IRAs"). Under a payroll deduction program, an employee may contribute to an IRA by electing to have the employer withhold amounts from the employee's paycheck and forward them to the employee's IRA. Payroll deduction contributions are included in the employee's wages for the taxable year but the employee may deduct the contributions on the employee's tax return, subject to the normal IRA deduction limits.

The legislative history of the Taxpayer Relief Act of 1997 provides that employers that choose not to sponsor a retirement plan should be encouraged to set up a payroll deduction system to help employees save for retirement by making payroll deduction contributions to their IRAs. The Secretary of Treasury is encouraged to continue his efforts to publicize the availability of these payroll deduction IRAs.

Under present law, an IRA payroll deduction program may be exempt from the provisions of Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), which include reporting and disclosure and fiduciary requirements. In general, ERISA regulations provide an exception from the provisions of Title I of ERISA for an IRA payroll deduction program in which no contributions are made by the employer, participation is completely voluntary for employees, the employer does not endorse any part of the program (but may publicize the program, collect contributions, and remit them), and the employer receives no form of consideration other than reasonable compensation for services actually rendered in connection with payroll deductions. A payroll deduction program may be subject to Title I of ERISA if, for example, an employer makes contributions to the program or an employer receives more than reasonable compensation for services rendered in connection with payroll deductions.

Description of Proposal

Under the 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 employment taxes (FICA and FUTA), and would be reported as a contribution to an IRA on the employee's W-2. If the full amount of the payroll deduction IRA contributions would not have been deductible had the employee contributed directly to an IRA, the employee would be required to include the amount that would not have been deductible in income.

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

Analysis

The proposal is intended to encourage employers to offer payroll deduction programs to their employees and encourage employees to save for retirement. While present law permits such payroll deduction programs, the proposal is designed to make them more attractive (and more widely utilized) by providing employees with a convenient way to obtain the tax benefits for IRA contributions that will eliminate the need for some employees to report IRA contributions on their tax returns.

It is not clear whether the proposal would have the desired effect. Increased IRA participation may not result because there is no change in the economic incentive to make IRA contributions (that is, the proposal would not change the present-law tax benefits of making IRA contributions). On the other hand, by increasing the convenience of making contributions, some taxpayers may participate who would not otherwise participate and more taxpayers may begin to save on a regular basis. Oppositely, some analysts have noted that under present law many IRA contributions are not made until immediately prior to the date the taxpayer files his or her tax return. Such taxpayers may not be motivated by the long-term economic benefits of an IRA, but rather by a short-term desire to affect the immediate consequence of tax filing. The proposal may or may not affect the psychology of such taxpayers.

For the proposal to be effective, employers must create payroll deduction programs. In order to do so, employers may have to revise current payroll systems. Employers may not be willing to incur the costs of establishing and maintaining a payroll deduction program. The proposal does not create a direct economic incentive for employers to incur such costs, although implementation of the proposal to provide a small business tax credit for new retirement plan expenses may provide such an incentive for some employers. On the other hand, if employees find the payroll deduction program attractive and know such payroll options are available elsewhere, employers may find it to their benefit to extend this payroll deduction option to their employees. In addition, some employers may already have the systems capability to make payroll deduction contributions, for example, if the employer has a section 401(k) plan.

The exclusion provided by the proposal may be confusing for some employees who may mistakenly believe they are entitled to the exclusion when they are not because of the IRA deduction income phase-out rules. In addition, some employees could mistakenly claim both the exclusion and the deduction on their return.

Prior Action

The proposal is similar to proposals contained in the President's Fiscal Year 1999 and 2000 Budget Proposals.

5. The "SMART" plan - a simplified pension plan for small business

Present Law

Any employer, including a small employer, may adopt a qualified plan for its employees. In addition, present law contains some special plans designed specifically for small employers. Present law provides for a simplified retirement plan for small business employers called the savings incentive match plan for employees ("SIMPLE") retirement plan. SIMPLE plans are not subject to the nondiscrimination rules applicable to qualified plans (including the top-heavy rules). A SIMPLE plan can be either an individual retirement arrangement ("IRA") for each employee or part of a qualified cash or deferred arrangement ("401(k) plan"). SIMPLE plans can be adopted by employers who employ 100 or fewer employees who received at least $5,000 in compensation and who do not maintain another employer-sponsored retirement plan. Under a SIMPLE retirement plan, employees can elect to make pre-tax deferrals of up to $6,000 per year. In general, employers are required to make either a matching contribution of up to 3 percent of the employee's compensation or a nonelective contribution equal to 2 percent of compensation. In the case of a SIMPLE IRA, the employer can elect a lower matching contribution percentage if certain requirements are satisfied. Employees are 100 percent vested in all contributions made to their accounts. A SIMPLE retirement plan cannot be a defined benefit plan.

Alternatively, small business employers may offer their employees a simplified employee pension ("SEP"). SEPs are employer-sponsored plans under which employer contributions are IRAs established by the 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).

Description of Proposal

In general

The proposal would create a new simplified tax-qualified pension plan for small business employers called the Secure Money Annuity or Retirement Trust ("SMART") Plan. The SMART Plan would combine the features of both a defined benefit plan and a defined contribution plan. As is the case with other qualified retirement 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 not be subject to many of the rules generally applicable to qualified plans, including the nondiscrimination and top-heavy rules.

Employer and employee eligibility and vesting

The SMART Plan could be adopted by an employer who (1) employed 100 or fewer employees who received at least $5,000 in compensation in the prior year, and (2) has not maintained a defined benefit pension plan or money purchase pension plan within the preceding 5 years.

All employees who have completed two years of service with at least $5,000 in compensation would participate in the SMART Plan. An employee's benefit would be 100 percent vested at all times.

Benefits and funding

SMART Plans would provide a fully funded minimum defined benefit. 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, as elected by the employer. For example, if an employee participates for 25 years in a SMART Plan, and the employer had 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. 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. 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).

Each year the employer would be required to contribute an amount to the SMART Plan on behalf of each participant sufficient to provide the annual benefit accrued for that year payable at age 65, using specified actuarial assumptions (including a 5-percent annual interest rate). Funding would be provided either through a SMART Plan individual retirement annuity ("SMART Annuity") or through a trust ("SMART Trust"). 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 make up the shortfall. In addition, 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 for an annuity paying the minimum guaranteed benefit when an employee retires and takes a life annuity. If the investment returns exceed the 5-percent assumption, the employee would be entitled to the larger account balance. SMART Trusts could invest only in readily tradable securities and insurance products regulated by state law.

In the case of a SMART Annuity, each year the 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 plans. An excise tax would apply if the employer failed to make the required contributions for a year.

Distributions

No distributions would be allowed from a SMART Plan prior to the employee's attainment of age 65, except in the event of death or disability, or if the account balance of a terminated employee does not exceed $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 such distribution tax-free to a SMART Annuity, a SMART Account, or a regular IRA.

SMART Plans would be subject to the qualified joint and survivor annuity rules that apply to qualified defined benefit 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 SMART Trust to either a SMART Annuity or a SMART Account.

Distributions from SMART Plans would be subject to tax under the present-law rules applicable to qualified plans. 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 Pension Benefit Guarantee Corporation ("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.

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 contributions and benefits under qualified plans (sec. 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 limitations applicable to the defined benefit plan.

Other rules

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, a 401(k) plan, or a 403(b) tax-sheltered annuity plan under which the only contributions that are permitted are elective contributions and employer contributions that are not greater than those provided for under the design-based safe harbor for 401(k) plans.

Reporting and disclosure.--SMART Plans would be subject to simplified reporting requirements.

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. Employers would not be required to use the IRS 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 adjusted gross income in excess of the applicable thresholds would be phased out of making deductible IRA contributions. This rule 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.

Effective date

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

Analysis

Under present law, small businesses have many options available for providing retirement benefits for their employees, including SIMPLE plans and SEPs not available to larger employers. Nevertheless, retirement plan coverage is lower among smaller employers. There may be a number of reasons for such lower coverage. Some believe the retirement plan coverage for small business employers continues to be inadequate. They argue that the limits on qualified plan benefits are not sufficient to induce owners to establish a plan because the owners will not be able to receive as high a retirement benefit as they would like. Others point out that the limits are high enough to allow significant retirement benefits (the lesser of $135,000 per year or 100 percent of compensation), and that there are other causes for the low small employer plan coverage, such as the administrative burdens and costs, and the unpredictability of funding requirements associated with defined benefit plans that may inhibit small business employers from adopting and maintaining such plans.

The SMART Plan provides another option for small businesses that does not involve many of the administrative burdens of the present-law qualified plan rules. Thus, some small businesses who would not otherwise adopt a plan may adopt a SMART Plan, leading to increased pension coverage. On the other hand, some are concerned that the SMART Plan will primarily benefit the owners of a small business, particularly if the plan is adopted when the owner is nearing retirement age. For example, suppose an owner of a business establishes a SMART Plan when he is age 60. For each of the next 5 years, the contributions under the plan fund a benefit equal to 3 percent of compensation for the year, payable at age 65. Because there are only 5 years to fund the benefit for the owner, the contributions will be significantly larger than for other employees who may have many years until retirement. Thus, the SMART Plan in effect allows employers to weight contributions by age.

The proposal may increase complexity by adding another option for small businesses. Such businesses may explore all available options in an effort to determine which option is most favorable for them.

Prior Action

The proposal is similar to proposals contained in the President's Fiscal Year 1999 and 2000 Budget Proposals.

6. Enhancements to SIMPLE 401(k) plan nonelective contribution alternative

Present Law

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

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

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

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

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

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

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

Description of Proposal

The proposal would make several modifications of the SIMPLE 401(k) plan nonelective contribution alternative.

First, an employer would have the flexibility to make a nonelective contribution equal to up to 15 percent of compensation for all eligible employees. As under present law, the nonelective contribution rate would be uniform for all employees and contributions would be fully vested when made. In addition, these contributions would be subject to the distribution restrictions applicable to employer contributions under the 401(k) safe harbor rules (i.e., distribution only upon separation from service, death, disability, attainment of age 59½, hardship, plan termination without a successor plan, or acquisition of a subsidiary or substantially all the assets of a trade or business the employs the participant).

Second, the employer would be permitted to wait until as late as December 1 of the year for which a contribution is made to determine the level of nonelective contributions for the year. The level of nonelective contributions would be disclosed in the annual notice provided to employees at the end of the year.

Third, the elective contribution limit for nonhighly compensated employees under the nonelective contribution alternative would be conformed to the limit that generally applies to 401(k) plans ($10,500 for 2000) even when employers make no contributions. The elective contribution limit for highly compensated employees under the SIMPLE 401(k) nonelective contribution alternative would depend on the level of nonelective contributions made on behalf of all eligible employees. If an employer chose (by December 1) to make a nonelective contribution equal to 2 percent of compensation on behalf of all eligible employees, then, as under current law, highly compensated employees would be permitted to contribute up to $6,000 (indexed for inflation) in elective contributions to the SIMPLE 401(k) plan. Alternatively, if an employer chose (by December 1) to make a nonelective contribution equal to 1 percent of compensation, highly compensated employees would be permitted to contribute up to $3,000 (indexed for inflation) in elective contributions to the plan. As a further alternative, if an employer chose (by December 1) to make a nonelective contribution equal to 3 percent of compensation (or more), highly compensated employees would be permitted to contribute up to the maximum 401(k) elective contribution limit ($10,500 for 2000). An employer maintaining a SIMPLE 401(k) plan using the nonelective contribution alternative for a year also would have the option to make no nonelective contributions to the plan for a year, in which case highly compensated employees would not be permitted to make elective contributions to the plan for the year.

Finally, elective contributions by nonhighly compensated employees under the SIMPLE 401(k) plan nonelective contribution alternative would not be subject to the percentage-of-pay limit under section 415(c). The deduction limits for contributions to SIMPLE 401(k) plans under section 404 also would be modified to reflect the President's separate proposal relating to the deductibility of elective contributions on behalf of nonhighly compensated employees.

The IRS would be directed to issue model SIMPLE 401(k) plan provisions or a model SIMPLE 401(k) plan document. Vendors and employers would have the option of using their own documents instead of the models.

The proposal would not change the rules applicable to SIMPLE IRA plans or to the SIMPLE 401(k) plan matching contribution alternative, except that the law would be clarified to provide that matching contributions to a SIMPLE 401(k) plan are subject to the same withdrawal restrictions that apply to matching contributions under the section 401(k) safe harbor rules.

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

Analysis

Some statistics indicate that many small employers do not sponsor retirement plans because small businesses tend to have uncertain and fluctuating financial situations that discourage such businesses from making commitments to contribute for a year prior to or soon after the beginning of the year. On the other hand, some small employers that are attracted to the SIMPLE plan as a simplified means of providing 401(k)-type plan coverage may wish to have the flexibility to make nonelective contributions in excess of 2 percent of compensation in more profitable years.

In addition, some argue that while SIMPLE IRA plans provide an important retirement savings alternative for employees of small businesses, small businesses should be encouraged to consider "upgrading" to 401(k) or other qualified plans when they are reasonably able to do so. SIMPLE 401(k) plans, particularly those that offer nonelective contributions, can serve as a useful bridge between SIMPLE IRA plans and 401(k) and other qualified retirement plans.

Some would argue that making the elective contribution limit for highly compensated employees dependent upon the amount of the employer's nonelective contribution would provide an incentive for many employers to make nonelective contributions equal to at least 3 percent of compensation, thereby increasing benefits for nonhighly compensated employees. On the other hand, allowing highly compensated participants in a plan deemed to satisfy the applicable nondiscrimination requirements to contribute up to the maximum 401(k) elective contribution limit in exchange for a nonelective contribution that does not exceed the maximum top-heavy minimum contribution may permit significant contributions by highly compensated employees without comparable participation by rank-and-file employees. This result would be viewed by some as inconsistent with a basic reason for extending favorable tax treatment to employer-provided pension plans.

Although the proposal would provide flexibility for plan sponsors in the design and operation of their plans, the proposal may add additional layers of complexity to an arrangement intended to be a simplified method of providing 401(k)-type plan coverage without increasing retirement savings by rank-and-file employees.

Prior Action

No prior action.

7. Eliminate IRS user fees for initial determination letters for small businesses adopting a qualified retirement plan for the first time

Present Law

An employer that maintains a retirement plan for the benefit of its employees may request from the IRS a determination as to whether the form of the plan satisfies the applicable qualification requirements of section 401(a). In order to obtain from the IRS a determination letter on the qualified status of the plan, the employer must pay a user fee. The user fee may range from $125 to $1,250, depending upon the scope of the request and the type and format of the plan.

Description of Proposal

The proposal would eliminate the IRS user fee for the initial determination letter of one qualified retirement plan maintained by a small business if (1) the employer did not maintain a qualified plan in 1998, (2) the employer had no more than 100 employees who received at least $5,000 of earnings in the preceding year, and (3) the qualified retirement plan covers at least one nonhighly compensated individual. The proposal would apply only to requests by employers for determination letters concerning the qualified retirement plans they maintain. Therefore, a sponsor of a prototype plan would be required to pay a user fee for a request for a notification letter, opinion letter, or similar ruling. A small employer that adopts a prototype plan, however, would not be required to pay a user fee for a determination letter request with respect to the employer's plan.

Effective date.--The proposal would be effective for determination letter requests made after the date of enactment.

Analysis

One of the factors affecting the decision of an employer to adopt a plan is the level of administrative costs associated with the plan. Some believe that reducing administrative costs, such as IRS user fees for determination letters, will help further the establishment of qualified plans by employers. Others argue that because the IRS user fees for determination letters, especially for employers that adopt prototype plans, are relatively insignificant, the proposal will do little to encourage employers to adopt new plans.

Prior Action

A similar proposal was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President, except that under that proposal, a small employer would not be required to pay a user fee for any determination letter request with respect to the qualified status of a retirement plan that the employer maintains if the determination letter request is made during the first five years of the plan.

8. Simplify prohibited transaction provisions for loans to individuals who are S corporation owners or self-employed

Present Law

The Internal Revenue Code prohibits certain transactions ("prohibited transactions") between a qualified plan and a disqualified person in order to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries.[115] Certain types of transactions are exempted from the prohibited transaction rules, including loans from the plan to plan participants, if certain requirements are satisfied. In addition, the Department of Labor can grant an administrative exemption from the prohibited transaction rules if the exemption is administratively feasible, in the interest of the plan and plan participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan. Pursuant to this exemption process, the Secretary of Labor grants exemptions both with respect to specific transactions and classes of transactions.

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

For purposes of the prohibited transaction rules, an owner-employee means (1) a sole proprietor, (2) a partner who owns more than 10 percent of either the capital interest or the profits interest in the partnership, (3) an employee or officer of a Subchapter S corporation who owns more than 5 percent the corporation, and (4) the owner of an individual retirement arrangement ("IRA"). The term owner-employee also includes certain family members of an owner-employee and certain corporations owned by an owner-employee.

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

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

Description of Proposal

The prohibited transaction rules would be modified to permit loans from a qualified retirement plan to participants who are S corporation owners or self-employed persons whose ownership interest is less than 20 percent and by permitting loans that were exempted from the prohibited transaction rules when the company was taxable as a C corporation to continue to be exempted for 24 months after the first day of the first plan year beginning with or within the first tax year the company elects to be an S corporation.

Effective date.--The proposal would be effective for loans first made (including loans refinanced) after December 31, 2000.

Analysis

The prohibited transaction rules protect plan participants and beneficiaries from misdealing by persons close to the plan. In many cases, such transactions would also be violations of general fiduciary responsibilities. However, by identifying certain types of typical transactions that are likely to raise issues of misdealing, the prohibited transaction rules define a specific standard of conduct.

In the case of plans that cover only the owner or owners of a business, the issue is not whether other plan participants may be harmed, but whether the plan is being used for retirement benefits, or to further the individual interests of the owner by providing a means for tax-favored transactions. The prohibited transaction rules help ensure that the owner is not merely using the plan for tax avoidance purposes.

The statutory exemptions to the prohibited transaction rules reflect an understanding that in some cases transactions between a plan and persons close to the plan may be beneficial to plan participants. The administrative exemption process provides further opportunity to demonstrate that an otherwise prohibited transaction will benefit the plan. This process allows the Department of Labor to scrutinize transactions to make sure that the interests of plan participants and beneficiaries are adequately protected. In some cases, the Department of Labor will request that changes be made to a proposed transaction before granting an exemption.

The present-law rules relating to transactions by owner-employees reflect a view that such transactions may raise special questions as to whether they benefit the plan and thus should be reviewed by the Department of Labor before an exemption is granted. Some view the present-law rules as appropriate, because of the particularly close relationship owner-employees have with the plan and the potential for such individuals to misuse plan assets for their own benefit, rather than to provide retirement benefits under the plan. In some cases, the owner-employee may be making the decisions for the plan, as well as for themselves.

Most of the discussion regarding the present-law prohibited transaction rules has focused on the ability to obtain plan loans. Under present law, loans to participants other than owner-employees are permitted if loans are available to all participants on a reasonably equivalent basis, are not made available to highly compensated employees in an amount greater than made available to other employees, are made in accordance with specific provisions in the plan, bear a reasonable rate of interest, and are adequately secured. In addition, the Code places limits on the amount of loans and repayment terms. Some argue that it is appropriate to extend the plan loan exemption to owner-employees, because there are such specific rules regarding plan loans which provide adequate safe guards. Others, including the proponents of the proposal, argue that the historical abuses associated with the use of plan assets by business owners generally involve individuals who are sole owners or who have very substantial ownership control over the business and that the limit on loans to small business owners should be more consistent among the various forms of business and should permit individuals without meaningful control of the business to borrow under the same rules as other employees.

On the other hand, some believe that the present-law rules regarding loans unfairly discriminate against the owners of unincorporated businesses and S corporations. For example, the sole shareholder of a C corporation may take advantage of the statutory exemptions to the prohibited transaction rules for loans. The sole shareholder may also be the only employee of the corporation and the plan trustee, and there may be just as great a possibility for misdealing as with an owner-employee. Some who hold this view argue that the treatment of shareholders of C corporations and unincorporated businesses and S corporation shareholders should be equalized. Others argue that present law should be modified to provide a rule that eliminates the inequities based on form of business, but still denies the statutory cases in appropriate cases. For example, such a rule might take into account whether there are non-owner employees covered by the plan and whether there is an independent plan trustee.

Prior Action

A similar proposal was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President, except that under that proposal, the prohibited transaction rules would be modified to permit loans from a qualified retirement plan to all participants who are S corporation owners or self-employed persons.

9. Provide faster vesting for employer contributions to qualified retirement plans

Present Law

A plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the completion of 5 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent after 4 years of service, 60 percent after 5 years of service, 80 percent after 6 years of service, and 100 percent after 7 years of service.[116] If a plan is a "top-heavy plan", employer contributions either must be fully vested after the participant has completed 3 years of service, or must become vested in increments of 20 percent for each year beginning after 2 years of service, with full vesting after the participant completes 6 years of service.

Description of Proposal

Under the proposal, employer contributions under defined contribution and defined benefit plans would be required to be fully vested after an employee has 3 years of service, or to become vested in increments of 20 percent for each year of service, with full vesting after the employee has completed 5 years of service. Conforming changes would be made to the top heavy rules and Title I of ERISA.

Effective date.--The proposal would be effective for plan years beginning after December 31, 2000, with an (unspecified) extended effective date for plans maintained pursuant to a collective bargaining agreement.

Analysis

The general justification for accelerating the vesting of employer contributions focuses on the mobile nature of today's workforce and the substantial risk that many participants will leave employment before fully vesting in employer contributions. Shortening the vesting period is consistent with encouraging retirement savings, proponents argue.

Opponents may counter that in some cases accelerating the vesting schedule of employer contributions may reduce overall retirement savings by making plans more expensive for some employers. Because contributions that are forfeited are generally used by employers to reduce the contributions of the employer in subsequent years, employers may find that the shorter vesting period increases their plan costs. This could cause employers to eliminate or reduce additional

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

contributions such as matching contributions. Reductions in matching contributions may in turn reduce employee participation in 401(k) plans, because employer matching contributions are a significant feature of plans that for many employees may provide the economic incentive to participate in the plan.

Employers may use vesting schedules that are not immediate to promote longer job attachment from employees that may enable the employer and employee to reap benefits of job specific training the employee may have received when initially employed by the employer. Reducing the time to full vesting may cause the employer to make changes in other forms of compensation to balance any increased costs associated with accelerated vesting.

Prior Action

Similar proposals were included in the President's Fiscal Year 1999 and 2000 Budget Proposals and in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President, except that under those proposals, the faster vesting requirements would have applied only to employer matching contributions.

10. Count FMLA time toward retirement vesting and participation requirements

Present 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 employee 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.

Description of Proposal

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

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

Analysis

Individuals who take FMLA may lose service credit for determining plan eligibility or vesting of benefits. The proposal may increase the opportunity for workers taking leave under the FMLA to become eligible for or vest in retirement benefits.

Counting FMLA service under retirement plans may increase employer costs to the extent that workers vest or become eligible for plan benefits that might not otherwise do so. If the additional costs are significant, then employers may adjust plan benefits or other compensation to take into account the additional costs.

Prior Action

The proposal is similar to a proposal contained in the President's Fiscal Year 2000 Budget Proposal.

11. Increase defined contribution plan percentage of pay limitation

Present Law

Section 415 imposes limits on the contributions that may be made to tax-favored retirement plans. In the case of a tax-qualified defined contribution plan, the limit on annual additions that may be made to the plan on behalf of an employee is the lesser of $30,000 (for 2000) or 25 percent of the employee's compensation. Annual additions include employer contributions, including contributions made at the election of the employee (i.e., employee elective deferrals), after-tax employee contributions, and any forfeitures allocated to the employee. For this purpose, compensation means taxable compensation of the employee, plus elective deferrals, and similar salary reduction contributions.

Description of Proposal

The proposal would increase the maximum allowable annual addition, based on a percentage of pay, for defined contribution plans from 25 percent to 35 percent of compensation.

Effective date.--The proposal would be effective for limitation years beginning after December 31, 2000.

Analysis

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

The limitations applicable to defined contribution plans is an annual limit on the contributions, not on the ultimate benefit payable. From a retirement income policy perspective, the appropriate limit for such contributions may depend on one's views about the appropriate level of retirement earnings, as well as other factors. In addition, many view defined contribution plans as a supplement to more traditional pension plans, such as defined benefit plans, and question whether it is appropriate to allow employers to place a large reliance on defined contribution plans as the main source of retirement benefits.

Others argue that defined contribution plans are being more and more popular and, in some cases, allow individuals, particularly more mobile workers, to accumulate a larger retirement benefit than they could under a typical plan. It is also argued that the compensation limit has the most impact on relatively nonhighly compensated workers, because it is based on a percentage of compensation. In addition, the limitation may in some cases prevent relatively nonhighly compensated individuals to contribute as much as they would like to a section 401(k) plan. The limitation has no effect on very highly compensated individuals (i.e., those with compensation in excess of $120,000).

Proponents of the proposal argue that increasing the limitation from 25 percent to 35 percent would increase the retirement savings opportunities for lower- and moderate-income workers who are most in need of additional retirement savings and have the ability to increase their retirement savings, while continuing to maintain appropriate limits on the percentage of compensation that an employee is permitted to defer on a tax-favored basis. Others argue that any limitation of less than 100 percent of compensation is not an appropriate limit and continues to adversely affect nonhighly compensated workers. Some argue, however, that as a practical matter it is unlikely that an increase in the percentage limitation will actually benefit many nonhighly compensated workers. Many employers provide for contribution levels well below the 25 percent limitation. They also argue that, to the extent the limitation affects employee deferrals under a section 401(k) plan, it is not clear that lower income individuals would actually take advantage of the increased limits, because they have less income from which to save.

To the extent that the increase allows individuals to increase deferrals under a section 401(k) plan, some argue that it is not appropriate to allow individuals to defer 100 percent of compensation. Individuals who will be able to do so will have income from other sources, e.g., another job, retirement income from former employment, or investment earnings.

Prior Action

A similar proposal was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President, except that under that proposal, the maximum allowable annual addition, based on a percentage of pay, for defined contribution plans would have been increased from 25 percent to 100 percent of compensation.

12. Certain elective contributions not taken into account for purposes of deduction limits

Present Law

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

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

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

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

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

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

Description of Proposal

The proposal would increase the 15-percent deduction limit applicable to profit-sharing and stock bonus plans by the amount of contributions on behalf of nonhighly compensated employees participating in the profit-sharing or stock bonus plan that exceed, in the aggregate, 15 percent of compensation otherwise paid or accrued on behalf of those nonhighly compensated employees. The increased deduction limit would be available only if contributions under the plan other than elective deferral contributions of nonhighly compensated employees would be deductible under the 15-percent deduction limit. Elective contributions that are deductible only as a result of this special rule would be disregarded for purposes of determining the amount deductible under the 25-percent limit applicable when an employee participates in both a defined contribution plan and a defined benefit plan.

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

Analysis

The deduction limits for qualified plans attempt to balance tax policy concerns (including revenue issues) with retirement income security concerns. From a tax policy perspective, the deduction limits for contributions to qualified plans generally serve to limit the tax benefits associated with such plans, and help ensure that the plans are actually used to provide retirement benefits, rather than as a tax-saving mechanism for the employer. An employer may have an incentive to make nondeductible contributions to a plan because such contributions receive tax-free buildup on the earnings. The excise tax on nondeductible contributions provides a disincentive to make such contributions.

The deduction limits also reflect retirement policy objectives. The deduction limits for defined contribution plans result in an additional incentive for employers to sponsor nondiscretionary pensions plans by prescribing greater limits for money purchase and defined benefit pension plans than for profit-sharing or stock bonus plans. On the other hand, subjecting elective deferrals to the normally applicable deduction limits may cause employers to restrict the amount of elective contributions an employee may make or to restrict employer contributions to the plan, thereby reducing participants' ultimate retirement benefits and their ability to save adequately for retirement.

Because the proponents of the proposal believe that these restrictions primarily affect the ability of nonhighly compensated participants to save for retirement, the proposal would increase the applicable deduction limit only to the extent that elective deferrals would otherwise exceed the present-law deduction limit on behalf of nonhighly compensated participants. Others would argue for a broader proposal under which all elective deferral contributions would not be subject to the deduction limits and would not be taken into account for purposes of applying the deduction limits to other contributions. Proponents of a broader proposal believe that such special treatment is appropriate because employers do not have discretion regarding employee elective deferrals. Rather, each employee determines how much to contribute by reducing his or her compensation. While an employer may be able to reduce contributions to other plans so that all contributions are deductible, so doing might impair the funding of the other plans or result in reduced plan benefits. Some would argue that the limits placed on plan participants' elective contributions are sufficient from a tax policy perspective to limit tax-favored saving, and that it is inappropriate to limit employer deductions for what constitutes individual savings. It may also be argued that the proposal would create a "floating" deduction limit, thereby increasing uncertainty and complexity in plan administration.

Some argue that any proposal that increases the deductibility of elective deferrals will further encourage the adoption of section 401(k) plans as primary pension plans, which will place a greater burden for retirement saving on employees.

Prior Action

A similar proposal was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President, except that under that proposal, elective deferral contributions would not be subject to the deduction limits, and the application of a deduction limitation to any other employer contribution to a qualified retirement plan would not take into account elective deferral contributions.

13. Conform definition of compensation for purposes of deduction limits

Present Law

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan. Subject to certain exceptions, nondeductible contributions are subject to a 10-percent excise tax.

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

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

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

In the case of an employee stock ownership plan ("ESOP"), principal payments on a loan used to acquire qualifying employer securities are deductible up to 25 percent of compensation.

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

For purposes of the deduction rules, compensation generally includes only taxable compensation, and thus does not include salary reduction amounts, such as elective deferrals under a section 401(k) plan or a tax-sheltered annuity ("section 403(b) annuity"), elective contributions under a deferred compensation plan of a tax-exempt organization or a State or local government ("section 457 plan"), and salary reduction contributions under a section 125 cafeteria plan. For purposes of the contribution limits under section 415, compensation does include such salary reduction amounts.

Description of Proposal

Under the proposal, salary reduction amounts that are treated as compensation for purposes of section 415 would be treated as compensation for purposes of applying the limitations of section 404.

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

Analysis

Compensation unreduced by employee elective contributions is a more appropriate measure of compensation for plan purposes, including deduction limits, than the present-law rule. Applying the same definition for deduction purposes as is generally used for other qualified plan purposes will also simplify application of the qualified plan rules.

Prior Action

A similar proposal was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President.

14. Improve benefits of nonhighly compensated employees under 401(k) safe harbor plans

Present Law

Under present law, special nondiscrimination tests apply to contributions made to 401(k) plans. In general, the actual deferral percentage ("ADP") test applies to the elective contributions of all employees under the plan and the average contribution percentage ("ACP") test applies to employer matching and after-tax employee contributions. 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 more than a specified percentage. The ACP test is similar but it tests the average contribution percentages (i.e., employer matching and after-tax employee contributions) of the highly compensated employees and nonhighly compensated employees.

As an alternative to annual testing under the ADP and ACP tests, the Small Business Job Protection Act of 1996 provides two alternative "design-based" 401(k) safe harbors, effective beginning in 1999. Under the safe harbor, if the employees are provided a specified matching or nonelective contribution, ADP and ACP testing of employee elective contributions and employer matching contributions is not required. Under the matching contribution safe harbor, the employer must make nonelective contributions of at least 3 percent of compensation for each nonhighly compensated employee eligible to participate in the plan. Alternatively, under the other safe harbor, the employer must 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.

Elective contributions under a section 401(k) plan include contributions made pursuant to an "automatic enrollment" arrangement, i.e., an arrangement under which, in any case in which an employee has an effective opportunity to elect to receive cash and does not affirmatively elect to receive cash, the employee's compensation is reduced by a fixed percentage and that amount is contributed on the employee's behalf to the plan.[117]

Description of Proposal

The proposal would modify the matching contribution design-based safe harbor for section 401(k) plans by requiring that, in addition to the matching contribution, the employer either (1) make a nonelective contribution for nonhighly compensated employees equal to 1 percent of compensation, or (2) automatically enroll eligible employees in the plan at a 3-percent of compensation contribution rate. In addition, the proposal would permit an employer to reduce the matching contribution, beginning with matching contributions provided at the highest rate of elective contributions, by the amount of safe harbor nonelective contributions under the plan.

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

Analysis

The special nondiscrimination rules for 401(k) plans are designed to ensure that nonhighly compensated employees, as well as highly compensated employees, actually receive benefits under the plan. The nondiscrimination rules give employers an incentive to make the plan attractive to lower- and middle-income employees (e.g., by providing a match) and to

[117] Rev. Rul. 2000-8, 2000-7 I.R.B. 617.

undertake efforts to enroll such employees, because the greater the participation by such employees, the more highly compensated employees can contribute to the plan.

The design-based safe harbors were designed to achieve the same objectives as the special nondiscrimination rules, but in a simplified manner. The nonelective safe harbor ensures a minimum benefit for employees covered by the plan, and it was believed that the required employer match would be sufficient incentive to induce participation by nonhighly compensated employees. It was also hoped that the design-based safe harbors would reduce the complexities associated with qualified plans, and induce more employers to adopt retirement plans for their employees.

Some are concerned that the safe harbors will not have the intended effect, but instead will result in less participation by rank-and-file employees, in part because employers will no longer have a financial incentive to encourage employees to participate.

Requiring employers who use the section 401(k) matching formula safe harbor to make an additional one percent nonelective contribution for each eligible nonhighly compensated employee, whether or not the employee makes elective contributions to the plan, will provide a minimum benefit for employees covered in the plan and also may encourage more employees to contribute to the plan and help ensure that lower- and middle-income employees receive some benefits. On the other hand, some argue that the purpose of the safe harbor formulas is to encourage more employers to sponsor 401(k) plans by eliminating the costs associated with annual testing. Adding a required employer contribution increases costs to employers and may impede the establishment of retirement plans. Some also believe that it is inappropriate to require a contribution to a 401(k) plan if employees do not make any elective deferrals. Under this view, retirement savings is a shared obligation of the employer and employee.

The ability to provide for automatic enrollment in lieu of a mandatory additional nonelective contribution may make the proposal acceptable to some. In fact, some may argue that automatic enrollment constitutes an effective method of increasing employee participation in 401(k) plans and that employers should be encouraged to include automatic enrollment provisions in their plans. Others would argue that automatic enrollment would provide employers with a very attractive alternative to a required additional contribution and would defeat the purpose of providing a minimum benefit to employees.

Permitting plan sponsors to replace a portion of their safe harbor matching contributions with safe harbor nonelective contributions would afford plan design flexibility and possibly encourage the provision of a minimum benefit to employees through nonelective contributions. On the other hand, the option to reduce the level of required matching contributions would add another layer of complexity to the safe harbor without increasing retirement savings by rank-and-file employees.

Prior Action

The proposal is similar to proposals contained in the President's Fiscal Year 1999 and 2000 Budget Proposals, except the prior proposals did not include the options to automatically enroll eligible employees in the plan at a 3-percent of compensation contribution rate or to reduce the level of required matching contributions.

15. Simplify definition of highly compensated employee

Present Law

Under present law, an employee is treated as highly compensated if the employee (1) was a 5-percent owner of the employer at any time during the year or the preceding year or (2) either (a) had compensation for the preceding year in excess of $80,000 (indexed for inflation) or (b) at the election of the employer had compensation for the preceding year in excess of $80,000 (indexed for inflation) and was in the top 20 percent of employees by compensation for such year.

Description of Proposal

The proposal would eliminate the top-paid group election from the definition of highly compensated employee. Under the new definition, an employee would be treated as a highly compensated employee if the employee (1) was a 5-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).

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

Analysis

The proposal would further simplify the definition of highly compensated employee by eliminating the top-paid group election. Permitting elections that may vary from year to year increases complexity as employers that may benefit from the election may feel it necessary to run tests under both options. In addition, by use of the election, it is possible for employees earning very high compensation (in excess of $80,000) to be treated as nonhighly compensated for testing purposes if the employer has a sufficient percentage of high-paid employees in its workforce (i.e., if employees earning more than $80,000 are in the top paid 20 percent of employees). This would allow some employers to effectively eliminate benefits for low- and moderate-wage workers without violating the nondiscrimination rules. The proposal may help ensure that the simplified definition of highly compensated employee better reflects the purpose of promoting meaningful benefits for low- and moderate-wage workers, not only the high paid. On the other hand, some would argue that the greater flexibility provided to employers under present law is appropriate. Without the flexibility in testing, some employers may reduce plan benefits or choose to terminate plans, reducing aggregate pension coverage and potentially reducing aggregate retirement saving

Prior Action

The proposal is similar to proposals contained in the President's Fiscal Year 1999 and 2000 Budget Proposals.

16. Tax treatment of the division of section 457 plan benefits upon divorce

Present Law

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

Under present law, a distribution from a governmental plan or a church plan is treated as made pursuant to a QDRO if it is made pursuant to a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant. Such distributions are not required to meet the procedural requirements that apply with respect to distributions from qualified plans.

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

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

Description of Proposal

The proposal would extend the taxation rules for qualified plan distributions pursuant to a QDRO to distributions from section 457(b) plans made pursuant to a domestic relations order. In addition, a payment from a section 457(b) plan made pursuant to a QDRO would not be treated as violating the restrictions on distributions from such plans.

Effective date.--The proposal would be effective for payments made after the date of enactment.

Analysis

Many believe that the rules regarding qualified domestic relations orders should apply to all types of employer-sponsored retirement plans. In addition, the proposal may result in simplification of the Federal tax laws by clarifying and standardizing the rules regarding tax treatment of division of retirement benefits upon divorce.

Prior Action

A similar proposal was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President.

17. Require joint and seventy-five percent survivor annuity option for pension plans

Present Law

Defined benefit pension plans and money purchase pension plans are required to provide benefits in the form of a qualified joint and survivor annuity ("QJSA") unless the participant and his or her spouse consent to another form of benefit. A QJSA is an annuity for the life of the participant, with a survivor annuity for the life of the spouse which is not less than 50 percent (and not more than 100 percent) of the amount of the annuity payable during the joint lives of the participant and his or her spouse. In the case of a married participant who dies before the commencement of retirement benefits, the surviving spouse must be provided with a qualified preretirement survivor annuity ("QPSA") which provides the surviving spouse with a benefit that is not less than the benefit that would have been provided under the survivor portion of a QJSA.

Defined contribution plans other than money purchase pension plans are not required to provide a QJSA or QPSA if the participant does not elect an annuity as the form of payment (or the plan does not offer an annuity) and the surviving spouse is the participant's beneficiary (unless the spouse consents to designation of another beneficiary).

The participant and his or her spouse may waive the right to a QJSA and QPSA provided certain requirements are satisfied. In general, these conditions include providing the participant with a written explanation of the terms and conditions of the survivor annuity, the right to make, and the effect of, a waiver of the annuity, the rights of the spouse to waive the survivor annuity, and the right of the participant to revoke the waiver. In addition, the spouse must provide a written consent to the waiver, witnessed by a plan representative or a notary public, which acknowledges the effect of the waiver. Similar waiver and election rules apply to the waiver of the right of the spouse to be the beneficiary under a defined contribution plan that is not required to provide a QJSA.

Description of Proposal

Under the proposal, plans subject to the survivor annuity rules would be required to offer a 75-percent joint and survivor annuity as an option. The definition of a QJSA and QPSA would not be modified. For example, the proposal and the QJSA and QPSA rules would be satisfied if a plan offers a 75-percent joint and survivor annuity as its only annuity option for married participants. Under this example, benefits would be paid as a 75-percent QJSA unless the participant and his or her spouse elect another option. The QPSA would be based on the 75-percent joint and survivor annuity. As another example, the proposal and the QJSA and QPSA rules would also be satisfied if a plan offers a 50-percent QJSA and QPSA and, in addition, allows married participants to elect a 75-percent joint and survivor annuity. Under this example, benefits would be paid in the form of a 50-percent QJSA unless the participant and his or her spouse elect otherwise. The QPSA would be based on the 50-percent joint and survivor annuity.

Effective date.--The proposal would be effective for plan years beginning after December 31, 2000, with an (unspecified) extended effective date for plans maintained pursuant to a collective bargaining agreement.

Analysis

A joint and survivor annuity is generally the actuarial equivalent of an annuity payable over the life of the participant (a single life annuity). Under a joint and survivor annuity, the amount payable during the lifetime of the participant is generally less than the amount that would be paid if the benefit were paid as a single life annuity. Thus, while a joint and survivor annuity offers a survivor benefit, it typically pays a lower benefit during the participant's lifetime. Plans may, but are not required to, provide a fully subsidized joint and survivor annuity that pays the same amount during the participant's lifetime as would have been paid under a single life annuity. Under present law, a plan may provide for a more generous survivor benefit than the 50-percent joint and survivor annuity. In addition, a plan may provide for an optional joint and survivor benefit, e.g., a 50-percent QJSA and a 75-percent or 100-percent joint and survivor annuity option.

The stated rationale for the proposal is that many couples may prefer an option that pays a somewhat smaller benefit to the couple while both are alive but a larger benefit than the present-law 50-percent survivor benefit. It is also argued that a surviving spouse typically 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. Proponents of the proposal argue that the 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.

Some plans may already provide options that satisfy the proposal. Other plans, however, would need to be modified to comply. Some employers may wish to restrict the options offered under the plan in order to minimize administrative costs. If an employer wishes to offer only one joint and survivor annuity option, it would have to provide a 75-percent joint and survivor annuity. Some participants prefer the 50-percent joint and survivor annuity, because they do not wish to receive lower benefits during the participant's lifetime. For such participants, the proposal may have the effect of causing the participant to elect a nonannuity form of benefit (if one is available) or a single life annuity.[118]

Prior Action

The proposal is similar to a proposal contained in the President's Fiscal Year 2000 Budget Proposal.

18. Encourage pension asset preservation by default rollover to IRAs of involuntary distributions

Present Law

If a qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed $5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which a benefit was involuntarily distributed unless the employee repays the benefit.[119]

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

Description of Proposal

The proposal would make a direct rollover the default option for involuntary cashouts that exceed $1,000 and that are eligible rollover distributions from qualified retirement plans, tax-sheltered section 403(b) annuities, or governmental section 457 plans. The distribution would be directly rolled over to an eligible retirement plan, including an IRA, unless the participant affirmatively elects to receive the distribution in cash or, if applicable, property. The recipient

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[118] Present law prohibits plan amendments that eliminate an optional form of benefit with respect to benefits attributable to service before the amendment (sec. 411(d)(6)). The proposal would not modify section 411(d)(6) to permit a plan to eliminate existing forms of joint and survivor annuities when adopting the option required under the proposal.

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

plan or IRA could be designated when the employee is enrolled as a participant in the distributing plan; alternatively, the recipient plan could be designated at termination of employment.

At the election of the plan sponsor, if a participant fails to designate a rollover plan or IRA and does not affirmatively elect to receive the distribution in cash, then involuntary cashout amounts could be retained in the distributing plan or the plan sponsor may designate an institution that will serve as the IRA trustee on behalf of the participant. In either case, the plan administrator would disclose to distributees the plan's choice of a default arrangement for cashout amounts, i.e., retention in the plan or direct rollover to a specified IRA in the participant's name.

Because the assets that are rolled over would constitute plan assets of the distributing plan, the plan sponsor's designation would be subject to ERISA's general fiduciary responsibility provisions (e.g., the requirements that the selection be prudent and solely in the interest of the participant) and the prohibited transaction provisions of ERISA and the Code. A plan sponsor would be permitted to choose an IRA provider that imposes reasonable annual maintenance fees and charges. The Department of Labor would be directed to issue safe harbors under which the designation of an institution and investment of the funds would be deemed to be prudent.

Once assets are rolled over to an IRA, they no longer would be assets of the plan from which they originated, and the plan fiduciary would not have any further responsibility under ERISA with respect to the IRA. Benefits directly rolled over to an IRA designated by the payor would be treated in the same way as any other benefits rolled over to an IRA. For example, the IRA owner could withdraw funds from the IRA at any time, subject to the normal income tax rules, including the additional 10 percent tax on early withdrawals where applicable.

Effective date.--The proposal would apply to distributions made after December 31, 2001, except that the proposal would not apply prior to January 1, 2003, to distributions from plans sponsored by small employers (i.e., employers with no more than 100 employees). In addition, any plan sponsor would be permitted to amend its plan and voluntarily comply with the proposal at an earlier date.

Analysis

Some statistics indicate that retirement plan distributions, particularly involuntary cashouts, often are not rolled over. Failure to make a rollover can significantly reduce the retirement income that would otherwise be accumulated by workers who change jobs frequently. Some believe that rollovers frequently do not occur because employees lack experience with financial institutions and are not familiar with the process of opening an IRA. Others believe that the proposal would do little to promote accumulation of retirement funds because in many cases employees decide to use retirement plan distributions for necessities or luxuries simply because they have access to the funds. It would likely be argued that the proposal would impose on plan sponsors an unfair administrative burden and additional potential fiduciary liability.

Prior Action

No prior action.

19. Rollovers allowed among various types of plans

Present Law

In general

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

Distributions from qualified plans

Under present law, an "eligible rollover distribution" from a tax-qualified employer-sponsored retirement plan may be rolled over tax free to a traditional individual retirement arrangement ("IRA")[120] or another qualified plan.[121] An "eligible rollover distribution" means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan, except the term does not include (1) any distribution which is one of a series of substantially equal periodic payments made (a) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or (b) for a specified period of 10 years or more, (2) any distribution to the extent such distribution is required under the minimum distribution rules, and (3) certain hardship distributions. The maximum amount that can be rolled over is the amount of the distribution includible in income, i.e., after-tax employee contributions cannot be rolled over. Qualified plans are not required to accept rollovers.

Distributions from tax-sheltered annuities

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

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

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

IRA distributions

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

Distributions from section 457 plans

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

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

Rollovers by surviving spouses

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

Direct rollovers and withholding requirements

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

Notice of eligible rollover distribution

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

Taxation of distributions

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

Description of Proposal

The proposal would provide that eligible rollover distributions from qualified plans could be rolled over to another qualified plan, section 403(b) annuity, a governmental section 457 plan, or traditional IRA. Similarly, an eligible rollover distribution from a section 403(b) annuity could be rolled over to another 403(b) annuity, qualified plan, governmental section 457 plan, or traditional IRA. In addition, an eligible rollover distribution from a governmental section 457 plan could be rolled over to another governmental section 457 plan, 403(b) annuity, qualified plan, or traditional IRA.

A special rule would prevent individuals from receiving special capital gains and income averaging treatment available to qualified plan distributions if the individual's account includes any amounts previously held under a section 403(b) annuity or governmental section 457 plan. Benefits under a governmental section 457 plan attributable to a rollover from another type of plan would not be includible in income until paid. A distribution from a governmental section 457 plan of amounts rolled over from another type of plan would be subject to the early withdrawal tax. Governmental section 457 plans would be required to separately account for rollover amounts. In addition, the rules regarding direct rollovers, withholding, and written notification concerning eligible rollover distributions would be extended to distributions from a governmental section 457 plan.

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

Analysis

Some individuals may accumulate retirement savings in more than one different type of tax-favored retirement saving vehicle. Allowing rollovers between different types of plans will allow individuals to combine their retirement savings in one vehicle. The ability to combine savings may be administratively easier for individuals, and may also affect investment choices and returns.

In general, the rationale for not permitting rollovers among qualified plans, section 403(b) annuities, and governmental section 457 plans has been that benefits under such plans are taxed differently. The key differences are the application of the additional tax on early withdrawals and the special rules providing capital gains and income averaging treatment for certain qualified retirement plan distributions. These special rules providing capital gains and income averaging treatment have been repealed so that, after the expiration of certain transition rules, these differences in tax treatment between qualified plans and section 403(b) annuities will no longer remain. Furthermore, many believe that it is appropriate to extend the same rollover rules to governmental section 457 plans; like qualified plans, such plans are required to hold plan assets in trust for employees.

The proposal addresses the current differences in tax treatment by requiring that governmental section 457 plans separately account for rollover amounts subject to the early withdrawal tax and by providing that the special rules providing capital gains and income averaging treatment will not apply to section 403(b) annuity and governmental section 457 plan amounts. In order to preserve the availability of averaging or capital gains treatment, it may be necessary for individuals to separately keep track of amounts attributable to section 403(b) annuities and governmental section 457 plans. Individuals may make mistakes, which can result in claiming averaging or capital gains treatment when the individual is not eligible to do so, or in losing the ability to claim such treatment when it is available.

Prior Action

The proposal is similar to proposals contained in the President's Fiscal Year 1999 and 2000 Budget Proposals, except that under those proposals, the rollover rules would not have been extended to governmental section 457 plans. A similar proposal also was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President.

20. Rollovers of after-tax contributions

Present Law

Under present law, a qualified plan may permit individuals to make after-tax contributions to the plan. Present law provides that the maximum amount that can be rolled over to another qualified plan or an IRA is the amount of the distribution that is taxable. That is, employee after-tax contributions cannot be rolled over to another retirement plan or an IRA.

Description of Proposal

The proposal would provide that employee after-tax contributions could be rolled over to another qualified retirement plan or a traditional IRA, provided that the plan or IRA provider agrees to track and report the after-tax portion of the rollover for the individual.[122]

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

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[122] Under the proposal, it is not clear what tax consequences result when an individual rolls over some, but not all, of a distribution that consists of both taxable and nontaxable amounts. Ordering rules are necessary to determine which amounts are considered to be rolled over. A number of rules are possible. For example, the individual could be permitted to designate which amounts are treated as being rolled over. Under such a rule, the individual could roll over all taxable amounts, and retain the nontaxable amounts. This would allow an individual to in effect withdraw after-tax contributions from a plan, as occurs under present law. Under another possible rule, the individual could be deemed to roll over taxable amounts first. This would generally have the same effect as the first rule, assuming that taxpayers would generally wish to retain the nontaxable portion of the distribution in order to avoid paying tax currently. Under another possible rule, a pro rata rule could be applied. That is, the amount rolled over could consist in part of taxable amounts and in part of nontaxable amounts. This rule is more consistent with the present-law rules regarding taxation of distributions, which generally apply a pro rata rule. On the other hand, some individuals may not want to roll over their own contributions. Resolution of this issue is relevant not only in determining the tax consequences to the individual, but also could affect the plan's withholding obligations.

Under present law, distributions that can be rolled over are subject to 20 percent withholding unless the distribution is directly rolled over into another qualified plan or IRA. This rule is intended to encourage direct rollovers. The proposal does not indicate whether this rule would apply to distributions of after-tax employee contributions.

Analysis

The proposal may help individuals to save for retirement. By increasing the opportunities to retain after-tax contributions in a tax-favored vehicle, it may help increase retirement security.

The primary rationale for not permitting after-tax contributions to be rolled over has generally been that the record keeping involved is too complex. An individual who rolls over such contributions will need to keep accurate records in order to determine the taxable amount of any subsequent distribution from the IRA or plan. Maintaining such records may be difficult, because they may have to be kept for a long time. In addition, keeping track of the after-tax contributions may be more difficult if new contributions are made to the plan or IRA or amounts are subsequently transferred to another IRA or plan. The proposal addresses this issue by placing the burden of keeping track of such amounts on the financial institution offering the IRA or the plan. However, financial institutions and plans may not want or may not be able to fulfill the responsibility of keeping track of such contributions. It is unclear how many plans will not accept such contributions because they do not want the record keeping burdens. Others argue that the individual who rolls over after-tax contributions, not the financial institution or plan, should be responsible for keeping track of such contributions using forms that IRS should develop. Such forms could, for example, expand Form 8606-Nondeductible IRAs, to include information regarding after-tax contributions.

Prior Action

The proposal is similar to a proposal contained in the President's Fiscal Year 2000 Budget Proposal. A similar proposal was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President, except that under that proposal, the responsibility for keeping track of after-tax contributions would be imposed on the individual who makes the rollover rather than the financial institution offering the IRA or the plan.

21. Rollovers of regular IRAs into workplace retirement plans

Present Law

In general, amounts in an individual retirement arrangement ("IRA") may not be rolled over into a tax-qualified retirement plan, a section 403(b) tax-sheltered annuity, or a governmental section 457 plan.[123]

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[123] An exception to this rule applies in the case of a "conduit IRA." Under the conduit IRA rule, amounts can be rolled from a qualified retirement plan into a traditional IRA and then subsequently rolled back to another qualified plan if the amounts in the IRA are attributable solely to rollovers from qualified retirement plans. A similar rule applies to conduit IRAs with respect to section 403(b) annuities.

Description of Proposal

An individual who has a traditional IRA and whose IRA contributions have all been tax deductible would be offered the opportunity to transfer funds from the traditional IRA into a qualified defined contribution retirement plan, section 403(b) tax-sheltered annuity or governmental section 457 plan -- provided that the retirement plan trustee meets the same standards as an IRA trustee.[124] A special rule would prevent individuals from receiving special capital gains and income averaging treatment available to qualified plan distributions if the individual's account includes any amounts previously held under a section 403(b) annuity or governmental section 457 plan. In addition, amounts distributed from a governmental section 457 plan would be subject to the early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from a traditional IRA. Governmental section 457 plans would be required to separately account for such amounts.

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

Analysis

Like the proposal relating to rollovers among various types of plans, allowing rollovers from IRAs into qualified plans, section 403(b) annuities, or governmental section 457 plans will allow individuals to combine their retirement savings in one vehicle. The ability to combine savings may be administratively easier for individuals, and may also affect investment choices and returns.

Prior Action

The proposal is similar to a proposal contained in the President's Fiscal Year 1999 Budget Proposal, except that under that proposal, rollovers to governmental section 457 plans would not be allowed. A similar proposal was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President.

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[124] Under present law, an IRA trustee must either be a bank or another person who demonstrates to the satisfaction of the Secretary that such other person will administer the trust in a manner consistent with the IRA rules. Persons wishing to be IRA trustees must make application to the Secretary. Among other things, the applicant must demonstrate in detail its ability to act within the accepted rules of fiduciary conduct, its experience and competence with respect to accounting for the interests of a large number of individuals, and its experience and competence with respect to other activities normally associated with the handling of retirement funds.

22. Facilitate the purchase of service credits in governmental defined benefit plans

Present Law

Under present law, limits are imposed on the contributions and benefits under qualified pension plans (Code sec. 415). In the case of a defined contribution plan, the limit on annual additions is the lesser of $30,000 (for 2000) or 25 percent of compensation. Annual additions include employer contributions, as well as after-tax employee contributions. In the case of a defined benefit pension plan, the limit on the annual retirement benefit is the lesser of (1) 100 percent of compensation or (2) $135,000 (for 2000). The 100 percent of compensation limitation does not apply in the case of State and local governmental pension plans.

Present law provides special rules with respect to contributions by a participant in a State or local governmental plan to purchase permissive service credits under a governmental defined benefit plan. Such contributions are subject to one of two limits. Either (1) the accrued benefit derived from all contributions to purchase permissive service credit must be taken into account in determining whether the defined benefit pension plan limit is satisfied, or (2) all such contributions must be taken into account in determining whether the $30,000 limit on annual additions is met for the year (taking into account any other annual additions of the participant). These limits may be applied on a participant-by-participant basis. That is, contributions to purchase permissive service credits by all participants in the same plan do not have to satisfy the same limit.

Permissive service credit means credit for a period of service recognized by the governmental plan only if the employee voluntarily contributes to the plan an amount (as determined by the plan) which does not exceed the amount necessary to fund the benefit attributable to the period of service and which is in addition to the regular employee contributions, if any, under the plan. Section 415 is violated if more than 5 years of permissive service credit is purchased for "nonqualified service". In addition, section 415 is violated if nonqualified service is taken into account for an employee who has less than 5 years of participation under the plan. Nonqualified service is service other than service (1) as a Federal, State, or local government employee, (2) as an employee of an association representing Federal, State or local government employees, (3) as an employee of an educational institution which provides elementary or secondary education, or (4) for military service. Service under (1), (2) or (3) is not qualified if it enables a participant to receive a retirement benefit for the same service under more than one plan.

Under present law, benefits in a section 403(b) tax-sheltered annuity or under a governmental section 457 plan cannot be rolled over or transferred in a tax-free transfer to a governmental defined benefit plan.

Benefits under section 403(b) annuities and section 457 plans are subject to certain distribution restrictions. Benefits under a section 403(b) annuity cannot be distributed prior to age 59-1/2, separation from service, hardship, death or disability. Benefits under a section 457 plan cannot be distributed prior to the earliest of age 70-1/2, hardship, or separation from service.

Description of Proposal

Governmental employees would be able to transfer funds from a section 403(b) plan or a section 457 plan in a tax-free transfer in order to purchase permissive service credits under a governmental defined benefit plan or to repay contributions and earnings with respect to an amount previously refunded under a forfeiture of service credit under the plan (or another plan maintained by a State or local government employer within the same State). A transfer could be made even if the individual could not take a distribution from the transferee plan. Transferred funds would be subject to the present-law rules regarding permissive service credit.

Effective date.--The proposal would be effective with respect to transfers made after December 31, 2000.

Analysis

Permitting tax-free transfers as under the proposal will make it easier for State and local government employees to purchase permissive service credit, thereby allowing such employees to increase their retirement benefits. Some question whether it is appropriate to provide such special rules only for employers of certain types of entities.

Prior Action

Similar proposals were included in the President's Fiscal Year 2000 Budget Proposal and in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President.

23. Thrift Savings Plan portability proposals

Present Law

The Thrift Savings Plan ("TSP") is a retirement savings and investment plan for Federal and Postal employees. It offers employees the same type of before-tax savings and tax-deferred investment earnings that many private corporations offer their employees under section 401(k) plans.

A newly-hired Federal employee is first allowed to contribute to the FERS Thrift Savings Plan (TSP) in the second semi-annual election period -- six to twelve months after being hired. Rehired employees become eligible in the first election period following their rehire and thus wait up to six months. When an employee becomes eligible to participate in the TSP, the employing agency will automatically contribute 1 percent of pay to the employee's account. If the employee contributes, the agency makes certain matching contributions. Employee contributions to the TSP are limited to salary reduction amounts, precluding rollover contributions from a qualified trust.

Description of Proposal

All waiting periods for employee elective contributions and agency contributions to the TSP would be eliminated for new hires and rehires. In addition, an employee would be allowed to roll over an "eligible rollover distribution" from a qualified trust sponsored by a previous employer to the employee's TSP account.

Effective date.--The proposal would be effective after December 31, 2000.

Analysis

New and rehired Federal employees should be provided the same retirement savings opportunities as current employees. Eliminating waiting periods for employee contributions would reduce gaps in savings opportunities for new and rehired Federal employees. Eliminating waiting periods for agency matching and automatic contributions would increase retirement savings and enhance employees' incentives to contribute.

Allowing tax-free rollovers to the TSP from qualified trusts sponsored by previous employers would make it easier for TSP participants to consolidate their retirement savings. Changing these rules would conform TSP practices to those followed by many private employer plans.

Prior Action

A similar proposal was included in H.R. 208, a bill to amend Title 5, United States Code, to allow for the contribution of certain rollover distributions to accounts in the Thrift Savings Plan, to eliminate certain waiting-period requirements for participating in the Thrift Savings Plan, and for other purposes, as passed by the House of Representatives on April 20, 1999.

24. Permit accelerated funding of defined benefit plans

Present Law

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

No contribution is required under the minimum funding rules in excess of the full funding limit. The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 155 percent of the plan’s current liability, over (2) the value of the plan's assets (sec. 412(c)(7)).[125] In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits. The current liability full funding limit is scheduled to increase as follows: 160 percent for plan years beginning in 2001 or 2002, 165 percent for plan years beginning in 2003 and 2004, and 170 percent for plan years beginning in 2005 and thereafter.[126] In no event is a plan's full funding limit less than 90 percent of the plan's current liability over the value of the plan's assets.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Under a special rule, an employer that sponsors a defined benefit pension plan (other than a multiemployer plan) which has more than 100 participants for the plan year may deduct amounts contributed of up to 100 percent of the plan's unfunded current liability. In addition, in the case of a single employer plan terminating under a standard termination, contributions are currently deductible up to the level of the benefits guaranteed by the PBGC under Title IV of ERISA.

Description of Proposal

The full funding limitation based on current liability would be phased up more quickly than under present law, so that it would be 170 percent of current liability for years beginning after December 31, 2002. In addition, the 10 percent excise tax on nondeductible contributions would not apply to the extent a contribution is nondeductible solely as a result of the current liability full funding limit.

Finally, the special deduction rule for terminating plans under section 404(g) would be modified so that all contributions needed to satisfy the plan's liabilities upon plan termination would be immediately deductible. In the case of a plan with fewer than 100 participants, liabilities attributable to recent benefit increases for highly compensated employees would be disregarded for this purpose.

Conforming changes would be made to Title I of ERISA.

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

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

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

Analysis

The deduction limits for qualified plans attempt to balance tax policy concerns (including revenue issues) with retirement income security concerns. From a tax policy perspective, the deduction limits for contributions to qualified plans generally serve to limit the tax benefits associated with such plans, and help ensure that the plans are actually used to provide retirement benefits, rather than as a tax-saving mechanism for the employer. An employer may have an incentive to make nondeductible contributions to a plan because such contributions receive tax-free buildup on the earnings. The excise tax on nondeductible contributions provides a disincentive to make such contributions.

The deduction limits also reflect retirement policy objectives. Thus, the minimum funding cost of a defined benefit plan and the amount necessary to fully fund a defined benefit plan (i.e., eliminate unfunded current liabilities) are always deductible. Exceptions to the nondeductible excise tax ensure that, even though certain contributions are not deductible, the employer is not penalized for making such contributions.

Some employers are concerned that the current liability full funding limit may put their employees at risk by forcing funding to be deferred into the future. Permitting an employer to contribute amounts which are currently nondeductible as a result of the current liability full funding limit, without applying the excise tax on nondeductible contributions, may provide more security for employees while restricting employers' ability to use excessive pension funding as a tax shelter.

Prior Action

A similar proposal was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President, except that under that proposal, the current liability full funding limit would be repealed for plan years beginning in 2004 and thereafter, and up to 100 percent of a plan's unfunded termination liability, determined as if the plan terminated at the end of the plan year, would be deductible.

25. Benefit limits for multiemployer plans under section 415

Present Law

In general, under present law, annual benefits under a defined benefit pension plan are limited to the lesser of $135,000 (for 2000) or 100 percent of average compensation for the 3 highest years. Reductions in these limits are generally required if the employee has fewer than 10 years of service or plan participation. If benefits under a defined benefit plan begin before social security retirement age, the dollar limit must be actuarially reduced to compensate for the early commencement. A special rule applies to defined benefit plans maintained by governmental or tax-exempt employers and qualified merchant marine plans. In the case of such plans, the dollar limit is reduced in the case of retirement before age 62 and increased in the case of retirement after age 65. In addition, there is a floor on early retirement benefits. Pursuant to this floor, the minimum benefit payable at age 55 is $75,000.

For purposes of section 415, all plans maintained by an employer and related entities are combined, except that a multiemployer plan may disregard benefits provided by the same employer through other multiemployer plans. Thus, aggregation of benefits within a multiemployer plan that are attributable to service with a specific employer and a single-employer plan maintained by the same or a related employer is required.

Description of Proposal

Under the proposal, the 100-percent-of-compensation limit on defined benefit plan benefits would not apply to multiemployer plans. Also, the rule requiring aggregation of benefits provided from a single employer for purposes of section 415 would be modified to eliminate aggregation between a multiemployer defined benefit plan and a single employer defined benefit plan for purposes of the 100-percent-of-compensation limit. In addition, the special early retirement rules that apply under present law to defined benefit plans sponsored by governmental or tax-exempt employers and qualified merchant marine plans would apply to multiemployer plans.

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

Analysis

The limits on benefits under qualified plans were designed to limit the tax benefits and revenue loss associated with such plans, while still ensuring that adequate retirement benefits could be provided. The 100-percent-of-compensation limitation reflects Congressional judgment that a replacement rate of 100-percent-of-compensation is an adequate retirement benefit.

The stated rationale for the proposal is that the qualified plan limitations present significant administrative problems for many multiemployer plans which base benefits on years of credited service rather than compensation. In addition, it is argued that, because pension benefits under multiemployer plans are typically based upon factors other than compensation, the 100-percent of compensation rule produces an artificially low limit for employees in certain industries, such as building and construction, where wages vary significantly from year to year. Furthermore, some argue that multiemployer plans should be permitted to provide for higher early retirement benefits because participants in such plans often need to retire early due to the physical stress of the work they perform.

Others argue that the limits on benefits under qualified plans create administrative problems for all plan sponsors, and that these problems are no greater for multiemployer plans than for any other plan. In addition, it is argued that there is no justification for higher benefit limitations, including higher early retirement benefits, for multiemployer plans, as persons affected by these limits are not all participants in multiemployer plans. Providing a special rule for such plans would merely create inequities among plan participants based upon the type of plan in which they are a participant. For example, many individuals work in industries where wages may vary significantly from year to year, but not all of those employees are participants in multiemployer plans. To the extent that the qualified plan limits are deemed to inappropriately reduce benefits in such (or similar) cases, it is argued that it would be more equitable to provide an across the board rule that is not based upon the type of plan. If it is believed that a 100-percent of compensation limitation or an early retirement reduction is not appropriate, it is not clear why only participants in multiemployer plans should receive the benefit of a higher limit.

Prior Action

Similar proposals were included in the Taxpayer Relief Act of 1997, as passed by the Senate. Similar proposals were also included in the Administration's 1995 Pension Simplification Proposal,[127] in the Small Business Job Protection Act of 1996 as passed by the Senate, and in the President's Fiscal Year 1999 and 2000 Budget Proposals, except that those proposals would not eliminate the aggregation of benefits between multiemployer and other plans or extend to multiemployer plans the special rules regarding early retirement benefits.

26. Full funding limit for multiemployer plans

Present Law

Under present law, employer deductions for contributions to a defined benefit pension plan cannot exceed the full funding limit. In general, the full funding limit is the lesser of a plan's accrued liability and 155-percent of current liability. The 155-percent of current liability limit is scheduled to increase gradually, until it is 170 percent in 2005 and thereafter.

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

Description of Proposal

Under the proposal, the current liability full funding limit would not apply to multiemployer plans. In addition, such plans would be required to have an actuarial valuation at least once every three years. Changes would be made to the corresponding provisions of title I of the Employee Retirement Income Security Act of 1974, as amended.

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

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[127] See Department of the Treasury, Department of Labor, *General Explanation of the Administration's Pension Simplification Proposal*, September 1995.

Analysis

The current liability full funding limit was enacted as a balance between differing policy objectives. On one hand is the concern that defined benefit pension plans should be funded so as to provide adequate benefit security for plan participants. On the other hand is the concern that employers should not be entitled to make excessive contributions to a defined benefit pension plan to fund liabilities that it has not yet incurred. Such use of a defined benefit plan was believed to be equivalent to a tax-free savings account for future liabilities, and inconsistent generally with the treatment of unaccrued liabilities under the Internal Revenue Code. The current liability full funding limit as initially enacted was 150 percent of current liability. It was increased to the present-law level by the Taxpayer Relief Act of 1997 because the Congress believed that the 150-percent limit unduly restricted funding of defined benefit pension plans.

Proponents of the proposal argue that employers have no incentive to make excess contributions to a multiemployer plan, because the amount an employer contributes to the plan is set by a collective bargaining agreement and a particular employer's contributions are not set aside to pay benefits solely to the employees of that employer.

Others would argue that it is inappropriate to provide special rules based on the type of plan. While many multiemployer plans restrict the ability of the employer to obtain reversions of excess plan assets on termination of the plan, not all do, so that an employer may still have an incentive to fund unincurred liabilities in order to obtain tax benefits. Also, many plans that are not multiemployer plans restrict the ability of employers to obtain excess assets, limiting any incentive to make excess contributions.

Prior Action

Similar proposals were included in the Administration's 1995 Pension Simplification Proposal[128] and in the President's Fiscal Year 1999 and 2000 Budget Proposals.

27. Increase disclosure for pension amendments that reduce the future rate of benefit accrual

Present Law

Section 204(h) of Title I of ERISA provides that a defined benefit pension plan or a money purchase pension plan may not be amended so as to provide for a significant reduction in the rate of future benefit accrual, unless, after adoption of the plan amendment and not less than 15 days before the effective date of the plan amendment, the plan administrator provides a written notice (“section 204(h) notice”), setting forth the plan amendment (or a summary of the amendment written in a manner calculated to be understood by the average plan participant) and

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[128] *Ibid.*

its effective date. The plan administrator must provide the section 204(h) notice to each plan participant, each alternate payee under an applicable qualified domestic relations order ("QDRO"), and each employee organization representing participants in the plan. The applicable Treasury regulations provide, however, that a plan administrator need not provide the section 204(h) notice to any participant or alternate payee whose rate of future benefit accrual is reasonably expected not to be reduced by the amendment, nor to an employee organization that does not represent a participant to whom the section 204(h) notice must be provided. In addition, the regulations provide that the rate of future benefit accrual is determined without regard to optional forms of benefit, early retirement benefits, retirement-type subsidiaries, ancillary benefits, and certain other rights and features.

A covered amendment generally will not become effective with respect to any participants and alternate payees whose rate of future benefit accrual is reasonably expected to be reduced by the amendment but who do not receive a section 204(h) notice. An amendment will become effective with respect to all participants and alternate payees to whom the section 204(h) notice was required to be provided if the plan administrator (1) has made a good faith effort to comply with the section 204(h) notice requirements, (2) has provided a section 204(h) notice to each employee organization that represents any participant to whom a section 204(h) notice was required to be provided, (3) has failed to provide a section 204(h) notice to no more than a de minimis percentage of participants and alternate payees to whom a section 204(h) notice was required to be provided, and (4) promptly upon discovering the oversight, provides a section 204(h) notice to each omitted participant and alternate payee.

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

Description of Proposal

The proposal would require that the notice of a significant reduction of the rate of future benefit accrual summarize the important terms of the plan amendment, including identification of the effective date, a statement that the amendment is expected to significantly reduce the rate of future benefit accrual, a general description of how the amendment significantly reduces the rate of future benefit accrual, and a description of the class or classes of participants to whom the amendment applies. Participants would receive the notice at least 45 days before the effective date of the plan amendment.

For a plan with 100 or more active participants, the plan administrator would also be required to provide affected participants an enhanced advance notice of the amendment that describes, and illustrates using specific examples, the impact of the amendment on representative affected participants, to make available the formulas and factors used in those examples in order to permit similar calculations to be made, and to make available a follow-up individualized benefit statement estimating the participant's projected retirement benefits. Certain amendments, such as amendments that do not make a fundamental change in a plan's formula, could be to the extent provided by Treasury regulations.

In the case of an egregious failure to comply with the notice requirements (for example, a failure to provide the required information to most affected participants or an intentional failure to provide notice to any affected participant), the amendment would be prohibited from going into effect for all affected participants, and the employer would be subject to excise taxes. In the case of a failure that is not an egregious failure, the employer would be subject to excise taxes (which could be waived in certain cases), but the amendment would be permitted to take effect, provided the notice is promptly furnished to the affected participants who did not previously receive it.

Effective date.--The proposal would be effective for plan amendments taking effect after the date of enactment, with special transition rules in certain circumstances.

Analysis

Significant publicity has been given recently to conversions of traditional defined benefit pension plans to "cash balance" plans, with particular focus on the impact such conversions have on affected workers. Many believe that the limited notice requirement under present law does not provide pension plan participants with clear, adequate, and timely information about pension plan amendments that may result in reductions of future benefit accruals and therefore hinders the ability of participants to plan for retirement. Proponents of the proposal argue that participants cannot understand certain types of plan amendments without (1) a notice that includes examples showing how the change affects future benefits for illustrative participants, (2) the ability to obtain plan documents in order to do their own calculations regarding future pension benefits, and (3) the ability to obtain individualized projections of the effect of the change on their own future pensions.

Some are concerned that the proposal fails to strike a balance between providing meaningful disclosure and avoiding the imposition of unnecessary administrative burdens on employers. Others are concerned that the proposal would not adequately protect the interests of plan participants, and therefore support proposals that would require employers to permit affected participants to choose between pre-amendment and post-amendment benefit formulas, require employers to take measures to mitigate the impact of amendments on future benefit accrual, or restrict the ability of employers to amend plans.

Prior Action

A similar proposal was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President, except that under that proposal, an employer that amends a pension plan with 100 or more participants to provide for a significant reduction in the rate of future benefit accrual generally would be subject to an excise tax for failure to provide within a reasonable time before the effective date of the amendment (except as provided in Treasury regulations) a notice written in a manner calculated to be understood by the average plan participant and providing sufficient information (as determined in accordance with Treasury regulations) to allow participants to understand the effect of the plan amendment.

F. Individual Alternative Minimum Tax Provisions and Simplification Provisions

1. Alternative minimum tax ("AMT") relief for individuals

Present Law

In general

Present law imposes a minimum tax ("AMT") on an individual to the extent the taxpayer's minimum tax liability exceeds his or her regular tax liability. The AMT is imposed on individuals at rates of (1) 26 percent on the first $175,000 of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent on the remaining AMTI. The exemption amounts are $45,000 in the case of married individuals filing a joint return and surviving spouses; $33,750 in the case of other unmarried individuals; and $22,500 in the case of married individuals filing a separate return. These exemption amounts are phased out by an amount equal to 25 percent of the amount that the individual's AMTI exceeds a threshold amount. These threshold amounts are $150,000 in the case of married individuals filing a joint return and surviving spouses; $112,500 in the case of other unmarried individuals; and $75,000 in the case of married individuals filing a separate return, estates, and trusts. The exemption amounts, the threshold phase-out amounts, and the $175,000 break-point amount are not indexed for inflation. The lower capital gains rates applicable to the regular tax apply for purposes of the AMT.

AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

Preference items in computing AMTI

The minimum tax preference items are:

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

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

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

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

(5) Forty-two percent of the amount excluded from income under section 1202 (relating to gains on the sale of certain small business stock).

In addition, losses from any tax shelter, farm, or passive activities are denied.[129]

Adjustments in computing AMTI

The adjustments that individuals must make in computing AMTI are:

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

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

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

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

(5) Miscellaneous itemized deductions are not allowed.

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

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

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

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

(9) The amount allowable as a deduction for circulation expenditures must be capitalized and amortized over a 3-year period.

(10) The amount allowable as a deduction for research and experimental expenditures must be capitalized and amortized over a 10-year period.[130]

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

<u>Other rules</u>

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

The various nonrefundable credits of the Code generally are allowed only to the extent that the individual's regular tax exceeds the tentative minimum tax, except that for taxable years beginning before 2002, the personal nonrefundable credits are allowed against both the regular tax and the AMT. Because the earned income credit and the additional child credit for those taxpayers with three or more qualified children are refundable credits, these credits may offset the taxpayer's AMT; however, a taxpayer must reduce these refundable credits by the amount of taxpayer's AMT.[131]

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

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

[131] For taxable years beginning before January 1, 2002, the additional child credit is not reduced by the AMT.

Description of Proposal

The proposal would allow the standard deduction and the deduction for personal exemptions for dependents (but not the taxpayer and spouse) in computing AMTI. The standard deduction would be allowed for taxable years beginning in 2000 and 2001. The deduction for personal exemptions would be allowed for taxable years beginning after 1999, except that no deduction would be allowed for two dependents in taxable years beginning before 2008, and no deduction would be allowed for one dependent in taxable years beginning in 2008 and 2009.

Effective date.--Subject to the phase in rules discussed above, the proposal would be effective for taxable years beginning after December 31, 1999.

Analysis

Data on taxpayers affected by the AMT

Relatively few individuals have been subject to the AMT. Table 4, below, presents individual AMT data and projections for the 1987-2010 tax years.

Table 4.–Actual and Projected Individual Income Tax Returns With Tax Liability Under the Individual Alternative Minimum Tax, 1987-2010

Year	Number of returns paying AMT (thousands)	Percentage of filed returns paying AMT	Excess of AMT liability over regular tax liability ($ billions)
1987	140	0.1%	1.7
1988	134	0.1%	1.0
1989	117	0.1%	0.8
1990	132	0.1%	0.8
1991	244	0.2%	1.2
1992	287	0.3%	1.4
1993	335	0.3%	2.1
1994	369	0.3%	2.2
1995	414	0.4%	2.3
1996	478	0.4%	2.8
1997	616	0.5%	4.0
1998	data not available	data not available	data not available
1999	data not available	data not available	data not available
2000	1,071	0.8%	4.6
2001	1,301	1.0%	5.2
2002	1,563	1.2%	5.9
2003	1,901	1.4%	6.6
2004	2,428	1.8%	7.7
2005	3,110	2.3%	9.2
2006	3,889	2.8%	10.8
2007	4,980	3.5%	13.1
2008	6,255	4.4%	15.7
2009	8,354	5.8%	19.4
2010	10,479	7.1%	23.8

Note: These statistics represent taxpayers who actually pay AMT and do not include taxpayers whose regular tax liabilities are affected by the AMT through tax credit limitations.

Source: Internal Revenue Service, *Statistics of Income*, 1987-1997; projections for years 2000-2010 from Joint Committee on Taxation Staff estimates.

Table 5 and 6, below, show the distribution of individual taxpayers with AMT liability among income classes in 2001 and 2009 under present law.

Table 5.--Distribution of Individual AMT Taxpayers with AMT Liability under Present Law, 2001

Income category[1]	Number of returns (thousands)	AMT taxpayers as a percentage of all taxpayers
Less than $10,000	(2)	(3)
$10,000 to less than $20,000	1	(3)
$20,000 to less than $30,000	2	(3)
$30,000 to less than $40,000	7	(3)
$40,000 to less than $50,000	18	0.1%
$50,000 to less than $75,000	101	0.5%
$75,000 to less than $100,000	140	1.1%
$100,000 to less than $200,000	443	3.7%
$200,000 and over	583	18.2%
Total (all taxpayers)	**1,296**	**0.9%**

(1) The income concept used to place tax returns into income categories is AGI plus: (a) tax-exempt interest; (b) employer contributions to health plans and life insurance; (c) employer share of FICA tax; (d) workers compensation; (e) nontaxable Social Security benefits; (f) insurance value of Medicare benefits; (g) AMT preference items; and (h) excluded income of U.S. citizens living abroad. Categories are measured at 2000 levels. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income, resulting in differences with Table 4.

(2) Less than 500.

(3) Less than .05 percent.

Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

Table 6.--Distribution of Individual AMT Taxpayers with AMT Liability under Present Law, 2009

Income category[1]	Number of returns (thousands)	AMT taxpayers as a percentage of all taxpayers
Less than $10,000	(2)	(3)
$10,000 to less than $20,000	(2)	(3)
$20,000 to less than $30,000	(2)	(3)
$30,000 to less than $40,000	16	0.1%
$40,000 to less than $50,000	83	0.6%
$50,000 to less than $75,000	757	2.7%
$75,000 to less than $100,000	1,298	7.8%
$100,000 to less than $200,000	3,712	16.2%
$200,000 and over	2,474	44.4%
Total (all taxpayers)	**8,341**	**5.4%**

(1) Same income concept as used in Table 5, measured at 2000 levels.
(2) Less than 500,000.
(3) Less than .05 percent.
Details may not add due to rounding.

Source: Joint Committee on Taxation.

The increase in the number of taxpayers subject to the AMT largely can be attributed to the fact that the personal exemptions, standard deduction, and tax bracket break points of the regular tax are indexed for inflation, while the AMT exemption amounts and tax bracket break point are not indexed for inflation. Proposals that would increase or index these amounts or allow a deduction for personal exemptions or the standard deduction would decrease the number of taxpayers subject to the AMT and reduce the tax burden of those individuals otherwise subject to the AMT.[132]

[132] Both the House- and Senate-passed versions of H.R. 2014, the "Taxpayer Relief Act of 1997," would have increased or indexed the exemption amounts of the individual AMT. However, the final conference agreement on H.R. 2014 as passed by the Congress and signed by the President, did not contain any provision to change the AMT exemption amounts (P.L. 105-34, August 5, 1997).

The lack of indexing in the AMT also explains the increase of AMT taxpayers in the middle-income categories. Under present law, the relatively large AMT exemption amounts[133] shelter most of a low- or middle-income taxpayer's AMTI from tax. However, over time, with inflation, a taxpayer's income is expected to grow in nominal dollars. Most of this inflated income of a middle-income individual will remain subject to tax at a 15-percent rate for regular tax purposes because the personal exemptions, standard deduction, and tax bracket break points of the regular tax are indexed for inflation. However, for AMT purposes, relatively less of the taxpayer's inflated income will be sheltered by the unindexed AMT exemption amount and the amount not sheltered will become subject to the higher AMT rate of 26 percent. Because the AMT exemption amounts are phased out over relatively high levels of AMTI, indexing these amounts would provide benefits to taxpayers in all income classes.[134]

Table 7 demonstrates the results if the AMT exemption amounts were indexed for inflation, starting in 2001. With indexing, the number of taxpayers subject to the AMT and the amount of AMT collected is expected to remain relatively constant.

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[133] The exemptions amounts are $45,000 in the case of married individuals filing a joint return and surviving spouses; $33,750 in the case of other unmarried individuals; and $22,500 in the case of married individuals filing a separate return.

[134] The phase-out ranges are $150,000 to $330,000 of AMTI for married individuals filing a joint return and surviving spouses; $112,500 to $262,500 of AMTI for other unmarried individuals; and $75,000 to $165,000 of AMTI for married individuals filing a separate return.

Table 7.--Projected Individual Income Tax Returns With Tax Liability Under the Individual AMT if Exemptions Were Indexed, 2001-2010

Year	Number of returns paying AMT (Thousands)	Percentage of filed returns paying AMT	Excess of AMT liability over regular tax liability ($ Billions)
2001	1,127	0.9%	4.9
2002	1,198	0.9%	5.2
2003	1,246	0.9%	5.5
2004	1,331	1.0%	6.0
2005	1,406	1.0%	6.5
2006	1,489	1.1%	7.0
2007	1,565	1.1%	7.7
2008	1,768	1.2%	8.4
2009	1,976	1.4%	9.2
2010	2,170	1.5%	10.0

Source: Joint Committee on Taxation.

As described above, the AMT acts as a floor with respect to the utilization of nonrefundable credits in that a taxpayer is allowed to reduce his or her regular tax liability with otherwise allowable credits only to the extent the taxpayer's regular tax exceeds his or her tentative minimum tax.[135] Tables 8, 9, and 10 demonstrate the estimated effects of the AMT on all nonrefundable tax credits, the child credit, and the education credits, respectively. Projections on the child and education credits are provided because these credits were only recently enacted by the Congress in 1997, they significantly increased the number of taxpayers eligible for nonrefundable credits, and they were targeted toward taxpayers with middle incomes.

Consistent with the projections in Table 4, relatively few taxpayers currently have tax credit utilization that is limited because of the AMT. However, over time, the number of taxpayers subject to this limitation is expected to increase. This pattern is consistent with the expected increase in the number of AMT taxpayers.

[135] The Tax Relief Extension Act of 1999 provided that personal credits are not so limited in taxable years beginning before 2002.

Table 8.--Projected Individual Income Tax Returns With Nonrefundable Tax Credits, 2002 and 2009 (in Millions of Returns)

	Taxable Year 2002	Taxable Year 2009
Returns with nonrefundable credits	46.3	47.6
Returns receiving full credits	18.2	14.0
Returns receiving zero or less than full credits .	28.1	33.6
Returns affected by the AMT	1.4	4.7

Source: Joint Committee on Taxation.

Table 9.--Projected Individual Income Tax Returns With Child Credits, 2002 and 2009[1] (in Millions)

	Taxable Year 2002	Taxable Year 2009
Returns with dependents under age 17	39.5	40.1
Returns receiving full child credit	21.0	15.5
Returns receiving zero or less than full child credit	18.5	24.6
Returns affected by the AMT	0.8	3.1

(1) Includes refundable portion of the credit.

Source: Joint Committee on Taxation.

Table 10.--Projected Individual Income Tax Returns With HOPE and Lifetime Learning Credits, 2002 and 2009 (in Millions)

	Taxable Year 2002	Taxable Year 2009
Returns with tuition expense	10.7	11.7
Returns receiving full education credit	3.3	2.4
Returns receiving zero or less than full education credit	7.4	9.3
Returns affected by the AMT	0.5	1.0

Source: Joint Committee on Taxation.

Issues

The individual AMT is a separate system within the individual income tax system that applies lower tax rates to broader bases of income. As a separate system, the AMT should be analyzed in terms of equity, efficiency, growth, and simplicity. In addition, the separate preferences and adjustments within the individual AMT should be subject to the same analysis.

Equity

In practice, the AMT has the effect of requiring more taxpayers to remit at least some funds to the Federal Treasury every year than would be the case if only the regular income taxes applied. This occurs if (1) the taxpayer's tentative minimum tax exceeds his or her regular tax liability, or (2) the use of tax credits allowed under the regular tax is limited by the taxpayer's tentative minimum tax. To the extent that taxpayers who outwardly appear to have the ability to pay taxes indeed do pay taxes, some observers conclude that the AMT increases the perceived fairness of the income tax system.

Indeed, the rationale for enacting the original individual minimum tax in 1969 and revising it in 1986 were perceptions that some taxpayers were able to avoid paying tax on relatively large incomes. Minimum tax legislation targeted those deductions, exemptions, exclusions, accounting methods, and tax credits that were considered to have contributed to such results. Some of the enacted AMT preferences and adjustments relate to business or investment income (e.g., the depreciation adjustment and the private activity tax-free bond preference) while others relate to regular-tax items that are more personal in nature (e.g., the denial of personal exemptions and certain itemized deductions).

To assess whether the AMT promotes the overall equity of the tax system, it is necessary to look beyond who remits tax payments to the Federal Treasury to who bears the burden of the AMT. Regarding the individual income tax, while economists generally believe that income taxes on wages are borne by taxpayers who supply labor, there is disagreement concerning the incidence of taxes that affect the returns earned by capital such as the taxation of interest, dividends, capital gains, and business income from pass-through entities. Economists generally believe that businesses do not bear the burden of the tax (including the AMT), but rather individuals bear the burden of the tax. There is disagreement, however, over which individuals bear the burden of a business income tax, whether it is customers in the form of higher prices, workers in the form of reduced wages, owners of all capital in the form of lower after-tax returns on investment, or some combination of these individuals.[136]

The uncertainty regarding the incidence of income taxes on the returns to capital make it difficult to assess the effect the AMT has on the equity of the burden of the income tax system. The AMT raises average tax rates for affected taxpayers. That is, the AMT increases the amount of the affected taxpayer's tax liability as a percentage of his or her income. At the individual level, higher-income taxpayers are more likely to be AMT taxpayers than are lower-income taxpayers (see Table 5 above). If the burden of the taxes were to rest with the affected taxpayers, the individual AMT might increase the overall progressivity of the income tax system.

Some analysts argue that the AMT promotes horizontal equity by taxing more equally taxpayers who have the same economic capacity but choose to engage in different patterns of tax-favored activities.[137] Other analysts note that in a market economy, investment by taxpayers would be expected to equilibrate risk-adjusted, after-tax returns. As a consequence, the prices of tax-favored investments would be bid up (or their quantity increase) and the prices of tax-disfavored investments would fall (or their quantity decrease). In equilibrium, the pre-tax returns of tax-favored and tax-disfavored investments would differ, but their after-tax returns would be the same. For example, tax-exempt bonds trade at interest rates lower than otherwise comparable taxable bonds. This is because the tax-exempt borrower does not have to offer as great an interest rate to the lender to provide the lender with a competitive after-tax return. If after-tax returns equilibrate, analysts may question whether a horizontal inequity existed prior to the enactment of the AMT.

The AMT also raises equity issues with respect to preference items that are personal in nature. For example, some believe that it is fair that families with multiple dependents pay less tax than families with fewer dependents and support the regular-tax allowance of personal

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[136] For a discussion of incidence of taxes on the return to capital, see, Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens* (JCS-7-93), June 14, 1993, pp. 44-51.

[137] This argument was stronger upon enactment of the Tax Reform Act of 1986 than it is today. Since 1986, several preferences and adjustments have been eliminated or modified, including those relating to charitable gifts of appreciated property, percentage depletion and intangible drilling costs for oil and gas properties, installment sales of farmers, and depreciation for tangible property.

exemptions and child credits to further this goal. The AMT, in disallowing these exemptions and credits, may frustrate this perception of fairness.

Efficiency and growth

A tax system is efficient if it does not distort the choices that would be made in the absence of the tax system. No tax system can be fully efficient. Whether the AMT contributes to the efficiency of the United States tax system depends on the extent to which it reduces other inefficiencies in the tax system and the extent to which it creates new inefficiencies. By discouraging some taxpayers from undertaking what are otherwise tax-favored investments, efficiency may be increased to the extent that the tax-favored investments are inefficient. However, the AMT generally does not eliminate tax-favored treatment of certain activities or investments, but rather limits which taxpayers may take full advantage of the tax-favored treatment provided by the regular income tax. In addition, limiting which taxpayers can profitably undertake tax-favored activities could lead to more efficient investors finding the activity unprofitable, while less efficient investors find the activity profitable. Moreover, some tax-favored activities may be permitted as part of the regular income tax as a way to reduce some other inefficiency in the economy. These arguments might suggest that efficiency could be better improved by changes in the regular income taxes.[138]

In addition, the AMT may affect the level of investment in the United States and thereby affect economic growth. By increasing average tax rates (the total tax paid by certain taxpayers), the AMT may reduce the cash flow of potential investors. If as some analysts believe, investors' cash flows are important to the investment decision, the AMT may reduce aggregate investment. Further, the effect of the AMT on effective marginal tax rates, and thereby on the cost of capital, may change the incentive to undertake marginal investment projects and thereby affect the level of aggregate investment.

Some specific preferences and adjustments within the AMT seem inconsistent with other parts of the AMT and thus may lead to inefficiencies. For example, it is often presumed that one goal of the AMT is to apply tax to a better measure of economic income, relative to the regular tax. It is generally conceded that in measuring economic income, deductions should be allowed for expenses incurred in the production of income. However, the AMT disallows the deduction of miscellaneous itemized deductions--including un-reimbursed employee business expenses and investment expenses that relate to the production of income. The disallowance of such deductions may lead to inefficiencies as taxpayers may be discouraged from certain otherwise profitable

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[138] Congress has, in certain instances, conformed the regular tax base to the broader AMT base. For example, the regular tax rules applicable to installment sales and long-term contracts generally have been amended to conform to the AMT treatment. In other instances, the AMT rules have been liberalized to conform to the regular tax treatment (e.g., the use of the same recovery periods for depreciable property).

investments or activities or encouraged to rearrange their affairs to secure AMT deductions for such costs (e.g., by attempting to move such deductions "above-the-line").

Simplicity and compliance

The AMT requires a calculation of a second income tax base and computation of a tax on that base, so the present tax system, with an AMT, is not as simple to administer or comply with as would be the same system without an AMT. As detailed above, relatively few taxpayers currently are subject to the AMT. However, this observation understates the extent to which the AMT imposes a compliance burden on taxpayers. Many taxpayers must undertake the AMT calculation to determine whether, in fact, they are liable or whether the utilization of certain credits is limited.

Tables 4, 8, 9, and 10 above, indicate that many more individuals will become affected by the AMT in the future. There are no studies that specifically measure compliance costs arising from the individual AMT. Indirect evidence of the complexity imposed by the individual AMT may be the increased utilization of the services of paid tax preparers by individual taxpayers subject to the individual AMT. In 1988, 14 percent of taxpayers with AGI of $100,000 or more and no significant farming or self-employment income prepared their own tax returns. Of taxpayers with AGI of $100,000 or more and significant income from self-employment or farming, nine percent and four percent of taxpayers prepared their own returns. By contrast, only one percent of all taxpayers subject to the individual AMT prepared their own returns.[139] If taxpayers subject to the AMT are more likely to have complicated financial affairs, they might use paid tax preparers even in the absence of the AMT. However, Tables 5 and 6 indicate that middle-income taxpayers, whose financial affairs are less likely to be complicated, are more likely to become subject to the AMT in the future and thus may be faced with more complicated tax compliance burden.

Prior Action

The Taxpayer Refund and Relief Act of 1999,[140] as passed by the Congress and vetoed by the President, would have phased out the individual AMT, with full repeal in 2008. Present law, as amended by the Tax Relief Extension Act of 1999, allows the personal nonrefundable credits to offset the entire regular tax in 1999 and both the regular tax and the AMT in 2000 and 2001.

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139 Based on tabulations of the staff of the Joint Committee on Taxation of the 1988 IRS Taxpayer Compliance Measurement Program (TCMP).

140 The bill as passed by the Senate would have allowed the personal exemptions in computing AMTI.

2. Simplify and increase the standard deduction for dependents

Present Law

In the case of individual who may be claimed as a dependent by another taxpayer, the basic standard deduction is the lesser of: (1) the basic standard deduction for an unmarried individual ($4,400 in 2000); or (2) the special standard deduction for dependent filers. The special standard deduction for dependent filers is the larger of: (1) $700 (in 2000); or (2) the individual's earned income plus $250 (in 2000).

Description of Proposal

The proposal would increase the standard deduction for dependent filers with earned income. Under the proposal, the amount of the special standard deduction would be equal to the individual's earned income plus $700 (in 2000). Therefore, the basic standard deduction for an individual filer who may be claimed a dependent by another taxpayer would be the lesser of: (1) the basic standard deduction for an unmarried individual ($4,400 in 2000); or (2) the individual's earned income plus $700 (in 2000). Also, the proposal would index the $700 figure for inflation.

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

Analysis

Under present law, many dependent taxpayers, primarily children, must file income tax returns even though they owe very little tax. The proposal would reduce the number of dependents who have to file tax returns. It may also increase the number of dependent filers who claim the standard deduction in lieu of claiming itemized deductions. The proposal therefore eliminate the need to file a return and reduce record keeping and filing complexity, respectively, for affected individuals and the IRS.

Prior Action

No prior action.

3. Simplification of the definition of dependent

Present Law

In general

For Federal income tax purposes, an individual is considered a dependent of the taxpayer if the individual: (1) satisfies a relationship test or is a member of the taxpayer's household for a full year; (2) is a citizen or resident of the United States or a resident of Canada or Mexico[141]; and (3) satisfies a support test. In order for a taxpayer to claim a dependency exemption with respect to a dependent, the individual must also satisfy a gross income test and not file a joint return with his or her spouse.[142]

For purposes of the definition of dependent, a taxpayer is considered to maintain a household if the taxpayer provides over one half of the support for the household for the taxable year.

The relationship test is satisfied with respect to an individual who is the taxpayer's: (1) child (including a legally adopted child) or descendent of the taxpayer's child (e.g., grandchild or great-grandchild); (2) stepchild; (3) brother or sister (including half brother, half sister, stepbrother, or stepsister); (4) parent, grandparent, or other direct ancestor (but not foster parent); (5) stepfather or stepmother; (6) brother or sister of the taxpayer's father or mother; (7) son or daughter of the taxpayer's brother or sister; or (8) the taxpayer's father-in-law, mother-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law. A foster child is treated as a child of the taxpayer if the foster child is a member of the taxpayer's household for the year.

The gross income test is satisfied with respect to an individual if the individual has gross income which is less than the amount of the personal exemption amount ($2,900 for 2001)[143] for the taxable year. If the individual is the child of the taxpayer and under age 19 (under age 24, if a full-time student) the gross income test does not apply.

Support test for taxpayer's children

To satisfy the support test with respect to the child of a taxpayer a taxpayer must provide more than one half of the child's total support during the calendar year. For purposes of the support test, governmental benefit payments (e.g., Temporary Assistance to Needy Families

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[141] This requirement does not apply to a child of the taxpayer if the child lives with the taxpayer and the taxpayer is a citizen or national of the United States.

[142] Certain exceptions apply to this requirement.

[143] Source: Joint Committee on Taxation staff projection.

("TANF") payments, food stamps, and housing) are not treated as support provided by the taxpayer but rather are treated as support provided by the government. Expenses that are not directly related to any one member of a household, such as the cost of food for the household, must be divided among the members of the household.

To determine whether a taxpayer has provided more than half of a child's support, the amount the taxpayer contributed to the child's support is compared with the entire amount of support the child received from all sources. This amount includes the child's own funds used for support.

A taxpayer may be able to claim a child as a dependent even though the taxpayer provided support for less than half the year. Support is determined based upon the amount spent, not the length of time over which it is spent. As long as the taxpayer provides more than half of the total amount of the child's support for a year, the taxpayer satisfies the support test.

Where the child's parents provide more than one-half of a child's support, special support rules apply for parents: (1) who are divorced or legally separated under a decree of divorce or separate maintenance; (2) who are separated under a written separation agreement; or (3) who live apart at all times during the last six months of the calendar year. If the child is in the custody of one or both of these parents for more than one half of the calendar year, then the parent having custody for the greater portion of the calendar year is deemed to satisfy the support test. That parent can release claim to the exemption for any year by filing a proper written declaration (Form 8322 or similar statement) with the Secretary of the Treasury.

In some cases no one taxpayer provides more than half of the support of a child. Instead, two or more taxpayers, each of whom would be able to claim a dependency exemption but for the support test, together provide more than half of the person's support. If this occurs, taxpayers can agree to designate that one of the taxpayers who individually provides more than 10 percent of the person's support can claim a dependency exemption for that person. Each of the others must sign a written statement agreeing not to claim the exemption for that year. The statements must be filed with the income tax return of the person who claims the exemption.

<u>Definition of child for purposes of the earned income credit</u>

If certain requirements are satisfied, a taxpayer may claim the earned income credit ("EIC") with respect to a qualifying child of the taxpayer. A child is a qualifying child if: (1) the child is the son or daughter of the taxpayer or a descendent of either, a stepson or stepdaughter of the taxpayer, or an eligible foster child; (2) the child resides with the taxpayer for more than half the year (the full year in the case of a foster child); and (3) the child is under age 19 (or under 24 if a full-time student).[144]

[144] No age requirement applies in the case of a disabled child.

For purposes of the EIC, a foster child is defined as a child who: (1) is cared for by the taxpayer as if he or she were the taxpayer's own child; (2) has the same principal place of abode as the taxpayer for the taxpayer's entire taxable year, and (3) either is the taxpayer's brother, sister, stepbrother, stepsister, or descendant of any such relative, or was placed in the taxpayer's home by an agency of a State or one of its political subdivisions or by a tax-exempt child placement agency licensed by a State.

Interaction with filing status and certain tax credits

The definition of dependent and whether a taxpayer may claim a dependency exemption with respect to an individual is relevant for a variety of Code provisions. For example, a taxpayer may file an income tax return as a surviving spouse if: (1) the taxpayer's spouse died during either of the two preceding taxable years; (2) the taxpayer is entitled to a dependency exemption for certain dependents; and (3) the taxpayer pays more than one half of the cost of maintaining a home which is the principal place of abode for a dependent for the year.

A taxpayer may file as a head of household if the taxpayer is unmarried (and not a surviving spouse) and pays more than one half of the cost of maintaining a home which is the principal place of abode for more than one half of the year of (1) an unmarried son, daughter, stepson or stepdaughter of the taxpayer or an unmarried descendant of the taxpayer's son, stepson, daughter, or stepdaughter, (2) a married child or stepchild of the taxpayer or a married descendant of a child or stepchild of the taxpayer if the taxpayer may claim a dependency exemption with respect to the child or stepchild, or (3) any other person with respect to whom the taxpayer may claim a dependency exemption. If certain other requirements are satisfied, head of household status may also be claimed if the taxpayer is entitled to a dependency exemption with respect to the taxpayer's parents.

Taxpayers with incomes below certain amounts are eligible for a child credit of up to $5000 for each child of the taxpayer that is under age 17 and with respect to which the taxpayer may claim a dependency exemption. For this purpose, each child must meet the same relationship test used for the EIC.

Similarly, a dependent care tax credit may be allowed in the case of taxpayers who maintain a household for a dependent who is under the age of 13 or other individual who meets certain other requirements, and for whom the taxpayer has paid employment related expenses to care for the child or other individual.

Description of Proposal

Support test

Under the proposal, in order to claim a child as a dependent, the taxpayer would not have to satisfy the support test in the case of a child who: (1) is the son, daughter, stepchild, grandchild, or foster child of the taxpayer; (2) is under the age of 19 at the end of the taxable year (24 in the case of a full-time student); and (3) resides with the taxpayer for more than one half the year (the full year in the case of a foster child). If more than one taxpayer could claim a child as a dependent under the proposal, then only the taxpayer with the highest adjusted gross income ("AGI") could claim the exemption ("AGI tiebreaker"). A taxpayer who is eligible to claim a child as a dependent under the proposal (after application of the AGI tiebreaker, if applicable) may agree to waive the dependency exemption with respect to that child. If a proper waiver is made, the dependency exemption may be claimed by a taxpayer that satisfies the present-law rules for determining dependency (including the support test).

The proposal would repeal the present-law rule that a custodial parent is entitled to claim a child as a dependent only if both parents, in combination, provide over half the support of the child. Thus, under the proposal, the child would be considered a dependent of the custodial parent if the residency test of the proposal is satisfied. As under present law, the custodial parent could release the claim to the dependency exemption so that the exemption could be claimed by the noncustodial parent.

Foster child definition

The proposal would define a foster child for purpose of determining dependency as a child who is: (1) under the age of 19 (24 if a full-time student); (2) cared for by the taxpayer as if he or she were the taxpayer's own child; and (3) the taxpayer's sibling or descendent of a sibling or has been placed with the taxpayer by an authorized placement agency. The proposal is silent on the treatment of a taxpayer's stepbrother or stepsister for these purposes.

Gross income test

The proposal would expand the class of persons exempted for the gross income test to include grandchildren of the taxpayer who are under the age of 19 (24 if a full-time student).

Effective date

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

Analysis

Support test

The proposal would apply the same residency test for purposes of determining whether a child is a dependent of the taxpayer and whether a child qualifies under the EIC. This would achieve simplification in two ways. First, taxpayers would no longer be required to determine if the support test is met. While in many cases it is easy to determine whether the taxpayer provides over one half of the support of a child, it can be difficult in some cases, such as if more than one person provides support for the child, the household receives government assistance, or the taxpayer has more than one child with different sources of support. The proposal would eliminate record keeping and calculations relating to the support test. Second, the proposal would simplify tax preparation for taxpayers who claim the EIC. Under present law, a child may be a qualifying child for purposes of the EIC, but not a dependent for purposes of the dependency exemption. This can occur if the child lives with the taxpayer but the taxpayer does not provide over one half the support of the child. Under the proposal, a taxpayer would be able to claim the same child as a dependent and a qualifying child under the EIC. Some argue that the proposal would merely conform the law to actual practice. Some believe that, as a practical matter, few taxpayers actually calculate whether the support test is met.

While the stated objective of the proposal is simplification, in some cases a different taxpayer would be entitled to the dependency exemption under the proposal than under present law and in some cases the proposal would allow a dependency exemption where one would not be allowed under present law. For example, if more than half of the support of a child is provided by the government, then no dependency exemption would be allowed under present law, but would be allowed under the proposal.

There is some concern as to how the tie-breaker test would be administered in practice. For example, it could be difficult for both the taxpayers and the IRS to determine, within a household, the taxpayer with the highest AGI. Others argue that an identical tie-breaker test used for purposes of the EIC has not resulted in any reported difficulties.

Foster child definition

Proponents of the proposal to clarify the definition of foster child argue that the proposal achieves simplification by: (1) providing a clearer definition of a foster child; and (2) conforming to a greater degree the definition of a foster child for purposes of the exemption with the definition of a foster child for purposes of the EIC. Opponents may counter that this changed definition, like the change to the definition of a foster child (recently enacted in the Ticket-to-Work Act of 1999) may create a trap for the unwary. To the extent that a taxpayer cares for a child as his own but: (1) that child does not meet the specific familial relationship to the taxpayer (e.g., a cousin or a godchild); and (2) the taxpayer does not formalize the foster care relationship with the State or its authorized placement agency, no taxpayer may be able to claim the dependency exemption with regard to that child. Further, there is a question why the proposal would not exactly conform the definition of a foster child for purposes of the exemption to the EIC (by including a disabled child who is not under the age of 19 (24 if a full-time student) in the definition of foster child for purposes of the exemption), if greater conformity is viewed as a favorable result.

Gross income test

The proposal would conform the gross income test applicable to parents and grandparents with otherwise qualifying dependents if the children meet certain age requirements. Specifically, the gross income test would not apply in cases where the children meet certain age requirements. Proponents argue that this proposal is more fair and simpler than the present-law rules. Opponents argue if it is appropriate to repeal the gross income test for dependent children of parents and grandparents, that it should also be repealed for dependent children of other family members.

Prior Action

No prior action.

4. Index maximum exclusion for capital gain on the sale of principal residence

Present Law

Under present law, a taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met. A taxpayer may claim the exclusion only once in any two-year period. The maximum exclusion amounts ($250,000/$500,000) are not indexed for inflation.

Description of Proposal

The proposal would index for inflation the maximum exclusion amounts for gains from the sale or exchange of a principal residence.

Effective date.--The proposal would be effective beginning in the year 2001.

Analysis

The Taxpayer Relief Act of 1997 contained provisions which increased the maximum exclusion amounts and made other modifications to the rules relating to the exclusion of gain on the sale or exchange of a principal residence which significantly reduced the number of taxpayers subject to taxation or the sale or exchange of a principal residence.

In the absence of the exclusion, all homeowners would need to keep records in order to determine the amount of taxable gain upon the sale or exchange of their principal residence. The exclusion eliminates the need for such record keeping in many cases.[145] Proponents of this proposal argue that inflationary increases in the sales prices of residences may mean that significant numbers of taxpayers will have taxable gain upon the sale or exchange of a principal residence. They believe that the simplification achieved by increasing the maximum exclusion amounts would be eroded unless the maximum exclusion amounts are indexed for inflation.

Opponents of this proposal argue that the maximum exclusion amounts are already quite large and that other tax benefits might be more desirable targets for inflation indexing. For example, they might argue that tax benefits targeted to lower-income individuals and small businesses carry out more important social goals. On the other hand, proponents argue that elderly taxpayers whose principal asset is a residence which has appreciated over many years are appropriate beneficiaries of inflation indexing under the proposal.

Prior Action

No prior action.

5. Tax credit to encourage electronic filing of individual income tax returns

Present Law

Electronic filing may be accomplished in a number of ways. To file a return electronically, a taxpayer may prepare his or her own return and have an authorized professional electronically transmit it to the IRS. In addition, many tax professionals prepare and file tax returns electronically for their clients. Taxpayers can also file their tax returns using their personal computer. Taxpayers prepare their returns on a personal computer using commercial tax preparation software and transmit the information via modem to a third party, an electronic return transmitter ("ERT"). The ERT converts the file from the tax preparation software format to a format that meets IRS specifications and transmits it to the IRS. The IRS then checks the return and notifies the ERT (who then informs the taxpayer) whether the return has been accepted or

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[145] Taxpayers may wish or need to keep records, for example, if the expected capital gains exceed the exclusion amount or if the requirements of the exclusion are not met (e.g., the taxpayer rents a former principal residence for a number of years before it's sale).

rejected. The IRS does not charge a fee; however, an ERT offering this service to taxpayers may charge a fee for transmission.[146]

Tax return preparation costs of individuals, including any costs of electronic filing, may be deducted only by taxpayers who itemize deductions and then only to the extent that such costs, in combination with other miscellaneous itemized deductions, exceed two percent of AGI.

Form 1040 EZ taxpayers may file their returns via TeleFile by using a touch-tone telephone. The taxpayer calls a toll-free number and enters the information to complete the return using the keypads of the telephone.

Electronic filing by computer has been permitted on a nationwide basis since 1990; filing via TeleFile, since 1996.[147] The IRS expects to receive 33.6 million electronically filed returns this year, out of a projected total of 127 million returns to be received.[148] The IRS recently estimated its per unit cost for electronically filed individual income tax returns at $4.14.[149] The comparable per unit cost for paper returns was $4.28.[150]

Description of Proposal

The proposal would provide a temporary, refundable tax credit for the electronic filing of individual income tax returns. The credit would be $10 for each electronically filed return. The credit for individuals using a telephone to file their returns via TeleFile would be $5.

The proposal also would provide that, no later than tax year 2002, the IRS would be required to offer one or more options to the public for preparing and filing individual income tax

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[146] The Volunteer Income Tax Assistance/Tax Counseling for the Elderly ("VITA/TCE") programs use volunteers to prepare basic income tax returns free of charge to individuals of low to moderate income, individuals with disabilities, non English speaking taxpayers, and the elderly. Many of these VITA/TCE sites also offer electronic filing, free of charge to the taxpayer.

[147] Internal Revenue Service, *Strong Start for 15th Electronic Filing Season,* Information Release IR-2000-05 (January 19, 2000).

[148] *Id.*

[149] Internal Revenue Service, *Electronic Tax Administration: A Strategy for Growth*, Publication 3187, at 10 (November 1999). This figure is based on a volume of approximately 30 million returns filed electronically in fiscal year 1999. *Id.* The IRS stated that in 1998, 6 million returns were filed using TeleFile, 17.7 million returns were filed electronically using an authorized professional, and .9 million using a personal computer. *Id.* at 59.

[150] *Id.* at 10.

returns over the Internet at no cost to the taxpayer. If the IRS offered such options through contract arrangements with Authorized IRS E-file Providers[151], it would be with the assurance that the taxpayer's return information would not be used by the provider without the taxpayer's permission for any purpose other than submission to the IRS.

Effective date.--The proposal would be effective for tax years 2002 through 2006.

Analysis

Electronic filing is generally thought to have advantages over paper returns for both the IRS and taxpayers. According to the IRS, taxpayers are able to obtain their refunds in half the time by filing electronically, as compared with paper filing.[152] In addition, electronic filing is more accurate than paper filing. The error rate associated with processing paper tax returns is approximately 20 percent, half of which is attributable to the IRS and half to errors in taxpayer data. Because electronically filed returns usually are prepared using computer software programs with built-in accuracy checks, undergo pre-screening by the IRS, and experience no key punch errors, electronic returns have an error rate of less than one percent.[153]

For these reasons, the Internal Revenue Service Restructuring and Reform Act of 1998 stated that it is the policy of the Congress to promote paperless filing, and set a goal for the IRS to have at least 80 percent of all tax and information returns filed electronically by the year 2007.[154]

Currently, many taxpayers have to pay a fee to file electronically. The credit proposal may encourage more paperless filing by at least partially offsetting the cost of electronic filing. The proposal also seeks to encourage paperless filing by requiring the IRS to develop free Internet-based options for preparing and filing returns to coincide with the availability of the credit in 2002. The effectiveness of this part of the proposal will depend in part on the ability of the IRS to develop the program and the specifics of the program.

Some question whether the amount of the proposed credit, $5 or $10, would be a sufficient incentive to file electronically. For example, while a $10 credit may offset the cost of electronic

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[151] An "Authorized IRS E-file Provider" can be a preparer, service bureau, an ERT, or software developer. Service bureaus are third parties that assist preparers with a variety of services, such as data entry, data formatting, and the transfer of data to an ERT. Software developers write the programs to IRS specifications to make electronic filing possible. Internal Revenue Service, Publication 3112, *The IRS E-File Application Package* (July 1999).

[152] Internal Revenue Service, *IRS e-file*, Publication 1875 (September 1999).

[153] *Id.*

[154] Pub. L. No. 105-206, section 2001 (1998).

filing, it may not offset the cost of tax preparation (e.g. the purchase of software, or the use of a tax professional to prepare the return).

Some have commented that the proposal may not be efficient because those already using electronic filing would receive the credit. Some argue that the temporary nature of the credit may reduce its effectiveness. Once the monetary incentive to file electronically is removed, those persons who were using the electronic medium to obtain the credit may revert to paper filing, and, thus, the credit would fail to produce a permanent increase in electronic filing. On the other hand, the convenience of electronic filing may be sufficient incentive for a taxpayer to continue the practice. While the credit may temporarily make electronic returns more expensive to process than paper returns, the lower error rate and relative ease of processing electronically filed returns may outweigh those costs.

The IRS has noted that a significant barrier to overcome is the public's perception that there is a greater chance that they will be contacted or audited by the IRS if they file electronically.[155] The IRS asserts that the higher accuracy of electronic returns reduces the likelihood of contact by the IRS to resolve errors.[156] Furthermore, the IRS states that its audit criteria does not take into account whether a return was filed electronically or by paper.[157]

The IRS must also overcome the security and privacy concerns of some taxpayers.[158] Some may be reluctant to transmit their sensitive financial information electronically because of concerns that the transmission could be intercepted. On the other hand, the current filing season has seen a 10 percent increase in electronic filing over the same period last year, suggesting that more taxpayers have become comfortable with this method of filing.[159]

Prior Action

No prior action.

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155 Internal Revenue Service, *Electronic Tax Administration: A Strategy for Growth*, Publication 3187, at 17 (November 1999).

156 *Id.*

157 *Id.*

158 "Many taxpayers also have concerns about the security and privacy of electronic transactions with the IRS." *Id.* at 18.

159 Internal Revenue Service, *Early Returns: E-filing Growth Continues*, Information Release 2000-10 (February 17, 2000). Self prepared electronically filed returns showed a 98.1 percent increase over the previous period last year, with 1.236 million returns having been filed as of February 11, 2000, as compared with 624,000 filed as of February 12, 1999. TeleFile, however, was down 11.9 percent for the same period.

6. Clarification of employment tax treatment of individuals in sheltered workshops

Present Law

Sheltered workshops are typically operated by charitable organizations and provide training, job-placement, and on-site employment for individuals with disabilities. During training, participants learn skills for employment outside the workshop. In many cases, the amount of remuneration paid by the workshop is below minimum wage under a special waiver granted by the Department of Labor.[160]

Whether individuals are employees of a sheltered workshop for employment tax purposes is determined under the generally applicable rules relating to employment status. In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common-law test. Treasury regulations provide that an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished. In other words, an employer-employee relationship generally exists if the person providing the services "is subject to the will and control of the employer not only as to what shall be done but how it shall be done."[161] Whether the requisite control exists is determined based on all the relevant facts and circumstances.[162]

In 1965, the IRS issued a ruling addressing the employment tax consequences of three different situations involving sheltered workshops.[163] The ruling is based on the application of the common-law test described above. In the first situation, the IRS ruled that blind individuals who are being trained in a charitable organization's sheltered workshop under a program of rehabilitation are not employees of the organization for Federal employment tax purposes. Second, the IRS ruled that blind individuals who, after completion of training, are working in the sheltered workshops at pay scales and under working conditions comparable to those in private industry (either temporarily while awaiting placement in industry or permanently because they are unable to compete in industry), are employees of the organization for Federal employment tax purposes. Third, the IRS ruled that blind individuals who are incapable of rehabilitation and who

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[160] Subject to certain requirements, the Secretary of Labor is authorized to issue certificates of exemption from the minimum wage with respect to individuals whose earning or productive capacity is impaired by age, physical or mental deficiency or injury to the extent necessary to prevent curtailment of opportunities for employment. 29 U.S.C. section 214.

[161] Treas. reg. sec. 31.3401(c)-(1)(b).

[162] The IRS has developed a list of 20 factors that may be examined in determining whether an employer-employee relationship exists. Rev. Rul. 87-41, 1987-1 C.B. 296.

[163] Rev. Rul. 65-165, 1965-1 C.B. 446.

are given materials by the organization on which they may work at home whenever they please and are free to seel the competed articles to the public or the organization are not employees of the organization for Federal employment tax purposes.

Under the Federal Unemployment Tax Act ("FUTA"), services performed in the employ of a religious, charitable, educational, or other tax-exempt organization described in section 501(c)(3) are not subject to FUTA.[164] Thus, employees of sheltered workshops of charitable organizations are not subject to FUTA. There is no similar exemption from the Federal Insurance Contributions Act ("FICA"), i.e., Social Security and Medicare, or for Federal tax withholding purposes.[165]

Description of Proposal

The proposal would provide that, for Social Security tax purposes, employment would not include services rendered by disabled individuals in a sheltered workshop if the services are performed (1) for no more than 18 months under a minimum wage certificate issued by the Department of Labor, and (2) in a sheltered workshop operated by a section 501(c)(3) organization or a State or local government. Organizations could voluntarily agree to provide coverage under Social Security, pursuant to an agreement with the Social Security Administration. Corresponding changes would be made to the Social Security Act.[166]

Effective date.--The proposal would be effective for services performed after December 31, 2000.

Analysis

The use of sheltered workshops has expanded since the IRS issued its ruling regarding such workshops in 1965. Sheltered workshops provide a variety of services in addition to job training. It may be difficult to determine when a training period ends and when employment begins. Ambiguities under present law have resulted in disputes between the IRS and operators of sheltered workshops regarding the application of the employment tax provisions.

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[164] Section 3306(c)(8).

[165] Churches may elect not to be subject to FICA taxes. Sections 3121(b)(8)(B) and 3121(w).

[166] It is unclear whether the proposal is intended to apply only for FICA purposes or also for Federal tax withholding purposes.

The proposal is likely to reduce disputes between the IRS and operators of sheltered workshops by providing a specific statutory exemption from employment taxes for certain services rendered by disabled individuals in sheltered workshops.[167]

Some operators of sheltered workshops argue that the proposal does not address all issues relating to employment tax status. For example, some operators of sheltered workshops argue that, in the case of individuals whose disability is such that they could not ever perform competitive services, the "employment" in the sheltered workshop is not like commercial employment, but rather is provided in order to provide individuals with a full and meaningful life experience, and therefore should not be subject to employment taxes.

Prior Action

No prior action.

7. Enhance section 179 expensing for small businesses

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $20,000 (for taxable years beginning in 2000) of the cost of qualifying property placed in service for the taxable year (sec. 179). In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $20,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

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

Present law provides that in the case of a partnership or S corporation, the limitations on the deduction under section 179 are applied both at the partnership or S corporation level, and also at the partner or shareholder level. Under this rule, each partner or shareholder is subject to the

[167] Special treatment of earnings from sheltered workshops is not without precedent. For purposes of the personal exemption rules, certain income attributable to services performed by disabled individuals in sheltered workshops is not taken into account in determining whether the dependent has gross income less than the exemption amount. Section 151(c)(5).

same maximum limitations on section 179 deductions from all sources as each partnership or S corporation.

The section 179 election may not be revoked except with the consent of the Treasury Secretary.

Description of Proposal

The proposal includes five parts. First, the $20,000 amount would be increased to $25,000 in taxable years beginning in 2001, and would be indexed for inflation starting with taxable years beginning in 2002. The indexed annual amount would be rounded down to the nearest $1,000.

Second, the present-law limitations on the section 179 deduction at the partner or S corporation shareholder level would be eliminated. The limitations would apply only at the entity level. It would be intended that section 179 deductions of partners or S corporation shareholders from entities that are unrelated to each other would not be aggregated, but that for this purpose, aggregation rules similar to those of section 448(c) would apply. For this purpose, related entities would be treated as one for purposes of applying the section 179 deduction limitations.

Third, the proposal would provide that computer software described in section 167(f) (that is not eligible for amortization under section 197) would be eligible for section 179 expensing.

Fourth, the proposal would eliminate the phase-out of the $20,000 expensing limit starting at $200,000 in investment in qualifying property. The proposal would substitute for this phase-out a rule limiting section 179 expensing to small businesses. A small business would be defined as one averaging no more than $10 million in gross receipts over the 3 preceding taxable years (or over the period of its existence, if shorter). A business would include predecessors and related businesses, as under present law.

Last, the proposal would permit a section 179 election to be revoked on an amended return.

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

Analysis

The overall effect of the proposal is to expand taxpayer-favorable expensing for small business. Proponents of the proposal argue that small business is an important source of economic growth and job creation in the United States. By reducing the cost of capital through expansion of the benefits of section 179, small business investment may increase.

Opponents of the proposal might argue that, in the current strong economy, no additional tax incentives are needed to promote capital investment. They might argue that stock indices are at or near all-time highs, and that the ready availability of capital in an environment of low inflation obviates the need for investment incentives.

Advocates of the proposal argue that present law does not direct the benefits of expensing very effectively to small business, because of the manner in which the limitations under the provision are designed. They note that the $200,000 threshold for phasing out the dollar amount that can be expensed is based on the total amount of section 179 property placed in service for the year, i.e., the total amount of capital invested in tangible property used in the trade or business. They argue that the provision should be targeted to businesses with receipts below a particular threshold, not capital investment below a threshold. They argue that the present-law test does not give the desired result, because small manufacturing businesses that have relatively low gross receipts, but substantial annual capital investments in tangible property, cannot qualify for expensing, while large, high-income businesses with more modest annual investments in tangible property may qualify. It is argued that the section 179 expensing rules should be refocussed on small businesses by modifying the eligibility test and increasing the dollar amount that can be expensed.

Opponents might argue that the current limitation on expensing, that is based on the amount of capital invested for the year in tangible property used in the business, makes sense if the desired incentive is to encourage additional, or incremental, capital investment. It should not matter, opponents argue, whether small or large businesses make these investments. The level of gross receipts of the business is not relevant to whether it is newly investing in tangible property. Rather, the provision should remain focussed -- as under present law -- on new capital investment in tangible property by taxpayers who have not already invested heavily for the year.

The definition of small business under the proposal could also be criticized in that it creates a cliff effect. The definition provides that a small business is one averaging no more than $10 million in gross receipts over the 3 preceding taxable years (or over the period of its existence, if shorter). Under this definition, a business with just over $10 million in average gross receipts for the preceding 3-year period would not qualify for any expensing, whereas a business with just under $10 million in average gross receipts for the preceding 3-year period could expense $25,000, indexed for inflation, under the proposal. This cliff effect creates an incentive to keep gross receipts under $10 million, which may be contrary to the goal of economic growth.

Advocates of the other parts of the proposal would assert that the rules for pass-through entities and their owners should be simplified by generally eliminating the application of the limitation at the owner level. Additional simplification would be achieved by allowing taxpayers to revoke a section 179 election on an amended return, rather than incurring the expense and uncertainty of seeking consent of the Treasury Secretary to revoke the election. Advocates further argue that present-law treatment of off-the-shelf computer software is needlessly complex, and could be simplified by making such software eligible for section 179 expensing.

Critics of the proposal might argue that allowing owners of partnerships and S corporations unlimited section 179 expensing from unrelated entities permits these taxpayers to minimize their income tax by participating in multiple small businesses. On the other hand, it could be said that the passive loss rules of present law (designed to limit individuals from zeroing their income through passive investments in tax shelters) prevent individual taxpayers from using unlimited section 179 deductions from businesses in which they do not materially participate as tax shelters to eliminate their income tax liability.

Prior Action

A proposal to increase the dollar amount of section 179 expensing to $30,000 for taxable years beginning in 2000 and thereafter was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President.

8. Provide optional Self-Employment Contribution Act ("SECA") computations

Present Law

The Self-Employment Contributions Act ("SECA") imposes taxes on net earnings from self-employment to provide social security and Medicare coverage to self-employed individuals. The maximum amount of earnings subject to the SECA tax is coordinated with, and is set at the same level as, the maximum level of wages and salaries subject to FICA taxes ($76,200 for OASDI taxes in 2000 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 individuals.

A farmer may increase his or her self-employment income, for purposes of obtaining social security coverage, by reporting two-thirds of the first $2,400 of gross income as net earnings from self-employment, i.e., the optional amount of net earnings from self-employment would not exceed $1,600. There is no limit on the number of times a farmer may use this method. The optional method for nonfarm 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 nonfarm method may not be used more than five times by any individual, and may only be used if the taxpayer had net earnings from self-employment of $400 or more in at least two of the three years immediately preceding the year in which the optional method is elected.

In general, to receive benefits, including Disability Insurance Benefits, under the Social Security Act, a worker must have a minimum number of quarters of coverage. A minimum amount of wages or self-employment income must be reported to obtain a quarter of coverage. A maximum of four quarters of coverage may be obtained each year. In 1978, the amount of earnings required to obtain a quarter of coverage began increasing each year. Starting in 1994, a farmer could obtain only two quarters of coverage under the optional method applicable to farmers.

Description of Proposal

The proposal would combine the farm and nonfarm optional methods into a single combined optional method applicable to all self-employed workers under which self-employment income for SECA tax purposes would be two-thirds of the first $2,400 of gross income. A self-employed individual could elect to use the 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 nonfarm. As under present law, the $2,400 amount would not be increased for inflation.

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

Analysis

Approximately 48,000 taxpayers use one of the optional methods. The proposal would simplify SECA calculations for those who use the optional method.

The present-law optional farm method is more advantageous than the nonfarm method. The proposal would eliminate inequities between the two methods.

Some argue that the proposal should be expanded to increase the $2,400 limit so that the optional method will continue to fulfill its original purpose of allowing self-employed individuals to earn full quarters of coverage.

Also, some argue that taxpayers should not be able to make an election on a retroactive basis, just as insurance cannot be purchased after the occurrence of an insurable event. On the other hand, some argue that not permitting the election on an amended return may unduly penalize taxpayers who mistakenly do not claim the election when they first file their return.

Prior Action

Similar proposals were included in the Administration's 1997 tax simplification proposals[168] and the President's Fiscal Year 1999 and 2000 Budget Proposals. A similar proposal was also included in the Taxpayer Relief Act of 1997, as passed by the House. However, that proposal also would have initially increased the $2,400 limit to the amount that would provide for four quarters of coverage in 1998, and increased the limit thereafter as the earnings requirement for quarters of coverage increases under the Social Security Act. That proposal also would have provided that the optional method could not be elected retroactively on an amended return.

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[168] See Department of the Treasury, *Taxpayer Bill of Rights 3 and Tax Simplification Proposals*, April 1997.

9. Clarify rules relating to certain disclaimers

Present Law

There must be acceptance of a gift in order for the gift to be completed under State law, and there is no taxable gift for Federal gift tax purposes unless there is a completed gift. Most States have rules which provide that, when there is a disclaimer of a gift, the property passes to the person who would be entitled to the property had the disclaiming party died before the purported transfer.

In the Tax Reform Act of 1976, Congress provided a uniform disclaimer rule (sec. 2518) that specified how and when a disclaimer must be made in order to be effective for Federal transfer tax purposes. Under section 2518, a disclaimer is effective for Federal transfer tax purposes if it is an irrevocable and unqualified refusal to accept an interest in property and certain other requirements are satisfied. One of the requirements is that the disclaimer generally must be made in writing not later than nine months after the transfer creating the interest occurs. In order to be a qualified disclaimer, the disclaiming person must not have accepted the disclaimed interest or any of its benefits. Section 2518 currently is effective only for Federal transfer tax purposes (e.g., it is not effective for Federal income tax purposes).

In 1981, Congress added a rule to section 2518 that allowed certain transfers of property to be treated as a qualified disclaimer, even if not a qualified disclaimer under State law. In order to qualify, these transfer-type disclaimers must be a written transfer of the disclaimant's "entire interest in the property" to persons who would have received the property had there been a valid disclaimer under State law (sec. 2518(c)(3)). Like other disclaimers, the transfer-type disclaimer generally must be made within nine months of the transfer creating the interest.

Under present-law assignment of income principles, an individual can avoid tax on the income from property only after the individual has made a gift of the income-producing property, rather than simply assigning the income from the property.

Description of Proposal

The proposal would allow a transfer-type disclaimer of an "undivided portion" of the disclaimant transferor's interest in property to qualify under section 2518. Also, the proposal would allow a spouse to make a qualified transfer-type disclaimer where the disclaimed property is transferred to a trust in which the disclaimant spouse has an interest (e.g., a credit shelter trust). Further, the proposal would provide that a qualified disclaimer for transfer tax purposes under section 2518 also would be effective for Federal income tax purposes (e.g., disclaimers of interests in annuities and income in respect of a decedent).

Effective date.--The proposal would apply to disclaimers made after the date of enactment.

Analysis

Under present law, a State-law disclaimer can be a qualified disclaimer even (1) when it is only a partial disclaimer of the property interest, or (2) when the disclaimant spouse retains an interest in the property. It is currently unclear, however, whether a transfer-type disclaimer described in section 2518(c)(3) can qualify under similar circumstances. Thus, in order to equalize the treatment of State-law disclaimers and transfer-type disclaimers, it may be appropriate to allow a transfer-type disclaimer of an undivided portion of property or a transfer-type disclaimer where the disclaimant spouse has retained an interest in the property to be treated as a qualified disclaimer for transfer tax purposes.

The present-law rules pertaining to qualified disclaimers, as set forth in section 2518, are effective for Federal transfer tax purposes but not Federal income tax purposes. If a disclaimer satisfies the requirements for a qualified disclaimer under present law, it may be appropriate to allow the disclaimer to be effective for Federal income tax purposes as well as Federal transfer tax purposes. It should be noted, however, that allowing disclaimers to be effective for Federal income tax purposes would override the general assignment of income concepts in that area.

Proponents of this proposal assert that it would simplify the rules regarding disclaimers to provide one uniform rule to both non-transfer-type and transfer-type disclaimers. Proponents also would assert that the proposal further simplifies the rules by allowing disclaimers to be effective for Federal income tax purposes, such as annuities and income in respect of a decedent.

The proposal would extend the estate, gift, and generation-skipping transfer tax disclaimer provisions to the Federal income tax. However, disclaimers also arise in the context of the procedure rules in subtitle F of the Code. For example, in the recent case of Drye v. United States, 120 S. Ct. 474 (December 7, 1999), the Supreme Court ruled a Federal tax lien attached to a taxpayer’s interest in estate property as an heir, despite the taxpayer’s valid disclaimer under Arkansas State law. In Drye, the Court held that a taxpayer’s interest in property as an heir constituted “property” or a “right to property” to which a Federal tax lien could attach. Thus, under the Court’s holding, a disclaimer is ineffective for Federal tax lien purposes. It is unclear whether the proposal would extend the estate, gift, and generation-skipping transfer tax disclaimer provisions to the procedural rules in the Code such as Federal tax liens.

Prior Action

Identical proposals were included in the Balanced Budget Act of 1995 as passed by the Congress and vetoed by the President and the Taxpayer Relief Act of 1997 as passed by the House. An identical proposal also was included in the President's Fiscal Year 1999 and 2000 Budget Proposals.

10. Simplify the foreign tax credit limitation for dividends from 10/50 companies

Present Law

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

Special foreign tax credit limitations apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote and which is not a controlled foreign corporation (a so-called "10/50 company").[169] Dividends paid by a 10/50 company in taxable years beginning before January 1, 2003 are subject to a separate foreign tax credit limitation for each 10/50 company. Dividends paid by a 10/50 company that is not a passive foreign investment company in taxable years beginning after December 31, 2002, out of earnings and profits accumulated in taxable years beginning before January 1, 2003, are subject to a single foreign tax credit limitation for all 10/50 companies (other than passive foreign investment companies). Dividends paid by a 10/50 company that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, continue to be subject to a separate foreign tax credit limitation for each such 10/50 company. Dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, out of earnings and profits accumulated in taxable years after December 31, 2002, are treated as income in a foreign tax credit limitation category in proportion to the ratio of the earnings and profits attributable to income in such foreign tax credit limitation category to the total earnings and profits (a so-called "look-through" approach). For these purposes, distributions are treated as made from the most recently accumulated earnings and profits. Regulatory authority is granted to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

Description of Proposal

The proposal would simplify the application of the foreign tax credit limitation by applying the look-through approach immediately to all dividends paid by a 10/50 company, regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated. The proposal would broaden the 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 both pre-acquisition earnings and profits and foreign taxes, in appropriate circumstances. The proposal would modify the effective date of a provision included in the Taxpayer Relief Act of 1997 (the "1997 Act").

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

Effective date.--The proposal would be effective for dividends paid in taxable years beginning after December 31, 1999.

Analysis

The proposal would eliminate the single-basket limitation approach for dividends from 10/50 companies and would accelerate the application of the look-through approach for dividends from such companies for foreign tax credit limitation purposes. It is argued that the current rules for dividends from 10/50 companies will result in complexity and compliance burdens for taxpayers. For instance, dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, will be subject to the concurrent application of both the single-basket approach (for pre-2003 earnings and profits) and the look-through approach (for post-2002 earnings and profits). In light of the delayed effective date for the look-through provision included in the 1997 Act, the 1997 Act's application of the look-through approach only to post-effective date earnings and profits was necessary to avoid affecting the timing of distributions before the effective date. The provision included in the 1997 Act was aimed at reducing the bias against U.S. participation in foreign joint ventures and foreign investment by U.S. companies through affiliates that are not majority-owned. In this regard, the proposal to accelerate the application of the look-through approach would be consistent with this objective.

Under present law, 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 the stock of a 10/50 company. The proposal would broaden such regulatory authority to include rules to disregard (upon distributions from a 10/50 company) both pre-acquisition earnings and profits and foreign taxes, in appropriate circumstances. Under such an approach, in appropriate cases, a shareholder of a 10/50 company would not be entitled to a foreign tax credit with respect to distributions from that company out of pre-acquisition earnings and profits, but also would not be required to include such distributions in its income. Such an approach may provide administrative simplification in cases where it would be difficult for a minority shareholder to reconstruct the historical records of an acquired company. Such an approach also may be appropriate in certain cases where a taxpayer enters into transactions effectively to “purchase” foreign tax credits that can be used to reduce the taxpayer's U.S. residual taxes on other foreign-source income. However, this concept of disregarding earnings and profits and taxes is inconsistent with the general treatment of distributions from acquired corporations for foreign tax credit purposes.

Prior Action

Similar proposals were included in the President's Fiscal Year 1999 and 2000 Budget Proposals.

11. Interest treatment for dividends paid by certain regulated investment companies to foreign persons

Present Law

A regulated investment company ("RIC") is a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act.[170]

In addition, to qualify as a RIC, a corporation must elect such status and must satisfy certain tests.[171] These tests include a requirement that the corporation derive at least 90 percent of its gross income from dividends, interest, payments with respect to certain securities loans, and gains on the sale or other disposition of stock or securities or foreign currencies or other income derived with respect to its business of investment in such stock, securities, or currencies.

Generally, a RIC pays no income tax because it is permitted a deduction for dividends paid to its shareholders in computing its taxable income. Dividends paid by a RIC generally are includable in income by its shareholders as dividends, but the character of certain income items of the RIC may be passed through to shareholders receiving the dividend. A RIC generally may pass through to its shareholders the character of its long-term capital gains by designating a dividend it pays as a capital gain dividend to the extent that the RIC has net capital gain. A RIC generally also can pass through to its shareholders the character of its tax-exempt interest from State and municipal bonds, but only if, at the close of each quarter of its taxable year, at least 50 percent of the value of the total assets of the RIC consists of these obligations.

Under the Code, a 30-percent tax, collected by withholding, generally is imposed on the gross amount of certain U.S.-source income, such as interest and dividends, of nonresident alien individuals and foreign corporations (collectively, "foreign persons"). Dividends paid by a RIC generally are treated as dividends for withholding tax purposes, subject to the exceptions noted above. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable income tax treaty. In the case of dividends on portfolio investments, U.S. income tax treaties commonly provide for a withholding tax at a rate of at least 15 percent.

An exception from the U.S. 30-percent withholding tax is provided for so-called "portfolio interest." Portfolio interest is interest (including original issue discount) which would be subject to the U.S. withholding tax but for the fact that specified requirements are met with respect to the obligation on which the interest is paid and with respect to the interest recipient. Pursuant to these requirements, in the case of an obligation that is in registered form, the U.S. person who otherwise

[170] Section 851(a).

[171] Section 851(b).

would be required to withhold tax must receive a statement that the beneficial owner of the obligation is not a United States person. Alternatively, if the obligation is not in registered form, it must be "foreign targeted." If the obligation is issued by a corporation or a partnership, the recipient of the interest must not have 10 percent or more of the voting power of the corporation or 10 percent or more of the capital or profits interest in the partnership. A corporate recipient of the interest must be neither a controlled foreign corporation receiving interest from a related person, nor (unless the obligor is the United States) a bank receiving the interest on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business. Finally, certain contingent interest does not qualify as portfolio interest.

Description of Proposal

In the case of a RIC that invests substantially all of its assets in certain debt instruments or cash, the proposal would treat all dividends paid by the RIC to shareholders who are foreign persons as interest that qualifies for the "portfolio interest" exception from the U.S. withholding tax. Under the proposal, the debt instruments taken into account to satisfy this "substantially all" test generally would be limited to debt instruments of U.S. issuers that would themselves qualify for the "portfolio interest" exception if held by a foreign person. However, under the proposal, some amount of foreign debt instruments that are free from foreign tax (pursuant to the laws of the relevant foreign country) also would be treated as debt instruments that count toward the "substantially all" test.

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

Analysis

The major advantage claimed by advocates of the proposal is that it would eliminate the disparity in tax treatment between debt instruments qualifying for the "portfolio interest" exception that are held by a foreign person directly and similar instruments owned indirectly through a RIC. The proposal may encourage investment by foreign persons in U.S. debt instruments by making the benefits of the "portfolio interest" exception available to investors who are willing to invest in such instruments only through a diversified fund. Expanding demand for U.S. debt instruments could lower borrowing costs of issuers. It is argued that U.S. RICs are at a competitive disadvantage as compared with foreign mutual funds whose home countries do not impose withholding tax on dividends attributable to income from debt investments. The proposal would ameliorate this disparate treatment between U.S. and foreign mutual funds.

Opponents of the proposal would argue that holding an interest in a RIC that holds debt instruments that qualify for the "portfolio interest" exception is sufficiently different from holding such instruments directly that the "portfolio interest" exception should not apply in the RIC case. A RIC is a widely diversified pool of investments, and managers of RICs have discretion to acquire and dispose of debt instruments in the pool. Moreover, under the proposal, a portion of the RIC's assets may be foreign debt instruments, making an investment in the RIC less analogous to a direct interest in U.S. debt instruments.

Prior Action

Similar proposals were included in the President's Fiscal Year 1999 and 2000 Budget Proposals.

12. Expand declaratory judgment remedy for noncharitable organizations seeking determinations of tax-exempt status

Present Law

To be granted tax-exempt status as a charitable organization described in section 501(c)(3), an organization generally must file an application for recognition of exemption with the IRS and receive a favorable determination of its status.[172] Similarly, for most organizations, a charitable organization's eligibility to receive tax-deductible contributions is dependent upon its receipt of a favorable determination from the IRS. In general, a section 501(c)(3) organization can rely on a determination letter or ruling from the IRS regarding its tax-exempt status, unless there is a material change in its character, purposes, or methods of operation. In cases in which an organization violates one or more of the requirements for tax exemption under section 501(c)(3), the IRS is authorized to revoke an organization's tax exemption, notwithstanding an earlier favorable determination.

In situations in which the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on the application, or if the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its status. Specifically, section 7428 provides a remedy in the case of a dispute involving a determination by the IRS with respect to: (1) the initial qualification or continuing qualification of an organization as a charitable organization for tax exemption purposes or for charitable contribution deduction purposes, (2) the initial classification or continuing classification of an organization as a private foundation, (3) the initial classification or continuing classification of an organization as a private operating foundation, or (4) the failure of the IRS to make a determination with respect to (1), (2), or (3). A determination in this context generally is a final decision by the IRS affecting the tax qualification of a charitable organization, although it also can include a proposed revocation of an organization's tax-exempt status or public charity classification. Section 7428 vests jurisdiction over controversies involving such a determination in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the U.S. Tax Court.

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[172] Certain organizations, such as churches, are not required to file an application for tax-exempt status.

Prior to utilizing the declaratory judgment procedure, an organization must have exhausted all administrative remedies available to it within the IRS. For the first 270 days after a request for a determination is made, an organization is deemed to have not exhausted its administrative remedies. Provided that no determination is made during the 270-day period, the organization may initiate an action for declaratory judgment after the period has elapsed. If, however, the IRS makes an adverse determination during the 270-day period, an organization may initiate a declaratory judgment immediately. The 270-day period does not begin with respect to applications for recognition of tax-exempt status until the date a substantially completed application is submitted.

In contrast to the rules governing charities, it is a disputed issue as to whether non-charities (i.e., organizations not described in section 501(c)(3), including trade associations, social welfare organizations, social clubs, labor and agricultural organizations, and fraternal organizations) are required to file an application with the IRS to obtain a determination of their tax-exempt status. If an organization voluntarily files an application for recognition of exemption and 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. Furthermore, as with section 501(c)(3) organizations, the IRS may revoke or modify an earlier favorable determination regarding an organization's tax-exempt status.

Under present law, a non-charity (i.e., an organization not described in section 501(c)(3)) may not seek a declaratory judgment with respect to an IRS determination regarding its tax-exempt status. The remedies available to such an organization are to petition the U.S. Tax Court for relief following the issuance of a notice of deficiency or to pay any tax owed and sue for refund in Federal district court or the U.S. Court of Federal Claims.

Description of Proposal

The proposal would extend declaratory judgment procedures similar to those currently available only to charities under section 7428 to other section 501(c) organizations seeking determinations from the IRS. 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.

Effective date.--The proposal would be effective for applications for recognition of exemption filed after December 31, 2000.

Analysis

The declaratory judgment procedures are designed to provide a relatively simple and prompt means (as compared to deficiency or refund proceedings) of judicial review of certain issues relating to the tax-exempt status of organizations. The primary benefit of permitting tax-exempt organizations other than those described in section 501(c)(3) to use the declaratory judgment procedures would be to provide a remedy in cases in which the IRS delays action on an application for recognition of tax-exempt status filed by such an organization and, consequently, the organization is left uncertain about its status and any potential tax liability for an extended period of time. While section 501(c)(3) organizations that are eligible to receive tax-deductible contributions arguably require faster judicial resolution of issues related to their tax-exempt status in order to protect their ability to receive deductible contributions, it is argued that allowing non-charities access to the declaratory judgment procedures would not impede this objective.

The proposal does not specify whether non-charities would be permitted to use the declaratory judgment procedures in situations other than an initial denial of tax-exempt status (e.g., a proposed revocation of exemption after the IRS previously had issued a favorable determination or a determination by the IRS that an organization should be reclassified from section 501(c)(4) to 501(c)(19)).

The proposal would limit jurisdiction over declaratory judgments for non-charities to the United States Tax Court.[173] The United States Tax Court is the only one of the three possible jurisdictions for present-law section 7428 declaratory judgment actions to have adopted formal procedural rules for such actions.[174] The most significant feature of these rules is that, in the case of a denial by the IRS for an initial determination of exemption, the rules generally confine the Tax Court to a review based solely on the facts contained in the administrative record. Thus, the parties are not permitted to submit new evidence while the case is pending before the Tax Court.

Prior Action

No prior action.

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[173] This limitation currently applies to declaratory judgments relating to tax qualification for certain employee retirement plans (sec. 7476).

[174] Rules of Practice and Procedure, U.S. Tax Court, Title XXI. Many of the U.S. Tax Court procedures have been adopted on a case-by-case basis by the U.S. District Court for the District of Columbia and the U.S. Court of Federal Claims.

13. Translation of foreign withholding taxes by accrual basis taxpayers

Present Law

Translation of income or earnings

In general, for each taxable year, a U.S. taxpayer with a foreign branch whose functional currency is a currency other than the U.S. dollar must compute income or loss separately for each qualified business unit ("QBU") in the business unit's functional currency, converting this amount to U.S. dollars using the weighted average exchange rate for the taxable period over which the income or loss was derived.[175] The translated amount is included in income of the taxpayer without reduction for remittances from the branch during the year.

For purposes of determining the tax of any shareholder of a foreign corporation, the earnings and profits of the foreign corporation are determined in the corporation's functional currency.[176] The Code prescribes appropriate exchange rates to translate actual distributions; deemed distributions under subpart F, the foreign personal holding company rules, and the rules relating to passive foreign investment companies; and gain that is recharacterized under section 1248 as dividend income on the disposition of stock in a controlled foreign corporation or former controlled foreign corporation.[177]

On the actual distribution of earnings and profits from a foreign corporation, a U.S. taxpayer is required to translate such amounts (if necessary) at the spot rate on the date the distribution is included in income.[178] Similarly, in the case of gain that is treated as a distribution of earnings under section 1248, the deemed dividend is translated (if necessary) at the spot rate on the date the amount is included in income.[179] Thus, for actual distributions and deemed dividends under section 1248, no exchange gain or loss is separately recognized as the result of exchange rate fluctuations between the time earnings and profits arise and the time of distribution (or deemed distribution).

In the case of deemed distributions under subpart F, the foreign personal holding company rules, or the passive foreign investment company rules, the required income inclusion is first calculated in the functional currency and then translated at the weighted average exchange rate for

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[175] Sections 987 and 989(b)(4).

[176] Sections 986(b)(1).

[177] Sections 986(b)(2) and 989(b).

[178] Section 989(b)(1).

[179] Section 989(b)(2).

the foreign corporation's taxable year.[180] Exchange gain or loss is recognized as the result of exchange rate fluctuations between the time of a deemed distribution and the time any previously taxed income is actually distributed.[181]

Interest income and expense on a nonfunctional currency debt instrument is initially determined in the nonfunctional currency and then translated into the taxpayer's functional currency. If interest income or expense is reported on a cash basis, it is translated at the spot rate on the date of receipt or payment. In general, no exchange gain or loss is realized when the interest is received or paid. If interest income or expense is reported on an accrual basis, each accrual generally is translated at the average exchange rate during the accrual period. Exchange gain or loss is realized on the payment of interest (in the case of the obligor) or receipt of interest (in the case of the holder) if the exchange rate at which the interest was translated differs from the spot rate on the date of payment or receipt. For example, the obligor's gain or loss on payment is the amount accrued in the functional currency less the amount paid, translated into the functional currency at the spot rate on the date of payment. The holder's exchange gain or loss is the amount received, translated into the functional currency at the spot rate on the date of receipt, reduced by the amount accrued in the functional currency.

Translation of foreign taxes

Taxpayers that take foreign income taxes into account when accrued generally are required to translate such taxes into U.S. dollars at the average exchange rate for the taxable year to which such taxes relate.[182] This rule applies to foreign income taxes imposed on a net basis and to foreign withholding taxes imposed on a gross basis. This rule, however, does not apply (1) to any foreign income (or withholding) taxes paid two years after the close of the taxable year to which such taxes relate, (2) with respect to taxes of an accrual-basis taxpayer that are actually paid in a taxable year prior to the year to which they relate, or (3) to tax payments that are denominated in an inflationary currency (as defined by regulations).[183]

Foreign taxes not eligible for application of the rule in the preceding paragraph (i.e., translation of accrued taxes at average exchange rates) generally are translated into U.S. dollars using the exchange rates as of the time such taxes are paid.[184] The Secretary of the Treasury is granted the authority to issue regulations that would allow foreign tax payments to be translated into U.S. dollars using an average exchange rate for a specified period.

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[180] Section 989(b)(3).

[181] Section 986(c)(1).

[182] Section 986(a)(1)(A).

[183] Section 986(a)(1)(B) and (C).

[184] Section 986(a)(2).

Description of Proposal

The proposal would modify present law to provide that foreign withholding taxes would be translated at the spot rate on the date of payment, regardless of the taxpayer's method of accounting. The Secretary of the Treasury would be granted the authority to modify this rule in certain cases, such as in the case of foreign withholding taxes paid by a foreign branch of a U.S. taxpayer.

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

Analysis

The present-law rules which generally require accrual basis taxpayers to translate foreign taxes at the average exchange rate for the taxable year was enacted in 1997 as part of the Taxpayer Relief Act of 1997 to reduce administrative burdens associated with the foreign tax credit.[185] The proposal would modify these rules for foreign withholding taxes and generally provide that such taxes would be translated into U.S. dollars at the spot rate on the date of payment, regardless of the taxpayer's method of accounting.

The proposal reflects the view that foreign withholding taxes are not accrued prior to the time the tax is paid and, thus, an average exchange rate may not be a relevant rate for purposes of translating the tax. The proposal would also eliminate certain compliance problems associated with the present-law rules. In this regard, certain taxpayers such as regulated investment companies that receive income subject to foreign withholding taxes may have difficulty determining the appropriate average exchange rate under present law if their taxable year differs from the calendar year. The proposal thus could be viewed as providing simplification for purposes of translating foreign taxes.

Moreover, proponents of the proposal assert that the proposal would more clearly reflect income than the present-law rules, which may result in a mismatch between the exchange rate used to translate foreign withholding taxes and the exchange rate used to translate the associated income. Under present law, foreign withholding taxes of accrual basis taxpayers generally are translated into U.S. dollars at the average exchange rate for the taxable year to which such taxes relate. However, the income associated with such withholding taxes generally is translated into U.S. dollars at a different rate -- at an appropriate spot rate (e.g., in the case of dividends), or if accrued by the taxpayer (e.g., in the case of interest), is adjusted as of the date the income is received to account for variations in exchange rates between the time of accrual and the time of payment. Proponents of the proposal argue that the proposal would apply similar rules for translating foreign taxes and the income to which such taxes relate.

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[185] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997*, at 297 (JCS-23-97), December 17, 1997.

On the other hand, the spot-payment rule under the proposal could result in mismatches in exchange rates in certain cases, such as in the case of foreign withholding taxes paid by a foreign branch of a U.S. taxpayer. Under present law, the earnings of the foreign branch are translated into U.S. dollars at the average exchange rate for the taxable year. Thus, applying a spot-payment rule for foreign withholding taxes with respect to such branch earnings may result in different exchange rates being applied to the foreign taxes and associated earnings (unlike under present law). The proposal, however, would grant the Treasury Secretary the authority to apply the same rule for translating withholding taxes and the branch earnings -- i.e., the average exchange rate for the taxable year. Some might argue that the proposal should explicitly provide for such a translation rule for branch withholding taxes, as opposed to granting the Secretary regulatory authority to address this issue.

Some may argue that a similar approach to apply the same translation rules with respect to dividends from a foreign corporation and associated indirect foreign tax credits was rejected by Congress as part of the Tax Reform Act of 1986 (the "1986 Act"). Prior to 1986, under the authority of the Bon Ami case,[186] the amount of a dividend and the foreign taxes deemed paid were translated at the same exchange rate -- the rate in effect on the date of the distribution. This approach was defended on the ground that it preserved the historic ratio between foreign taxes and accumulated profits, so that the U.S.-dollar value of the foreign tax eligible for credit was the same percentage of the U.S.-dollar value of the dividend as the effective foreign currency denominated tax was of the related foreign earnings. Congress determined in the 1986 Act, however, that retention of the foreign tax rate was not a goal of U.S. tax policy.[187] Proponents of the proposal would assert, however, that the proposal would be consistent with the 1986 Act and the rejection of the Bon Ami approach generally (which applied to indirect foreign tax credits). Following the 1986 Act (and before the changes enacted in 1997), foreign withholding taxes (i.e., direct taxes) were translated at the spot rate on the date of payment (i.e., the same rate as under the proposal).

Prior Action

No prior action.

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[186] Bon Ami Co. v. Commissioner, 39 B.T.A. 825 (1939) (a case decided under the predecessor to section 902).

[187] In Congress' view, the Bon Ami approach resulted in a tax advantage if the foreign corporation's functional currency appreciated against the dollar, and a tax penalty if the functional currency depreciated in value.

14. Simplify penalties for failure to file Form 5500

Present Law

Form 5500 filing requirements in general

A plan administrator of a pension, annuity, stock bonus, profit-sharing or other funded plan of deferred compensation must file with the Secretary of the Treasury an annual return for each plan year containing certain information with respect to the qualification, financial condition, and operation of the plan. Title I of ERISA also requires the plan administrator to file annual reports concerning the plan with the Department of Labor and the Pension Benefit Guaranty Corporation ("PBGC"). The plan administrator must use the Form 5500 series as the format for the required annual return. The Form 5500 series annual return/report, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 series annual return/report with the IRS, which forwards the form to the Department of Labor and the PBGC. The use of the Form 5500 series annual return/report for compliance with the Code and ERISA reporting requirements is not mandated by statute; the combined filing is a result of administrative efforts to simplify administration of the reporting requirements.

Penalties for failure to file Form 5500

If the plan administrator fails to file a timely and complete Form 5500 series annual return, the Code imposes on the plan administrator a penalty equal to $25 per day during which the failure continues, not to exceed $15,000 per return. The Secretary of the Treasury may waive the penalty if the plan administrator demonstrates that the failure to file is due to reasonable cause. In addition, Title I of ERISA provides that the Secretary of Labor may impose on the plan administrator a penalty of up to $1,100 per day. The Secretary of Labor may waive the penalty if the plan administrator demonstrates that the failure to file is due to reasonable cause. Furthermore, Title IV of ERISA provides that the PBGC may impose on the plan administrator a penalty of up to $1,100 per day. The PBGC may waive the penalty if the plan administrator demonstrates that the failure to file is due to reasonable cause.

The Department of Labor has instituted the Delinquent Filer Voluntary Compliance Program ("DFVC Program") to encourage, through the assessment of reduced penalties, delinquent plan administrators to comply with their annual reporting obligations under ERISA. The amount of the penalty under the DFVC Program depends upon whether the plan administrator files the Form 5500 series annual report within 12 months after the due date of the report. If the plan administrator files the delinquent report under the DFVC Program on or before 12 months after the date on which the annual report was due, the reduced penalty is $50 per day up to a maximum of $2,500 for plans with 100 or more participants or $1,000 for plans with less than 100 participants. If the plan administrator files the delinquent report under the DFVC Program more than 12 months after the due date, the reduced penalty is $5,000 for plans with 100 or more participants or $2,000 for plans with less than 100 participants. If a plan administrator elects to use the DFVC Program, the plan administrator must file the complete delinquent Form 5500 series report with the IRS and a copy of the first page of the report with the Department of Labor.

A plan administrator's use of the DFVC Program does not affect the penalty imposed under the Internal Revenue Code for failure to file a timely and complete Form 5500 series annual return. The Department of the Treasury has not established a voluntary compliance program similar to the DFVC Program, and a plan administrator may not correct a delinquent Form 5500 series filing under the IRS Employee Plans Compliance Resolution Program ("EPCRP").

Schedule SSA

The plan administrator of an employee pension benefit plan that is subject to the minimum vesting standards under Title I of ERISA must file with the Secretary of the Treasury for each plan year a registration statement that identifies and provides certain information concerning each plan participant who separates from service during the plan year with a deferred vested benefit under the plan as of the end of the plan year and with respect to whom no retirement benefits were paid under the plan during the plan year. The plan administrator must file the required information for a participant on Schedule SSA as an attachment to the plan's Form 5500 series annual return for the year following the year in which the participant separates from service.

The IRS provides the information contained on Schedule SSA to the Social Security Administration, which enters the information in an electronic pension benefit record. Each month, the Social Security Administration determines whether each new claimant for social security benefits or for hospital insurance coverage is listed in this electronic pension benefit record. The Social Security Administration sends a notice to each new claimant for whom it has pension benefit information, informing the claimant that he or she may have a right to future retirement benefits under the plan with respect to which the Schedule SSA was filed. If the claimant filed for the lump-sum death payment on the social security account of a relative, the Social Security Administration sends the claimant the pension information on the deceased individual. The notice shows the type, payment frequency, and amount of pension benefit, as well as the name and address of the plan administrator as reported on the Schedule SSA. The claimant may use this information to claim any pension benefits still due from the pension plan. The Social Security Administration also provides available pension benefit information on request.

If the plan administrator fails to file Schedule SSA as required, or omits from Schedule SSA a participant required to be included, a penalty is imposed on the plan administrator equal to $1 per day per failure or omitted participant, not to exceed $5,000 per plan year. The Secretary of the Treasury may waive the penalty if the plan administrator demonstrates that the failure to file or omission is due to reasonable cause.

Schedule B

For each plan year, the plan administrator of a defined benefit pension plan must file with the Secretary of the Treasury an actuarial report that contains, among other things, a description of the funding method and actuarial assumptions used to determine costs under the plan and a certification concerning the contribution required for compliance with the Code section 412 minimum funding standards. The plan administrator must file the actuarial report on Schedule B as an attachment to the plan's Form 5500 series annual return for the plan year.

If the plan administrator fails to file Schedule B as required, a penalty is imposed on the plan administrator equal to $1,000. The Secretary of the Treasury may waive the penalty if the plan administrator demonstrates that the failure to file is due to reasonable cause.

Change in status of plan

The plan administrator of an employee pension benefit plan that is subject to the minimum vesting standards under Title I of ERISA must notify the Secretary of the Treasury of any change in the name of the plan, any change in the name or address of the plan administrator, the termination of the plan, the merger or consolidation of the plan with any other plan, or the division of the plan into two or more plans. The plan administrator must provide the required notification of a plan status change on the plan's Form 5500 series annual return for the year in which the change in status occurs.

If the plan administrator fails to provide notification of a plan status change as required, a penalty is imposed on the plan administrator equal to $1 per day per failure, not to exceed $1,000 per plan year. The Secretary of the Treasury may waive the penalty if the plan administrator demonstrates that the failure is due to reasonable cause.

Description of Proposal

The proposal would repeal the separate Internal Revenue Code and PBGC penalties for failure to file an annual report, Schedule SSA, statement of plan changes and Schedule B for a retirement plan subject to penalties for failure to report under ERISA and consolidate into one ERISA penalty the present-law penalties imposed by the Internal Revenue Code and ERISA for failure to file the Form 5500 Series annual return/report for deferred compensation plans. The penalty that would result from this consolidation would not exceed a specified amount per day with a maximum penalty per return. Waiver or reduction of the penalty would be permitted upon a showing of reasonable cause. The proposal would designate the Department of Labor as the agency responsible for enforcement of the reporting requirements and encourage the Department of Labor to continue the DFVC Program, thereby reducing from three to one the number of government agencies authorized to assess, waive, and reduce penalties for failure to file the Form 5500 series annual return/report.

Effective date.--The proposal would be effective for plan years beginning after December 31, 2001.

Analysis

The Form 5500 series annual return/report is crucial to the efforts of the IRS, the Department of Labor, and the PBGC to monitor retirement plan compliance with the applicable requirements of the Internal Revenue Code and ERISA. The information contained in the annual report/return also is available to participants and beneficiaries who desire to learn about the operation and status of their retirement plan. The penalties for failure to comply with the reporting requirements should be clear enough to permit plan administrators to understand the consequences of noncompliance and significant enough to motivate plan administrators to comply.

The separate penalties imposed by the Internal Revenue Code and ERISA for a plan administrator's failure to file a timely and complete Form 5500 series annual return/report result in a confusing penalty structure. Because Schedule SSA, Schedule B, and notification of a plan status change are required as parts of the Form 5500 series annual return, a failure to file Schedule SSA or an omission of a required participant, a failure to file Schedule B, or a failure to provide notification of a plan status change is, in effect, a failure to file a complete Form 5500 series return. For penalty purposes, however, a failure or omission with respect to Schedule SSA or Schedule B does not constitute a Form 5500 series failure and results in a different and potentially significantly smaller penalty than the penalty for failure to file the Form 5500 series annual return.[188] A failure to provide notification of a plan status change produces the same result. The separate Code and ERISA penalty provisions for the Form 5500 series annual report/return, and the separate Code penalty provisions for Schedule SSA, Schedule B, and notification of a plan status change, complicate the Form 5500 series annual return penalty structure and create the possibility that a plan administrator may face multiple penalties for a failure to file one return/report. A plan administrator that fails to file an annual return/report may be required to pay six different penalties to three different government agencies, with five penalties based upon the number of days following the due date of the return and the other penalty based upon a flat dollar amount. If the plan administrator believes that the failure to file was due to reasonable cause, the plan administrator may be required to demonstrate the existence of reasonable cause to three different government agencies and may receive a different determination from each agency as to the sufficiency of the demonstration. Six different penalties based upon different theories for different components of the Form 5500 series annual return/report make it difficult for plan administrators to understand the penalty structure, as well as for the various agencies to administer the penalties.

Based on its determination that the possible assessment of the significant ERISA penalties for failure to file may deter certain delinquent filers from voluntarily complying with the annual

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[188] Rev. Rul. 84-54, 1984-1 C.B. 260.

reporting requirements under Title I of ERISA, the Department of Labor established the DFVC Program in an effort to encourage voluntary annual reporting compliance.[189] The possibility that, notwithstanding use of the DFVC Program, a delinquent filer who is unable to demonstrate reasonable cause may face a penalty under the Internal Revenue Code may discourage voluntary compliance.

Furthermore, the separate and relatively less significant Schedule SSA, Schedule B, and notification of plan status change penalties may imply that a plan administrator's obligations to facilitate the Social Security Administration's tracking of individual taxpayers' deferred vested retirement benefits, to demonstrate compliance with the minimum funding standards, and to report the status of the plan are less important than the obligation to report basic plan information. In light of the significant role that the Social Security Administration's electronic pension benefit record plays in ensuring that individuals receive their retirement benefits, the fluctuations in permitted or required pension funding that can result from incorrect actuarial assumptions, and the consequences of plan termination or merger, these implications are inappropriate.

The Joint Committee staff previously has made a recommendation similar to the proposal.[190] The proposal would simplify the Form 5500 series penalty structure, reduce the number of potential penalties for failure to file, and strengthen the incentive for plan administrators to comply with the Schedule SSA, Schedule B, and plan status change notification requirements. Some may question whether simplification and increased compliance justify the potential for higher penalties that would result from eliminating the separate penalties for failure to file Schedule SSA, Schedule B, and notification of plan status change and treating such failures as failures to file a complete Form 5500 series annual return/report.

The proposal would designate the Department of Labor as the agency responsible for the administration of the consolidated Form 5500 series penalty structure because the Department of Labor has been the lead agency in the Form 5500 series design and implementation, is the agency who will be the liaison with the central processor of all Form 5500 series annual returns/reports, is actively auditing compliance with reporting requirements, and is currently administering the DFVC Program to provide relief from penalties in connection with delinquent Form 5500 series annual returns/reports. The recommendation of the Joint Committee staff concerning the simplification and consolidation of the Form 5500 series penalty structure would designate the IRS as the agency responsible for enforcement of the reporting requirements and would replace

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[189] *Id.*

[190] Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1988 (Including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999, Volume I, page 164.

the DFVC Program with a similar program under the IRS EPCRP.[191] The Joint Committee staff would designate the IRS as the responsible agency because the IRS has extensive experience in administering various types of filing and reporting penalty structures and the actuarial expertise required for analyzing and utilizing Schedule B data. Furthermore, the integration of the DFVC Program into the successful IRS EPCRP would simplify and promote voluntary compliance by permitting plan sponsors to seek correction of tax-qualification and reporting defects through one program and one agency.

Prior Action

No prior action.

15. Provide that a domestic corporation is entitled to claim deemed-paid and direct foreign tax credits with respect to certain investments held indirectly by or through pass-through entities

Present Law

Under section 902, a domestic corporation that receives a dividend from a foreign corporation in which it owns ten percent or more of the voting stock is deemed to have paid a portion of the foreign taxes paid by such foreign corporation. Thus, such domestic corporation would be eligible to claim a foreign tax credit with respect to such deemed-paid taxes. The domestic corporation that receives a dividend is deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes based on the ratio of the amount of such dividend to the foreign corporation's post-1986 undistributed earnings and profits.

Foreign income tax paid or accrued by lower-tier foreign corporations are also eligible for the deemed-paid credit if the foreign corporation falls within a qualified group (sec. 902(b)). A "qualified group" includes certain foreign corporations within the first six tiers of a chain of foreign corporations if, among other things, the product of the percentage ownership of voting stock at each level of the chain (beginning from the U.S. corporation) equals at least five percent. In addition, in order to claim indirect credits for foreign taxes paid by certain fourth-, fifth-, and sixth-tier corporations, such corporations must be controlled foreign corporations ("CFCs") (within the meaning of sec. 957) and the U.S. shareholder claiming the indirect credit must be a U.S. shareholder (as defined in sec. 951(b)) with respect to the CFCs. The application of the indirect foreign tax credit below the third tier is limited to taxes paid in taxable years during which the payor is a CFC. Foreign taxes paid below the sixth tier of foreign corporations are ineligible for the indirect foreign tax credit.

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[191] *Id.*

Section 960 similarly permits a domestic corporation with subpart F inclusions from a CFC to claim deemed-paid foreign tax credits with respect to foreign taxes paid or accrued by the CFC on its subpart F income.

The foreign tax credit provisions in the Code do not specifically address whether a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit.[192] However, Rev. Rul. 71-141[193] held that two U.S. corporations would be attributed the foreign corporation stock held by their U.S. general partnership for purposes of determining eligibility to claim a deemed-paid foreign tax credit with respect to the foreign taxes paid by such foreign corporation.[194] The preamble to the final regulations under section 902 states that "[t]he final regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity."[195] In recognition of the holding in Rev. Rul. 71-141 that a general partner of a domestic general partnership is permitted to claim deemed-paid foreign tax credits with respect to a dividend distribution from the foreign corporation to the partnership, however, the preamble to the final regulations under section 902 states that a "domestic shareholder" for purposes of section 902 is a domestic corporation that "owns" the requisite voting stock in a foreign corporation rather than one that "owns directly" the voting stock. At the

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[192] In addition, the Code does not set forth indirect or constructive attribution rules for purposes of allowing U.S. corporations to claim indirect foreign tax credits. This implies that only direct ownership is considered. See, e.g., First Chicago Corp. v. Commissioner, 96 T.C. 421 (1991) (holding that members of a consolidated group in which no single member directly owned at least ten percent of the voting stock of a foreign corporation were not entitled to claim indirect foreign tax credits because section 902 and the consolidated return regulations, considered separately or in conjunction with each other, do not permit affiliated corporations to aggregate their share ownership in order to satisfy the ten-percent requirement of section 902). See also Rev. Ruls. 74-459 (1974-2 C.B. 208) and 85-3 (1985 C.B. 222).

[193] 1971-1 C.B. 211.

[194] In Rev. Rul. 71-141, two U.S. corporations formed a domestic general partnership, each taking a fifty percent voting interest. The general partnership owned forty percent of the voting stock of a foreign corporation. The ruling held that each U.S. partner should be treated as owning its share (i.e., twenty percent) of the foreign corporation's voting stock. Thus, each U.S. corporate partner was permitted to claim a section 902 deemed-paid foreign tax credit because each partner satisfied the ten-percent minimum ownership requirement under section 902.

[195] T.D. 8708, 62 Fed. Reg. 923 (1997).

same time, the preamble states that the IRS is still considering under what other circumstances Rev. Rul. 71-141 should apply.[196]

Under Section 1113(c)(2) of the Taxpayer Relief Act of 1997 (P.L. 105-34), no liquidation, reorganization, or similar transaction can have the effect of permitting taxes to be taken into account under the indirect foreign tax credit provisions of the Code that could not have otherwise been taken into account because of the denial of indirect taxes below the sixth tier.

Under section 901(b)(5), an individual member of a partnership or a beneficiary of an estate or trust generally may claim a direct foreign tax credit with respect to the amount of his or her proportionate share of the foreign taxes paid or accrued by the partnership, estate, or trust. This rule does not specifically apply to corporations that are either members of a partnership or beneficiaries of an estate or trust. However, section 702(a)(6) provides that each partner (including individuals or corporations) of a partnership must take into account separately its distributive share of the partnership's foreign taxes paid or accrued.

The regulations under section 7701 provide elective rules for classifying business organizations for federal tax purposes (the so-called "check-the-box regulations").[197] Under the check-the-box regulations, a business entity with only one owner may be classified as either a corporation or disregarded. If an entity is disregarded under these rules, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

Description of Proposal

The proposal would amend section 902(a) (as well as section 960) to clarify that a domestic corporation is eligible to claim a deemed-paid foreign tax credit with respect to a foreign corporation that is held indirectly through a foreign or domestic partnership. For these purposes, partnerships would include limited liability companies and other entities that are elected to be treated as partnerships under the check-the-box regulations. In order to claim the indirect foreign tax credit, the domestic corporation must own, indirectly through the partnership, ten percent or

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[196] Prior to the final section 902 regulations, the IRS issued proposed regulations under section 902 and stated in the preamble that consideration was being given to restricting the circumstances in which the principle of Rev. Rul. 71-141 would be applied. See 60 Fed. Reg. 2049 (1995). In the preamble to the proposed regulations, the IRS requested comments on whether the holding of Rev. Rul. 71-141 should be expanded to allow taxes paid by a foreign corporation to be considered deemed paid by domestic corporations that are partners in domestic limited partnerships or foreign partnerships, shareholders in limited liability companies, beneficiaries of domestic or foreign trusts, or interest holders in other pass-through entities. As described above, the final section 902 regulations do not resolve whether indirect foreign tax credits may be claimed in such cases.

[197] Treas. Reg. sec. 301.7701-1, et. seq.

more of the voting stock of the foreign corporation. The amount of deemed-paid foreign tax credits that would be available under the proposal is the amount attributable to the domestic corporation's proportionate share of dividend income from the foreign corporation.

The proposal would also treat a qualified business unit (as defined in section 989(a)) as a separate tier for purposes of the six-tier limitation rule of section 902(b). A qualified business unit, for this purpose, would include a branch, a partnership, and an entity that is disregarded under the check-the-box regulations (e.g., a single-member foreign entity in which the member elects to have the entity disregarded for U.S. tax purposes under the check-the-box regulations).

The proposal would codify the rule which provides that liquidations, reorganizations, or similar transactions cannot have the effect of permitting taxes that could not have otherwise been taken into account to be taken into account under the indirect foreign tax credit provisions of the Code. This rule generally would apply in the case of taxes that would be eligible for the indirect foreign tax credit but for the denial of indirect taxes below the sixth tier.

The proposal would expand section 901(b)(5) to allow a domestic corporation to claim a direct foreign tax credit for its proportionate share of taxes of a partnership, estate, or trust in which it is a partner or beneficiary, respectively. Thus, the same treatment would apply as applies under present law in the case of individuals.

<u>Effective date</u>.--The proposal would be effective for distributions made in taxable years beginning after the date of enactment.

Analysis

The proposal is intended to eliminate the uncertainty that may exist under present law with respect to (1) the application of the indirect foreign tax credit rules when a partner indirectly owns an interest in a foreign corporation through a partnership, and (2) the application of the direct foreign tax credit rules with respect to a domestic corporation owning an interest in a partnership, estate, or trust. Although Rev. Rul. 71-141 appears to address some of these issues in the context of deemed-paid foreign tax credits claimed through U.S. general partnerships, uncertainty with respect to present law may remain, particularly in light of the preamble to the 1997 section 902 final regulations which states that the IRS is still considering under what other circumstances Rev. Rul. 71-141 should apply. To provide certainty in this area, the proposal would permit a domestic corporation to claim deemed-paid foreign tax credits with respect to a foreign corporation that is held indirectly through a foreign or U.S. partnership, provided that the domestic corporation owns (indirectly through the partnership) ten percent or more of the foreign corporation's voting stock. In addition, the proposal would permit a domestic corporation to claim a direct foreign tax credit for its proportionate share of taxes of a partnership, estate, or trust in which it is a partner or beneficiary, respectively.

The proposal, however, goes beyond merely clarifying potential uncertainties in the law in this area. The proposal would significantly change the manner in which the six-tier limitation rule is applied. Under present law, the six-tier limitation rule applies only to foreign corporations and not to branches, partnerships, or disregarded entities. The proposal would modify present law by treating qualified business units, as defined in section 989(a), as separate tiers for purposes of the six-tier qualified group limitation. Qualified business units would, for purposes of the proposal, include a branch, a partnership, or an entity that is disregarded for U.S. tax purposes in accordance with the check-the-box regulations. Proponents of the proposal argue that applying the six-tier limitation to such types of pass-through entities would provide administrative simplification. Arguably, each set of books and records through which the IRS must investigate in the course of an audit creates increased administration burdens. In most cases, branches, disregarded entities, and partnerships maintain a distinct and separate set of books and records. The proposal, however, may in fact result in additional administrative and complexity burdens (and possibly traps for the unwary) for taxpayers that generally would treat such entities as pass-through or disregarded entities for Federal income tax purposes but as separate entities for purposes of the tier-limitation rule. For example, a taxpayer with a branch would treat the branch as disregarded generally for Federal income tax purposes, but would be required to treat that same unit as a separate entity for purposes of the tier-limitation rule.

Critics of the proposal argue that branches, partnerships, disregarded entities, and other pass-through entities should not be treated as separate entities for purposes of the tier-limitation rule, but rather should be treated consistently as pass-through or disregarded entities for Federal income tax purposes. For example, under an aggregate view of partnerships, the partners of a partnership take into account separately their distributive share of the partnership's foreign taxes paid or accrued. The proposal's treatment of a partnership as a separate entity for purposes of the six-tier limitation rule would be inconsistent with such an approach. Moreover, it is argued that entities that are disregarded under the check-the-box regulations should be disregarded for all federal income tax purposes, including for purposes of the indirect foreign tax credit provisions and the six-tier limitation. Some argue that disrespecting disregarded entity status for some but not all purposes of the Code would be inconsistent with the fundamental premise of the entity classification provisions (i.e., that such classifications are generally effective for all federal tax purposes). The lack of uniform treatment (i.e., disregarding the entity for some tax purposes but respecting the entity for other tax purposes) may create uncertainty and confusion for taxpayers in applying the check-the-box regulations and complying with federal income tax laws.

Under the proposal, domestic corporations would be permitted to claim a direct foreign tax credit for their proportionate share of taxes of a partnership, estate, or trust in which they are a partner or beneficiary, as the case may be. Thus, the proposal would expand section 901(b)(5), which presently is limited to individuals, to apply to corporations. This approach would be consistent with the partnership distributive share rules of section 702(a)(6), which require both individual and corporate partners of a partnership to take into account separately their distributive share of the partnership's paid or accrued foreign taxes.

The proposal does not address how a U.S. corporation's ownership of a partnership would be measured for purposes of attributing ownership of an underlying foreign corporation under the foreign tax credit rules. For instance, a U.S. corporation's ownership of a partnership could be based on either a capital or profits interests in the partnership. Also, the manner in which special partnership allocations might be taken into account would have to be clarified.

Prior Action

No prior action.

16. Treat corporations in an affiliated group as a single corporation

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if such property had been sold for its fair market value. An exception to this rule is where the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. Among the requirements that must be satisfied in order to qualify for tax-free treatment under section 355 is that, immediately after the distribution, both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business (sec. 355(b)(1)). [198] For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) the corporation is not directly engaged in an active trade or business, then substantially all of its assets consist of stock and securities of a corporation it controls that is engaged in the active conduct of a trade or business (sec. 355(b)(2)(A)).

In determining whether a corporation satisfies the active trade or business requirement, the IRS's position for advance ruling purposes is that the value of the gross assets of the trade or business being relied on must constitute at least five percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[199] However, if the corporation is not directly engaged in an active trade or business, then the "substantially all" test requires that at least 90 percent of the value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.[200]

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

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

[200] Rev. Proc. 86-41, section 4.03(4), 1986-2 C.B. 716; Rev. Proc. 77-37, section 3.04, 1977-2 C.B. 568.

Description of Proposal

The proposal would eliminate the "substantially all" test, and instead, apply the active business requirement on an affiliated group basis. In applying the active business test to an affiliated group, each relevant affiliated group (immediately after the distribution) must satisfy the requirement. For the distributing corporation, the relevant affiliated group would consist of the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under section 1504(b)). The relevant affiliated group for a controlled corporation would be determined in a similar manner (with the controlled corporation as the common parent).

Effective date.--The proposal would be effective for distributions after the date of enactment.

Analysis

The proposal should simplify the business planning for corporate groups that use a holding company structure to engage in distributions that qualify for tax-free treatment under section 355. It is common for affiliated groups with a holding company, in contemplation of a tax-free spin-off, to undergo a series of preliminary restructurings simply to satisfy the active trade or business test. The proposal would eliminate the need for such restructurings. Moreover, applying the active trade or business requirement on a limited affiliated group basis is consistent with the treatment accorded to affiliated groups for other purposes of section 355(b)(2).[201]

It is unclear whether section 355(b)(2)(A), which was enacted in 1954, was intended to impose different active trade or business tests depending on the corporate structure. Indeed, Treasury Regulations issued a year earlier had provided that a corporation would be treated as engaged in an active trade or business if it was engaged in the trade or business directly or indirectly through another corporation (the policies of which were directed by the corporate parent).[202] It is conceivable that the "substantially all" test was only intended to override that aspect of the regulations.

[201] The flush language to section 355(b)(2) provides that for purposes of determining acquisition of control of a corporation under section 355(b)(2)(D), all distributee corporations which are members of the same affiliated group are treated as one distributee corporation. However, section 355(b)(2)(D) is an anti-abuse provision, so the inconsistent treatment may be appropriate.

[202] Treas. Reg. section 29.112(b)(11)-2, 1953-1 C.B. 143.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

G. Philanthropy Provisions

1. Charitable contribution deduction for non-itemizers

Present Law

Generally, a taxpayer who itemizes deductions may deduct charitable contributions of cash and property made within a taxable year. In general, the amount of the deduction for a contribution of property is the fair market value of the property. However, in the case of contributions of ordinary income property and certain tangible personal property, the deduction is limited to the taxpayer's basis. The amount of the deduction otherwise allowable for the taxable year with respect to a charitable contribution may be reduced, depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer. Taxpayers who do not itemize their deductions and elect instead to claim the standard deduction may not deduct charitable contributions made during the taxable year.[203]

Under present law, total deductible contributions of individual taxpayers to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which generally is the taxpayer's AGI for a taxable year.[204] To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Under section 170(f)(8), no charitable contribution deduction is allowed for any contribution of $250 or more unless the taxpayer receives a contemporaneous written acknowledgment of the contribution from the donee organization, which includes, among other information, a description and good faith estimate of the value of any goods or services provided in return for the taxpayer's contribution.

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[203] Beginning in 1982, taxpayers claiming the standard deduction were allowed a deduction for charitable contributions. The maximum charitable contribution deduction for non-itemizers was $25 for 1982 and 1983 and $75 for 1984. For 1985, 50 percent of the amount contributed was deductible. For 1986, 100 percent of the amount contributed was deductible, subject to the limitations generally applicable to charitable deductions under section 170. Beginning in 1987, the charitable contribution deduction for non-itemizers was no longer allowed.

[204] Section 170(b)(1).

Description of Proposal

The proposal would provide a deduction for charitable contributions made by taxpayers who do not itemize their deductions. Under the proposal, a non-itemizer would be permitted to deduct 50 percent of his or her charitable contributions in excess of $1,000 ($2,000 for taxpayers filing joint returns) for taxable years beginning after December 31, 2000, and before January 1, 2006. For taxable years beginning after December 31, 2005, non-itemizers would be permitted to deduct 50 percent of their charitable contributions in excess of $500 ($1,000 for taxpayers filing joint returns).

Under the proposal, the charitable contribution deduction for non-itemizers would not be treated as an "above-the-line" deduction. Consequently, claiming the deduction would not affect the calculation of a taxpayer's adjusted gross income.

The deduction under the proposal would be subject to the present-law percentage limitations based on the taxpayer's contribution base. In addition, the section 170(f)(8) substantiation requirements would apply to all contributions in excess of $250.

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

Analysis

Rationale for tax deduction for charitable donations

Tax deductibility of charitable donations reduces the economic cost to the donor of his or her donation and encourages giving. There are a number of different rationales advanced for the deductibility of donations to charitable organizations described in section 501(c)(3). These rationales depend, in part, on differing views about the role of charitable organizations and the benefits they provide to society as a whole. One rationale for the charitable contribution tax deduction is that income given to a charity should not be taxed because it does not enrich the giver.

The standard deduction provides a minimum exemption from income that many analysts view as providing relief to taxpayers who choose not to itemize but who make charitable contributions, pay mortgage interest, or incur other expenses which are otherwise permitted as itemized deductions under the Code. These analysts note that taxpayers generally choose to itemize deductions, rather than claim the standard deduction, if it is in their financial interest to itemize. Thus, these analysts conclude that for most taxpayers who choose the standard deduction under present law, even when they have made substantial charitable contributions, the standard deduction more than compensates the donor for the income he or she has forgone.

Others describe charitable organizations as providing many services at little or no direct cost to taxpayers, which services otherwise would have to be provided by the government at full cost to taxpayers. In this view, the tax deduction for voluntary charitable donations is seen as equivalent to deductions permitted for many State and local taxes. The charitable contribution tax deduction could be said to provide neutrality in the choice to provide certain services to the public through direct government operation and financing or through the private operation and mixed private and public financing of a charitable organization. In this view, opponents of the proposal would argue that an additional deduction for charitable contributions is unwarranted as the taxpayer has chosen to claim the standard deduction in lieu of claiming an itemized deduction for State and local taxes and no additional deduction is necessary to maintain neutrality of choice.

Some observe that the activities of a number of charitable organizations are public in nature or provide significant spillover benefits to the public at large. For example, some charitable organizations maintain open spaces such as bird refuges. Open space is an example of a public good, that is, a good or service that may be simultaneously enjoyed by all. Other charitable organizations provide benefits that improve the health of specific individuals, such as through the provision of vaccinations, which provide spillover benefits[205] to the populace at large. Economists generally argue that, in the absence of a subsidy, the private market may provide insufficient levels of public goods or goods that create spillover benefits.[206] As discussed below, the tax deduction for charitable donations encourages such donations and thereby acts as a subsidy to the activities of charitable organizations. Accordingly, the philanthropic community and others believe the present-law deductions for the income tax serves a social purpose. Because of the social benefits, advocates of the proposal aver that all taxpayers should be encouraged to make donations which ultimately lead to spillover benefits.

A range of arguments for and against the tax deductibility of charitable contributions can be made in assessing deductibility in the context of a theoretically ideal income tax system. Wholly apart from any incentive effect or intent to encourage charitable giving, some argue the gratuitous transfer of funds from an individual to a charity should not be treated as a personal consumption of income that should be subject to tax even under a theoretically pure, broad-based income tax because the donation does not directly benefit the donor and, therefore, should represent a reduction in the wealth or well being of the donor. Alternatively, one could view charitable giving as a purely personal expenditure, a deduction for which would be denied under an ideal income tax. The tax deduction for charitable contributions sometimes is referred to as a tax expenditure in that it may be considered to be analogous to a direct outlay program which would direct Federal funds to charitable organizations. Applying this analogy, the tax deduction for charitable contributions is most similar to those direct spending programs that have no

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[205] Economists usually refer to such spillover benefits as "positive externalities," that is, benefits accrue to the individual who consumes the good and also to other individuals who are "external" to the initial consumption of the good.

[206] For example, see Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice*, (New York: McGraw Hill), 1984, and Harvey S. Rosen, *Public Finance* (Homewood, IL: Irwin), 1988.

spending limits, and that are available as entitlements to those organizations which meet the statutory criteria established under section 170(c). The proposal would expand the tax expenditure of present law by increasing the number of taxpayers who qualify to claim a tax deduction.

Economic effects of tax deductions for charitable donations

The proposal to provide those taxpayers who do not itemize with a charitable contribution deduction for contributions in excess of a specified floor amount is intended to provide an incentive for non-itemizers to make charitable contributions in excess of the specified floor amount. As with any tax deduction or credit, the price to the donor of charitable giving that benefits from a tax incentive is reduced by the value of the tax benefit provided. For example, for a taxpayer who itemizes deductions and is in the 31-percent tax bracket, a $100 cash gift to charity reduces the taxpayer's taxable income by $100, and thereby reduces tax liability by $31. As a consequence, the $100 cash gift to charity reduces the taxpayer's after-tax income by only $69. Economists would say that the price of giving $100 cash to charity is $69 for this taxpayer. As the preceding example shows, the price of giving is determined as one minus the taxpayer's marginal tax rate. Alternatively stated, the value of the tax deduction is the amount deducted multiplied by the taxpayer's marginal tax rate. A taxpayer who does not itemize deductions receives no value from the tax deductibility of charitable donations and the tax price of giving $1.00 is $1.00 of forgone other expenditures.

The proposal would provide a deduction for 50 percent of the contributions in excess of a specified floor amount. That is, a taxpayer whose total charitable contributions exceed the specified floor amount, could claim a deduction of 50 cents for each $1.00 of contributions in excess of the floor. By providing a deduction, the proposal would reduce the tax price of giving on the amount of charitable contributions in excess of the specified floor amount. The majority of taxpayers who claim the standard deduction are in the 15-percent marginal income tax bracket. For these taxpayers, the proposal would reduce the tax price of giving to $0.0925 for each $1.00 in excess of the specified floor amount, but the tax price would remain at $1.00 for each $1.00 contributed up to the specified floor amount. The charitable deduction is worth more the higher the taxpayer's marginal tax rate. Because higher-income taxpayers generally are in higher marginal tax rate brackets and are more likely to itemize deductions, the charitable donation tax deduction generally is more valuable to higher income taxpayers than to lower income taxpayers who often do not itemize such deductions and who generally are in lower marginal tax brackets.[207]

While factors other than tax benefits also motivate charitable giving, the preponderance of evidence suggests that the charitable donation tax deduction has been a stimulant to charitable giving, at least for higher-income individuals. Economic studies generally have established that

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[207] The obverse statement is that the tax price is lower the higher the marginal tax rate and that higher income taxpayers generally have a lower tax price of giving than do lower income taxpayers.

charitable giving responds to the price of giving. While the economic literature suggests that individuals alter their giving in response to changes in the price of giving, there is less consensus as to how large are the changes in donations induced by the tax deductibility of charitable donations.[208] In addition, most studies rely upon data relating to taxpayers who itemize deductions. Inferences drawn from such studies may be inappropriate when applied to taxpayers who currently claim the standard deduction. Some evidence suggests that higher-income taxpayers are more responsive to the incentives provided by the tax deduction.[209]

If taxpayers do respond to the incentive effect of the tax deduction for charitable donations, then the charitable sector would become larger because it receives more donations than it would in the absence of the preferential tax treatment. Depending upon the magnitude of the additional or induced donations, the increase in the size of the charitable sector may be less than, equal to, or greater than the tax revenue forgone. If the increase in donations to the charitable sector induced by the tax deduction exceeds the revenue lost to the government, then the tax deduction could be said to be an efficient means of providing public support to such charitable functions.[210] However, as reported above, there is little evidence relating to the responsiveness of current non-itemizers to the change proposed.

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[208] See, Charles Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago: University of Chicago Press), 1985, for a review of the literature. Martin Feldstein and Charles Clotfelter, "Tax Incentives and Charitable Contributions in the United States," Journal of Public Economics, 5, 1976, argue that the deduction for charitable contributions induces charitable contributions in amounts exceeding the revenue lost to the government from the tax deduction. More recently, William C. Randolph, "Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions," Journal of Political Economy, 103, August 1995, 709-738, argues the opposite. Randolph argues that earlier studies inadvertently confused timing effects that may be the result of an individual taxpayer's circumstances in a particular year or the result of changes from one tax regime to another with the permanent effects. Randolph's estimates suggest that on a permanent basis, charitable donations are much less responsive to the tax price than previously believed. Charles T. Clotfelter, "The Impact of Tax Reform on Charitable Giving: A 1989 Perspective," in Joel Slemrod, ed., *Do Taxes Matter? The Impact of the Tax Reform Act of 1986* (Cambridge: MIT Press), 1990, 228, points to the surge in giving in 1986 prior to enactment of the Tax Reform Act of 1986 as evidence of the tax-sensitive timing of gifts.

[209] See, Charles Clotfelter, "The Impact of Tax Reform on Charitable Giving: A 1989 Perspective."

[210] In the empirical economics literature, the notion of elasticity is used as a measure of taxpayer response to a change in the "tax price" or value of the tax deduction. An elasticity greater than one in absolute value (that is, a value smaller than negative one or a value greater than positive one) implies that recipients of charitable donations receive more in increased funding than the government loses in forgone revenue. See Clotfelter, *Federal Tax Policy and Charitable Giving*.

Opponents of proposals to expand charitable deductions argue that many charitable contributions are not tax motivated and for such contributions a tax deduction amounts to a windfall reduction in the taxpayer's liability with no change in behavior. Advocates of the proposal note that, by the design of the floor amount, such windfalls are reduced and the tax incentive is provided to those inclined to make substantial contributions.

Critics of the proposal note that one benefit of the present-law standard deduction is that the standard deduction eliminates the need to itemize and maintain supporting documentation for such deductions. They observe that one motivation behind the substantial increase in the standard deduction in the Tax Reform Act of 1986 was that "[t]axpayers who will use the standard deduction rather than itemize their deductions will be freed from much of the recordkeeping, paperwork, and computations that were required under prior law."[211]

A substantial amount of charitable donations made by individuals that are not claimed as itemized deductions. See Table 11, below. The data suggest that in 1997 more than $25 billion in charitable contributions were made by individuals were not claimed as itemized deductions. Individual donations claimed as itemized deductions on individual tax returns have grown in every year since 1984, excepting from 1986 to 1987.[212] Itemized deductions and total individual charitable contributions have grown more rapidly than the rate of inflation over this period.[213] However, this real, inflation-adjusted, growth did not occur evenly over the period. Between 1984 and 1990, the real growth in individual donations claimed as itemized deductions was more modest than was real growth since 1990. Also, as shown in the last line of table 11, the absolute difference between measured itemized deductions and total individual deductions has changed little since 1989. There has been little analysis attempting to explain these trends.

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211 Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, 11.

212 Most analysts attribute the high level of donations in 1986 followed by the lower level of donations in 1987 to the anticipation and enactment of the Tax Reform Act of 1986 which lowered expected future marginal tax rates for many taxpayers, thereby increasing the expected price of future donations. In addition, certain other modifications to charitable tax deductions as part of the individual alternative minimum tax may have altered the timing of some donations to charities. The increase in the standard deduction provided in the Tax Reform Act of 1986 also reduced the number of taxpayers who chose to itemize deductions.

213 The price level, as measured by changes in the consumer price index ("CPI"), increased by 54.4 percent over the period 1984 through 1997.

Table 11.–Individual and Corporate Charitable Donations, 1984-1997
(Billions of Dollars)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1992	1994	1995	1996	1997
Individual Donations														
Itemized deductions claimed for charitable donations	42.12	47.96	53.82	49.62	50.95	55.46	57.24	60.58	63.84	68.35	70.54	74.99	86.16	95.82
Total individual donations	56.46	57.39	67.09	64.53	69.98	79.45	81.04	84.27	87.70	92.00	92.52	95.36	107.65	122.95
Individual donations not claimed as itemized	14.48	9.43	13.27	14.91	19.03	23.99	23.80	23.64	23.86	23.65	21.98	20.37	21.49	27.13

Source: Individual itemized deductions taken from Internal Revenue Service *Statistics of Income data*. *Statistics of Income data* for 1997 are preliminary. Total individual donations taken from *Giving USA, 1999.* Data do not include donations from trusts. All tabulations prepared by staff of the Joint Committee on Taxation.

Prior Action

A proposal to permit a charitable contribution deduction for taxpayers who do not itemize their deductions was included in the Senate-passed version of the Taxpayer Refund Act of 1999. Under that proposal, non-itemizers would have been permitted a deduction for charitable contributions up to $50 for individuals or $100 for taxpayers filing a joint return.

2. Simplify private foundation excise tax

Present Law

Private foundations generally are subject to a two-percent excise tax on their net investment income.[214] Net investment income generally includes interest, dividends, rents, royalties, and capital gain net income, and is reduced by expenses incurred to earn this income. The excise tax rate can be reduced to one percent in any year in which a foundation exceeds the average historical level of its charitable distributions. Specifically, the excise tax rate is reduced to one percent if the amount of a foundation's distributions for charitable purposes for the taxable year is equal to or exceeds the sum of (1) the foundations's non-charitable assets multiplied by the average percentage of the foundation's charitable distributions over the five taxable years immediately preceding the taxable year in question, and (2) one percent of the foundation's net investment income for the taxable year. Exempt operating foundations, which are private foundations that carry on substantial charitable activities directly and that have qualified as publicly-supported public charities in the past, are exempt from the excise tax.

Under present law, private nonoperating foundations generally are required to make annual "qualifying distributions" equal to at least five percent of the fair market value of the foundation's net investment assets (sec. 4942). Qualifying distributions generally include grants to public charities and direct expenditures for charitable purposes, including administrative expenses associated with the conduct of the foundation's charitable activities and the acquisition of assets that will be used for charitable purposes. The amount that a private nonoperating foundation must distribute annually for charitable purposes is reduced by the amount of section 4940 excise tax paid by the foundation.

Description of Proposal

The proposal would replace the present-law two-tier excise tax on net investment income of private foundations with a single flat excise tax of 1.25 percent on such net investment income. The proposal would repeal the special one-percent excise tax for private foundations that exceed their historical level of charitable distributions. Under the proposal, exempt operating foundations would continue to be exempt from the excise tax.

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[214] Section 4940.

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

Analysis

The present-law excise tax on net investment income of private foundations was originally enacted as part of the Tax Reform Act of 1969 as a "charge or audit fee" to "share some of the burden of paying the cost of government.[215] Congress reduced the excise tax rate from four percent to two percent in 1978, and then restructured the excise tax in 1984 by adding the one-percent excise tax rate. Most analysts do not interpret the present-law excise tax as equivalent to a user fee for audits because the excise tax is imposed on net income and there is not a close relation between the cost of audits of private foundations and their net income. Moreover, analysts note, other tax-exempt organizations are audited but are not subject to similar excise taxes on net investment income.

Some have suggested that the present-law two-tier excise tax may serve as an incentive for foundations to increase the amounts they distribute to charities. Critics of the present-law two-tier excise tax have criticized the efficiency of the excise tax as an incentive to increase payout rates. First, critics note, the reduction in excise tax depends only upon an increase in the foundation's rate of distributions to charities, not on the size of the increase in the rate of distributions. Thus, a large increase in distributions is rewarded by the same reduction in excise tax rate as is a small increase in distributions. There is no extra incentive to make a substantial increase in distributions rather than a quite modest increase in distributions.

In addition, critics assert that, under a number of circumstances, the present-law two-tier excise tax can create a disincentive for foundations to increase charitable distributions substantially.[216] In order to take advantage of the one-percent excise tax rate, a private foundation must increase its rate of charitable distributions in the current year above that which prevailed in the preceding five years. Whether the present-law two-tier excise tax creates an incentive or disincentive to increased payout rates depends, in part, on whether the foundation currently is subject to the one-percent tax rate or the two-percent tax rate. Because modest increases in payout rates qualify a foundation for the one-percent tax rate, some analysts suggest that a foundation may be able to actively manage its distributions so that the foundation qualifies

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[215] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), Dec. 3, 1970, 29.

[216] See C. Eugene Steuerle and Martin A. Sullivan, "Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations," American Journal of Tax Policy, 12, Fall 1995, 399-447.

for the one-percent tax rate without substantially increasing its payout rate.[217] For a foundation subject to the one-percent rate in the current year, an increased payout in any year becomes part of the computation to determine eligibility for the one-percent rate in future years. Thus, under the present-law formula, the foundation can trigger the two-percent excise tax rate by increasing the payout amount in a particular year because increased payouts make it more difficult for the foundation to qualify for the one-percent rate in subsequent years, and it increases the possibility that the foundation will become subject to the two-percent tax rate. Consequently, over time, the one-percent rate provides a disincentive for increasing charitable distributions.

On the other hand, for a foundation currently subject to the one-percent excise tax rate and also making distributions at a rate above the minimum required five percent, the present-law two-tier excise tax can create a disincentive for foundations to reduce their payout rate. A reduction in payout rate in the future would reduce the foundation's five-year moving average, thereby increasing the likelihood the foundation's net investment income is taxed at the two-percent rate, rather than the one-percent rate.[218]

For a foundation currently subject to the excise tax at the two-percent rate, an increase in payout may qualify the foundation for the one-percent excise tax rate. If the increase does qualify the foundation for the one-percent rate, and the foundation maintains the same payout for the subsequent four years, the foundation generally will be eligible for the one-percent tax rate in each of the five years. Hence the reduced tax rate can create an incentive to increase payout rates. However, even in the case of a two-percent excise tax paying foundation, the present-law two-tier excise tax can create a disincentive for a foundation to increase charitable distributions substantially in any one year compared to a strategy of slowly increasing payouts over several years. For example, consider a foundation which has had a payout rate of 5.0 percent for several years. Suppose the foundation is considering increasing its payout rate. Consider two possible strategies: increase the payout rate to 8.0 percent in the current year followed by rates of 5.5 percent thereafter; or gradually increase the payout rate by increments of one-tenth of one percent annually for five years. While a substantial increase in any one year may qualify the foundation for the one-percent tax rate, subsequent year payout rates of 5.5 percent would fail to qualify the foundation for the one-percent tax rate.[219] Thus, under the first option, the foundation would pay the one-percent tax rate for one year and be a two-percent tax rate payor subsequently.

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[217] For example, if over a ten-year period the foundation increased its payout rate from the minimum 5.00 percent to 5.01 percent, to 5.02 percent, up to 5.10 percent, the foundation generally would qualify for the one-percent excise tax rate throughout the ten-year period.

[218] Whether a reduction in payout rate causes the foundation to pay the two-percent tax rate depends upon the specific pattern of its payout rate in the preceding five years and the magnitude of the decrease in the current year.

[219] In this example, after having paid out 8.0 percent, the five-year average payout for the first year in which the foundation pays out 5.5 percent would be 5.6 percent.

Under the second option, the foundation would qualify for the one-percent rate in each year. However, total payouts are greater under the first option.

In summary, the incentive effects of the present-law two-tier excise tax depend upon the situation in which the foundation finds itself in the current year. In 1995, 36 percent of foundations were one-percent tax rate payors and 64 percent were two-percent rate payors. Among large foundations (assets of $50 million or greater) 47 percent were one-percent rate payors and 51 percent were two-percent rate payors.[220] A number of analysts suggest the optimal tax strategy for a private foundation is to choose a target rate of disbursement, maintain that rate in all years, and never fall below the target in any year.[221]

These data also indicate that under the proposal some foundations will experience an increase in tax on net investment income while others will receive a decrease in tax on net investment income. Had the current proposal become effective for 1996, 36 percent of foundations may have had their tax rate on their net investment income increase from one percent to 1.25 percent. Under present law, a foundation that is subject to the one-percent tax rate is a foundation that has increased its payout rate compared to its preceding five-year average. A foundation paying at the two-percent rate is a foundation that has not increased its payout rate compared to its preceding five-year average. Under the proposal, the foundation that has increased its payout would see its tax rate increase. The foundation that has not increased its payout rate would see its tax rate decrease.

Critics of the present-law excise tax structure observe that the median payout rate of large nonoperating private foundations (foundations with total assets of $50 million or more) was 5.1 or 5.0 percent in each year from 1991 through 1995. The median payout rates for foundations with assets between $10 million and $50 million declined annually from 5.4 percent in 1990 to 5.1 percent in 1995. Similarly, the median payout rates for foundations with assets between $100,000 and $1 million declined from 6.7 percent in 1990 to 5.5 percent in 1995.[222] Critics of the present-law excise tax structure argue that these data suggest that the excise tax structure is not encouraging any noticeable increase in payout rates.

The proposal may have the effect of increasing the minimum charitable payout for certain private foundations. Under present law, the amount that a private nonoperating foundation must distribute annually for charitable purposes, generally five percent of the fair market value of the assets of the foundation, is reduced by the amount of excise tax paid by the foundation on its net

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[220] See Figure E in Paul Arnsberger, "Private Foundations and Charitable Trusts, 1995," Internal Revenue Service, Statistics of Income Bulletin, 18, Winter 1998-1999, 60-125.

[221] Steuerle and Sullivan, "Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations," 438.

[222] Arnsberger, "Private Foundations and Charitable Trusts, 1995," Figure I, 73.

investment income. That is, for a foundation subject to the two-percent excise tax on net investment income to satisfy the minimum distribution test, the foundation may distribute to charities an amount equal to five percent of assets less two percent of net investment income. Advocates of the proposal argue that lowering the excise tax rate to 1.25 percent will result in increased charitable distributions or charitable expenditures by those foundations currently taxed at the higher two-percent rate and subject to the minimum distribution requirement. Under the proposal, to meet the minimum distribution requirement such a foundation would have to distribute to charities five percent of assets less 1.25 percent of net investment income.

The present-law two-tier excise tax structure also has been criticized as unduly complicated requiring organizations to devote funds to tax planning rather than charitable purposes. Replacement of the two-tier structure would reduce the need for tax planning, as discussed above, and simplify the filing of Form 990PF as computations of a five-year average would no longer be required.

Prior Action

No prior action.

3. Increase percentage limits on donations of appreciated property

Present Law

Generally, a taxpayer who itemizes deductions may deduct charitable contributions of cash and property made within a taxable year. In general, the amount of the deduction for a contribution of property is the fair market value of the property. However, in the case of contributions of ordinary income property and certain tangible personal property, the deduction is limited to the taxpayer's basis. The amount of the deduction otherwise allowable for the taxable year with respect to a charitable contribution may be reduced, depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer. Taxpayers who do not itemize their deductions are not permitted to deduct charitable contributions[223]

Under present law, total deductible contributions of individual taxpayers, to public charities, private operating foundations, and certain types of private nonoperating foundations

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

may not exceed 50 percent of the taxpayer's contribution base, which generally is the taxpayer's AGI for a taxable year.[224] To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Description of Proposal

The proposal would increase the percentage limitation applicable to charitable contributions of capital gain property to public charities and certain other charitable entities (organizations and entities described in section 170(b)(1)(A)) by individuals from 30 percent to 50 percent. Thus, both cash and non-cash contributions to such entities would be subject to the 50-percent deductibility limit.

In addition, the proposal would increase the percentage limitation applicable to contributions of capital gain property to private foundations by individuals from 20 percent to 30 percent.

Effective date.--The proposal would be effective for charitable contributions made in taxable years beginning after December 31, 2000.

Analysis

The proposal would repeal the special 30- and 20-percent limits on gifts of capital gain property to charitable organizations. Thus, under the proposal, the limitations on gifts of cash and capital gain property would be the same.

Under present law, it can be more advantageous to make charitable contributions via gifts of appreciated property than to make a gift of equal value via a cash contribution. In general, the income which gives rise to cash, such as wage and salary income, interest income, and dividend income is taxed currently as it is earned. In general, gains on appreciated property are treated more favorably because they are not taxed until realized and, if an asset with accrued gain is donated to a charity, the accrued gain is untaxed. However, whether a charitable contribution is made in cash or by transfer of an asset with accrued gain, the taxpayer, but for the limitations of present law, may claim a deduction equal to the full market value of the cash or the asset. Opponents of liberalizing the annual limitation on gifts of appreciated property argue that gifts of appreciated property receive a double benefit, no taxation of income and a deduction for a charitable gift, while gifts of cash receive only the benefit of the deduction for a charitable gift.

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[224] Section 170(b)(1).

They argue that the tax benefit earned by the donor should not depend upon the form of the gift, especially as the donee receives no extra benefit from a gift of property as opposed to a gift of cash. Opponents note that an annual limitation on gifts of appreciated property limits the extent of such double benefits and promotes a sense of fairness in the tax system and argue that it is inappropriate to increase the limitation. They argue that the prospect of wealthy individuals paying little, if any, tax annually, even if such individuals have made gifts to charity, undermines respect for the fairness of the tax system and the government it supports.

Proponents of proposals to relax the annual limitations on gifts of appreciated property observe that the 30- and 20-percent limitations affect only a small percentage of donors. By definition, these limitations have no impact on donors with contributions of capital gain property of less than 30-percent (20 percent when the donee is a private foundation) of adjusted gross income. Nevertheless, proponents note that the present-law 30-percent limitation may discourage gifts of appreciated property and, thereby, may discourage gifts to charity. While some appreciated property, for example publicly traded stock, can be easily subdivided and donated annually to avoid the annual limitation, the limitation may discourage gifts of illiquid assets of substantial value.

Proponents further state that the present law limitations add complexity to the tax law and the existence of different limitations for different types of gifts confuses planning. Some also suggest that the existence of the lower annual limitation for gifts of appreciated property under present law may discourage giving by a "signalling" effect.[225]

Opponents question the simplification gains of the proposal. As noted, present law affects few taxpayers and such taxpayers are generally planning to make substantial gifts for which they seek the advice of tax planners. Therefore, they question the validity of deleterious effects some suggest are inherent in present law. In addition, opponents note the proposal does not eliminate all annual limitations on charitable gifts, so any gains in simplification are likely to be small.

Prior Action

A proposal to increase the percentage limitations on contributions to public charities was included in the Senate-passed version of the Taxpayer Refund Act of 1999. The proposal would have phased up the present-law 50-percent and 30-percent limitations for gifts of cash and capital gain property to public charities to 70 percent and 50 percent, respectively. The proposal would have retained the present-law 30-percent and 20-percent limitations for gifts of cash and capital gain property to private foundations and certain other charitable organizations.

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225 Some suggest that taxpayers may think the 30-percent limitation applicable to gifts of capital gain property is the limitation applicable to all gifts. The lower limitation may serve as a caution signal to taxpayers when contemplating charitable gifts. Steuerle and Sullivan, "Toward More Simple and Effective Giving."

4. Clarify public charity status of donor-advised funds

Present Law

Classification of section 501(c)(3) organizations and the benefits of public charity status

In general, tax-exempt organizations that are described in section 501(c)(3) are characterized as either private foundations or public charities. The classification is based on the nature and diversity of the organization's financial support. Private foundations are organizations that are supported primarily by a small number of contributors and that do not receive substantial support from the public. All other section 501(c)(3) organizations are characterized as public charities. Private foundations are subject to restrictions not applicable to public charities, including: (1) prohibitions on certain transactions with "disqualified persons";[226] (2) minimum annual payout requirements;[227] (3) limitations on the ownership of business interests;[228] (4) restrictions on risky investments;[229] and (5) prohibitions on the expenditure of funds for certain purposes, including lobbying, political activities,[230] grants to individuals (without prior IRS approval), grants to organizations other than public charities unless special procedures are followed, and expenditures for noncharitable purposes.[231] Private foundations also are subject to a tax on their net investment income.[232]

Contributions to organizations described in section 501(c)(3) are deductible, subject to certain limitations, as an itemized deduction from Federal income taxes.[233] Such contributions

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[226] Disqualified persons include trustees, directors, officers, substantial contributors to the foundation, and certain family members of the above (sec. 4946(a)).

[227] Private foundations are required to pay out each year, for charitable purposes, an amount equal to 5 percent of net investment assets (sec. 4942(d)).

[228] A private foundation generally may not hold more than 20 percent ownership in a business (sec. 4943).

[229] Section 4944.

[230] As noted above, public charities also may not engage in political activities. Unlike private foundations, however, they may engage in lobbying so long as it is not a substantial part of the organization's activities.

[231] Section 4945.

[232] Section 4940.

[233] Section 170. Certain contributions made to war veterans organizations, domestic fraternal societies, and member-owned cemetery companies also are deductible as charitable

also are generally deductible for estate and gift tax purposes.[234] However, if the taxpayer retains control over the assets transferred to charity, the transfer is not a completed gift for purposes of claiming a income, estate, or gift tax deduction.

Public charities enjoy certain advantages over private foundations regarding the deductibility of contributions.[235] For example, contributions of appreciated capital gain property to a private foundation generally are deductible only to the extent of the donor's cost basis.[236] In contrast, contributions to public charities generally are deductible in an amount equal to the property's fair market value, except for gifts of inventory and other ordinary income property, short-term capital gain property, and tangible personal property, the use of which is unrelated to the donee organizations' exempt purpose.

Under present law, total deductible contributions of individual taxpayers, to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which generally is the taxpayer's AGI for a taxable year.[237] To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Intermediate sanctions

Section 4958 imposes an excise tax on a "disqualified person" who engages in certain "excess benefit transactions" with a section 501(c)(3) public charity (or a section 501(c)(4) social welfare organization). Section 4958 also imposes a penalty on an organization manager who knowingly approves such a transaction. An "excess benefit transaction" is defined, in part, as a

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contributions under section 170.

[234] Sections 2055 and 2522.

[235] Some public charities, such as hospitals and certain educational organizations, are supported primarily by fees or program revenues and only secondarily by contributions from the general public.

[236] A special rule in section 170(e)(5) provides that taxpayers are allowed a deduction equal to the fair market value of certain contributions of appreciated, publicly traded stock contributed to a private foundation.

[237] Section 170(b)(1).

transaction in which the economic benefit provided directly or indirectly to a disqualified person exceeds the value received by the organization (including the performance of services). A “disqualified person” is defined as any person who is in a position to exercise substantial influence over the affairs of the organizations, as well as certain family members and 35-percent owned entities of disqualified persons.

Community foundations

Community foundations generally are broadly supported section 501(c)(3) public charities that make grants to other charitable organizations located within a community foundation's particular geographical area. Donors typically transfer their contributions to a community foundation in the form of a separate trust or fund, the assets of which are held and managed by a bank or investment company.

Certain community foundations are subject to special rules that permit them to treat the separate donor-advised funds maintained by the community foundation as a single entity for tax purposes. This "single entity" status allows the community foundation to be classified as a public charity. One of the requirements that these community foundations must meet is that donor-advised funds maintained by the community foundation may not be subject by the donor to any material restrictions or conditions. The prohibition against material restrictions or conditions is designed to prevent a donor from encumbering a donor-advised fund in a manner that prevents the community foundation from freely distributing the assets and income from it in furtherance of the community foundation's charitable purposes. Under Treasury regulations, whether a particular restriction or condition placed by the donor on the transfer of assets is material must be determined from all of the facts and circumstances of the transfer. The regulations set out some of the more significant facts and circumstances to be considered in making a determination, including: (1) whether the transferee public charity is the fee owner of the assets received; (2) whether the assets are held and administered by the public charity in a manner consistent with its own exempt purposes; (3) whether the governing body of the public charity has the ultimate authority and control over the assets and the income derived from them; and (4) whether the governing body of the public charity is independent from the donor. The regulations provide several non-adverse factors for determining whether a particular restriction or condition placed by the donor on the transfer of assets is material. In addition, the regulations list numerous factors and subfactors that indicate that the community foundation is prevented from freely and effectively employing the donated assets and the income thereon.

Description of Proposal

The proposal would provide that a charitable organization which has, as its primary activity, the operation of one or more donor-advised funds may qualify as a public charity only if: (1) there is no material restriction or condition that prevents the organization from freely and effectively employing the assets in such donor-advised funds, or the income therefrom, in furtherance of its exempt purposes; (2) distributions are made from such donor-advised funds only as contributions to public charities (or private operating foundations) or governmental entities; and (3) annual distributions from donor-advised funds equal at least five percent of the net fair market value of the organization's aggregate assets held in donor-advised funds (with a carry forward of excess distributions for up to five years). Any charity that maintains more than 50 percent of its assets in donor-advised funds would be deemed to meet this primary activity test.

Failure to comply with any of these requirements with respect to any donor-advised fund would result in the organization's being classified as a private foundation and, therefore, being subject to the current-law private foundation rules and excise taxes.

In addition, the proposal would require any other charitable organization that operates one or more donor-advised funds, but not as its primary activity, to comply with the above three requirements. If such an organization (e.g., a school that operates donor-advised funds) fails to satisfy these requirements with respect to its donor-advised funds, the organization's public charity status would not be affected, but all assets maintained by the organization in donor-advised funds would be subject to the current-law private foundation rules and excise taxes.

Under the proposal, a "donor-advised fund" would be defined as any segregated fund (or account) maintained by a charity for contributions received from a particular donor (or donors) as to which there is an understanding that the donor or the donor's designee may advise the charity regarding the investment or distribution of any amounts held in the fund. However, the term "donor-advised fund" would not include any fund (or account) as to which such advice is limited to the use to be made by the charity for its own operations (rather than grants to be made by the charity to third parties) of amounts held in the fund. The term would not include a contribution to charity where the donor, at the time of making the contribution, specifies a charitable recipient, but retains no advisory rights (e.g., certain contributions to an organization such as the United Way).

Under the proposal, the definition of "material restriction" generally would be based on present-law regulations under section 507. However, the proposal provides that the existence of a material restriction will not be presumed merely because a charity regularly follows a donor's advice.

The proposal also would amend the definition of disqualified person under section 4958 to clarify that a person who is a donor or a designated advisor to a particular donor-advised fund maintained by any public charity (and such person's family members and controlled entities) will be treated as having substantial influence with respect to any transactions involving that particular fund. In addition, the proposal would amend the definition of disqualified person to include any person who is a donor or a designated advisor to a particular donor-advised fund maintained by a private foundation (and such person's family members and controlled entities) for purposes of applying section 4941 (self-dealing rules) to transactions involving that particular fund.[238]

Under the proposal, 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 interpreting the "no material restriction" requirement, and regulations describing procedures sufficient to ensure that distributions from donor-advised funds are made only as contributions to eligible entities.

Effective date.--The proposal relating to the public charity status of certain charitable organizations operating donor-advised funds would be effective for taxable years beginning after the Treasury Department issues final regulations interpreting the "no material restriction" requirement with respect to donor-advised funds. The proposed amendments to sections 4946 and 4958 would be effective for transactions occurring on or after the date of enactment.

Analysis

In recent years, the number and value of "donor-advised funds" maintained by charitable organizations has grown. A donor-advised fund is a separate fund, but not a separate entity, within a public charity. A donor's contributions are accounted for separately within the public charity's records, and often the donor is permitted to name a fund after the donor or the donor's family, thus providing a name recognition benefit similar to that of a private foundation. Charitable organizations maintaining donor-advised funds generally permit a donor to claim a current charitable contribution deduction for amounts contributed to the charity and to provide ongoing advice regarding the investment or distribution of such amounts. Certain financial institutions have formed charitable entities for the purpose of offering such donor-advised funds, and other existing charities, including universities, have begun operating donor-advised funds. Although these donor-advised funds resemble the separate funds maintained by community trusts, the rules governing their operation are unclear under present law.

While some charities that maintain donor-advised funds voluntarily have adopted minimum annual payout requirements, there is concern that amounts maintained in donor-advised funds are not being distributed currently for charitable purposes. The lack of uniform guidelines governing the operation of donor-advised funds also raises concerns that such funds may be used to provide donors with the benefits normally associated with private foundations (such as control over grantmaking), without the regulatory safeguards that apply to private

[238] Section 4958.

foundations. Some argue that legislation is needed to reduce the potential for donor-advised being used to obtain current tax benefits for donors and advisors without safeguards to ensure that the donated amounts are used for charitable purposes. It is also argued that the application of clear and administrable rules to donor-advised funds will promote the continued growth of such funds.

Opponents of the proposal argue that there are no demonstrated abuses that require the enactment of restrictions on donor-advised funds. It can be argued that the proposal could have a chilling effect on the creation and funding of donor-advised funds because the proposal would not be effective until Treasury regulations are issued defining what constitutes a material restriction or condition.

The proposal would rely on the Treasury regulations defining what constitutes a "material" restriction or condition that prevents an organization from freely and effectively employing the assets in its donor-advised funds, or the income therefrom, in furtherance of its exempt purposes. Critics of the proposal claim that the factors enumerated in the sec. 507 regulations are unclear and can be difficult to apply. They argue that reliance upon these present-law regulations does not provide clear guidance for the establishment or maintenance of donor-advised funds. On the other hand, reliance upon whether the charitable organization has the legal right to control such funds may be inadequate to address the complex financial structure of some organizations.

Although the proposal applies to any public charity that operates donor-advised funds, it is not clear that the proposal would apply to supporting organizations (a subcategory of public charity) that can function as donor-advised funds but that may not meet the proposal's definition of donor-advised fund in all cases. A supporting organization typically is funded by a donor and his or her family rather than by the general public, and receives its public charity status by virtue of its relationship to one or more public charities. Some supporting organizations have been criticized for violating (at least in spirit) the restrictions on control and for functioning as donor-advised funds. Nevertheless, because the charitable recipients of a supporting organization generally must be designated in the supporting organization's charter, it is possible that such an organization would not be deemed to operate donor-advised funds, as defined in the proposal.

The proposal fails to clarify what happens to an organization that maintains donor-advised funds if it fails to meet one or more of the requirements to maintain its public charity status in a particular year and is reclassified as a private foundation. For example, the proposal does not specify whether it is possible for the organization to regain its public charity classification promptly and, if so, what procedures would apply. Similarly, the proposal leaves ambiguous whether a donor-advised fund may designate a successor donor-advisor.

In addition, some may criticize the proposal on the grounds that it imposes a substantial penalty on an organization--loss of public charity status--for small or unwitting mistakes by an organization that maintains the donor-advised funds as its primary activity. Critics argue that the proposal should address this issue, possibly through Treasury regulations.

Prior Action

No prior action.

H. Energy Efficiency and Environmental Provisions

1. Provide tax credit for energy-efficient building equipment

Present Law

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

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

Description of Proposal

A credit of 20 percent of the purchase price would be allowed for the purchase after December 31, 2000 and before January 1, 2005 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.

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 by the amount of the credit.

Effective date.--The proposed credit would be available for final purchases from unrelated third parties after December 31, 2000, and before January 1, 2005.

Prior Action

Similar proposals were contained in the President's Fiscal Year 1999 and 2000 Budget Proposals. The qualifying equipment in the Fiscal Year 2001 proposal is a subset of a more comprehensive set of proposals relating to energy-efficient building equipment contained in the President's Fiscal Year 2000 Budget Proposal.

2. Tax credit for the purchase of energy-efficient new homes

Present Law

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

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

Description of 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 International Energy Conservation Code (ICC). 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 ICC for single family residences. The tax credit would be $1,000 for new homes that reduce energy use by at least 30 percent compared with the ICC standard, and that are purchased in the three-year period beginning January 1, 2001 and ending December 31, 2003. The tax credit would be $2,000 for new homes that reduce energy use by at least 50 percent compared with the ICC standard, and are purchased in the five-year period beginning January 1, 2001 and ending December 31, 2005.

Effective date.--The $1,000 credit would apply to qualifying homes that are purchased in the three-year period beginning January 1, 2001 and ending December 31, 2003. The $2,000 credit would apply to qualifying homes that are purchased in the five-year period beginning January 1, 2001 and ending December 31, 2005.

Prior Action

Similar proposals were contained in the President's Fiscal Year 1999 and 2000 Budget Proposals.

3. Extend tax credit for electric vehicles and provide tax credit for certain fuel-efficient hybrid vehicles

Present Law

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000 (sec. 30). 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 electrical current, the original use of which commences with the taxpayer, and that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2002. The credit phases down in the years 2002 through 2004, and is unavailable for purchases after December 31, 2004.

Certain costs of qualified clean-fuel vehicle property may be expensed and deducted when such property is placed in service (sec. 179A). Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which methanol, ethanol, any other alcohol or ether. The maximum amount of the deduction is $50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacities of at least 20 adults; $5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and $2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction. The deduction phases down in the years 2002 through 2004, and is unavailable for purchases after December 31, 2004.

Description of Proposal

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

(1) <u>Credit for electric vehicles</u>.--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) <u>Credit for qualified hybrid vehicles</u>.--A credit of up to $3,000 would be available for purchases of qualified hybrid vehicles after December 31, 2002, and before January 1, 2007. The credit would be: (a) $500 if the rechargeable energy storage system provides at least 5 percent but less than 10 percent of the maximum available power; (b) $1,000 if the rechargeable

energy storage system provides at least 10 percent and less than 20 percent of the maximum available power; (c) $1,500 if the rechargeable energy storage system provides at least 20 percent and less than 30 percent of the maximum available power; and (d) $2,000 if the rechargeable energy storage system provides 30 percent or more of the maximum available power.

If the vehicle actively employs a regenerative braking system, the amount of the credit shown in (a) through (d) above would be increased by the following amounts:(i) $250 if the regenerative braking system supplies at least 20 percent but less than 40 percent of the energy available from braking in a typical 60 miles per hour (mph) to 0 mph braking event to the rechargeable energy storage system; (ii) $500 if the regenerative braking system supplies at least 40 percent but less than 60 percent of such energy; and (iii) $1,000 if the regenerative braking system supplies 60 percent or more of such energy.

A qualifying hybrid vehicle is a road vehicle that can draw propulsion energy from both of the following on-board sources of stored energy: (1) a consumable fuel, and (2) a rechargeable energy storage system. A qualifying vehicle must meet all applicable regulatory requirements.

Maximum available power means the maximum value of the sum of the heat engine and electric drive system power or other non-heat energy conversion devices available for a driver's command for maximum acceleration at vehicle speeds under 75 mph.

These credits would be available for all qualifying light vehicles including cars, minivans, sport utility vehicles, and light trucks. Taxpayers who claim one of the qualified hybrid vehicle credits would not be able to claim the qualified electric vehicle credit or the deduction for clean-fuel vehicle property for the same vehicle. Business taxpayers claiming the qualified hybrid vehicle credit would be subject to the limitations on the general business credit and would be required to reduce the basis of the vehicle by the amount of the credit.

Effective date.--The elimination of the phase down of the electric vehicle credit, and the extension of the credit, would be effective upon enactment, affecting purchases after December 31, 2001 and before January 1, 2007. The credit for qualifying hybrid vehicles would be available for purchases after December 31, 2002, and before January 1, 2007.

Prior Action

A similar proposal was contained in the President's Fiscal Year 2000 Budget Proposal.

4. Extend tax credit for electricity produced by wind and closed-loop biomass facilities and expand credit to facilities using certain additional fuel sources

Present Law

A 1.7-cents-per-kilowatt hour income tax credit is allowed for electricity produced by wind, "closed-loop" biomass, and poultry waste facilities (sec. 45). The credit applies to electricity produced from facilities placed in service during the periods below.

Energy source	Placed-in-service period
Wind	January 1, 1994-December 31, 2001
Closed-Loop Biomass	January 1, 1993-December 31, 2001
Poultry Waste	January 1, 2000-December 31, 2001

The credit is allowable for production during the 10-year period after a facility is originally placed in service. Electricity produced by a facility is eligible for the credit only if the facility exclusively produces electricity from the qualified energy source.

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

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

Description of Proposal

The proposal would extend the present income tax credit for electricity produced from wind and closed-loop biomass (but not poultry waste) facilities, would expand eligible biomass sources, and would provide a credit for electricity produced from methane gas from landfills.

The present credit for electricity from wind and closed-loop biomass would be extended for two and one-half years, to facilities placed in service before July 1, 2003. Eligible biomass sources would be expanded for facilities placed in service before January 1, 2006. Newly eligible biomass facilities that were placed in service before January 1, 2001, would be eligible for a reduced credit rate of 1.0 cent per kilowatt hour, and the credit would only apply to electricity produced after December 31, 2000 and before January 1, 2004. Electricity produced from biomass that is co-fired with coal also would be eligible for the credit at a reduced rate (0.5 cent per kilowatt hour for the portion of the electricity produced from biomass) from January 1, 2001 through December 31, 2005.

Non-closed-loop biomass qualifying for the credit would include any solid, nonhazardous, cellulosic waste material, which is segregated from other waste materials, and which is derived from (1) any of the following forest-related resources: mill residues, pre-commercial thinnings, slash and brush, but not including old growth timber or wood waste incidental to pulp and paper production; (2) waste pallets, crates, and dunnage, and landscape or right-of-way tree trimmings, but not including unsegregated municipal solid waste (garbage) and post-consumer waste paper; or (3) agricultural sources, including orchard tree crops, vineyard grain, legumes, sugar, and other crop by-products or residues.

In addition, electricity produced from landfill methane would be eligible for the credit, for facilities placed in service after December 31, 2000 and before January 1, 2006. The credit for electricity produced from methane from qualified facilities would be 1.5 cents per kilowatt hour for facilities at landfills that are not subject to the Environmental Protection Agency's 1996 New Source Performance Standards/Emissions Guidelines, and 1.0 cent per kilowatt hour for facilities that are subject to those guidelines. A qualified facility would include equipment and housing required to generate electricity (but not wells and related systems required to collect and transmit gas to the production facility).

Effective date.--The proposal would be effective on the date of enactment.

Prior Action

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal. The Taxpayer Refund Act of 1999, as passed by the Senate, also included a similar proposal.

5. Tax credit for rooftop solar equipment

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

Description of Proposal

The proposal would provide a tax credit for the purchase 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 and the basis of the qualified property would be reduced by the amount of the credit claimed. Taxpayers must choose between the proposed credit and the present tax credit for each investment.

Effective date.--The credit would apply to equipment placed in service during the five-year period after December 31, 2000 and before January 1, 2006 for solar water heating systems and during the seven-year period after December 31, 2000 and before January 1, 2008 for rooftop photovoltaic systems.

Prior Action

Identical proposals were contained in the President's Fiscal Year 1999 and 2000 Budget Proposals.

Analysis for 1.-5.

General rationale for tax benefits for energy conservation and pollution abatement

The general rationale for providing tax benefits to energy conservation and pollution abatement is that there exist externalities in the consumption or production of certain goods. An externality exists when, in the consumption or production of a good, there is a difference between the cost or benefit to an individual and the cost or benefit to society as a whole.[239] When the social costs of consumption exceed the private costs of consumption, a negative externality exists. When the social benefits from consumption or production exceed private benefits, a positive externality exists. When negative externalities exist, there will be over consumption of the good causing the negative externality relative to what would be socially optimal. When positive externalities exist, there will be under consumption or production of the good producing the positive externality. The reason for the over consumption or under consumption is that private actors will in general not take into account the effect of their consumption on others, but only weigh their personal cost and benefits in their decisions. Thus, they will consume goods up to the point where their marginal benefit of more consumption is equal to the marginal cost that they face. But from a social perspective, consumption should occur up to the point where the marginal social cost is equal to the marginal social benefit. Only when there are no externalities will the private actions lead to the socially optimal level of consumption or production, because in this case private costs and benefits will be equal to social costs and benefits.

Pollution is an example of a negative externality, because the costs of pollution are borne by society as a whole rather than solely by the polluters themselves. In the case of pollution, there are two possible government interventions that could produce a more socially desirable level of pollution. One such approach would be to set a tax on the polluting activity that is equal to the social cost of the pollution. Thus, if burning a gallon of gasoline results in pollution that represents a cost to society as a whole of 20 cents, it would be economically efficient to tax gasoline at 20 cents a gallon. By so doing, the externality is said to be internalized, because now the private polluter faces a private cost equal to the social cost, and the socially optimal amount of consumption will take place. An alternative approach would be to employ a system of payments, such as perhaps tax credits, to essentially pay polluters to reduce pollution. If the payments can be set in such a way as to yield the right amount of reduction (that is, without paying for reduction more than the reduction is valued, or failing to pay for a reduction where the payment would be less than the value of the pollution reduction), the socially desirable level of pollution will result.[240] The basic difference between these two approaches is a question of who

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[239] The social cost or benefit includes the cost or benefit to the individual actually doing the consuming or producing.

[240] This approach would be unwieldy to implement, as it would in general require case by case decisions as to the expenditure of funds to reduce pollution, rather than relying on market mechanisms once a socially efficient price has been set, as through the appropriate tax. Also, it

pays for the pollution reduction. The tax approach suggests that the right to clean air is paramount to the right to pollute, as polluters would bear the social costs of their pollution. The alternative approach suggests that the pollution reduction costs should be borne by those who receive the benefit of the reduction.

In the case of a positive externality, the appropriate economic policy would be to impose a negative tax (i.e. a credit) on the consumption or production that produces the positive externality. By the same logic as above, the externality becomes internalized, and the private benefits from consumption become equal to the social benefits, leading to the socially optimal level of consumption or production.

Targeted investment tax credits

Four of the proposals related to energy and the environment are targeted investment tax credits designed to encourage investment in certain assets that reduce the emissions of gases related to atmospheric warming.[241]The following general analysis of targeted investment tax credits is applicable to these proposals.

As a general matter of economic efficiency, tax credits designed to influence investment choices should be used only when it is acknowledged that market-based pricing signals have led to a lower level of investment in a good than would be socially optimal. In general, this can occur in a market-based economy when private investors do not capture the full value of an investment--that is, when there are positive externalities to the investment that accrue to third parties who did not bear any of the costs of the investments.[242]For example, if an individual or corporation can borrow funds at 10 percent and make an investment that will return 15 percent, they will generally make that investment. However, if the return were 15 percent, but only 8 percent of that return went to the investor, and 7 percent to third parties, the investment will generally not take place, even though the social return (the sum of the return to the investor and other parties) would indicate that the investment should be made. In such a situation, it may be desirable to subsidize the return to the investor through tax credits or other mechanisms in order that the investor's return is sufficient to cause the socially desirable investment to be made. In this example, a credit that raised the return to the investor to at least 10 percent would be necessary. Even if the cost of the credit led to tax increases for the third parties, they would

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can be difficult to measure pollution reduction, as the base from which the reduction is measured would necessarily be somewhat arbitrary. As a related matter, a general policy of paying for pollution reduction could, in theory, lead to threats to pollute in order to extract the payment.

[241] Another credit proposal, a production credit for electricity produced from wind or biomass, is discussed below.

[242] Investment in education is often cited as an example where the social return may exceed the private return, i.e., there are positive externalities.

presumably be better off since they enjoy a 7-percent return from the investment, and the credit would only need to raise the return to the investor by 2 percent for him or her to break even. Thus, even if the third parties would bear the full cost of the credit, they would, on net, enjoy a 5-percent return to the investment (7 percent less 2 percent).[243]

There are certain aspects of targeted tax credits that could impair the efficiency with which they achieve the desired goal of reduced atmospheric emissions. By targeting only certain investments, other more cost-effective means of pollution reduction may be overlooked. Many economists would argue that the most efficient means of addressing pollution would be through a direct tax on the pollution-causing activities, rather than through the indirect approach of targeted tax credits for certain technologies. By this approach, the establishment of the economically efficient prices on pollutants, through taxes, would result in the socially optimal level of pollution. This would indirectly lead to the adoption of the technologies favored in the President's budget, but only if they were in fact the most socially efficient technologies. In many cases, however, establishing the right prices on pollution-causing activities through taxes could be administratively infeasible, and other solutions such as targeted credits may be more appropriate.

A second potential inefficiency of investment tax credits is one of budgetary inefficiency, in the sense that their budgetary costs could be large relative to the incremental investment in the targeted activities. The reason for this is that there will generally have been investment in the activities eligible for the credit even in the absence of the credit. Thus, for example, if investors planned to invest a million dollars in an activity before a 10-percent credit, and the credit caused the investment to rise $100,000 to $1.1 million because of the credit, then only $100,000 in additional investment can be attributed to the credit. However, all $1.1 million in investments will be eligible for the 10-percent credit, at a budgetary cost of $110,000 (10 percent of 1.1 million). Thus, only $100,000 in additional investment would be undertaken, at a budgetary cost of $110,000. Because there is a large aggregate amount of investment undertaken without general investment credits, introducing a general credit would subsidize much activity that would have taken place anyway.[244]

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[243] The actual calculation as to whether the credit would improve economic efficiency should also consider the economic costs imposed to raise the necessary tax revenues to pay for the credit. Unless taxation is perfectly efficient (i.e., no distortions are imposed in raising tax revenue), the costs to society of raising a dollar in public funds will exceed a dollar. For a discussion of this issue, see Charles Ballard, John Shoven, and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," American Economic Review, March 1985, pp. 128-38; and Charles Ballard, John Shoven, and John Whalley, "The Total Welfare Cost of the United States Tax System: A General Equilibrium Approach," National Tax Journal, June 1985, pp. 125-40.

[244] For a general discussion of the effects of tax policy on business fixed investment, see Alan Auerbach and Kevin Hassett, "Tax Policy and Business Fixed Investment in the United

Targeted credits like the above proposals, on the other hand, are likely to be more cost effective, from a budget perspective, in achieving the objective of increased investment, if only for the reason that a government would likely not consider their use if there were already extensive investment in a given area.[245] Thus, investment that would take place anyhow is not subsidized, because there presumably is not much of such investment taking place. The presumption behind these targeted tax credits is that there is not sufficient investment in the targeted areas because the alternative and more emissions-producing investments are less costly to the investor. Hence, a tax credit would be necessary to reduce costs and encourage investment in the favored activity.

A final limitation on the efficiency of the proposed credits is their restricted availability. The proposed tax credits come with several limitations beyond their stipulated dollar limitation. Specifically, they are all nonrefundable and cannot offset tax liability determined under the AMT. Certain of the proposals, such as the credit for rooftop solar equipment and the credits for certain energy-efficient building equipment, have a cap on the dollar amount of the credit, and thus after the cap is reached the marginal cost of further investment becomes equal to the market price again, which is presumed to be inefficient.[246] The impact of these limitations is to make the credit less valuable to those without sufficient tax liability to claim the full credit, for those subject to the AMT, or those who have reached any cap on the credit. Given the arguments outlined above as to the rationale for targeted tax credits, it is not economically efficient to limit their availability based on the tax status of a possible user of the credit. It can be argued that, if such social benefits exist and are best achieved through the tax system, the credit should be both refundable and available to AMT taxpayers. Some would argue that making the credits refundable may introduce compliance problems that would exceed the benefits from encouraging the targeted activities for the populations lacking sufficient tax liability to make use of the credit. With respect to the AMT, the rationale for the limitation is to protect the objective of the AMT, which is to insure that all taxpayers pay a minimum (determined by the AMT) amount of tax. Two differing policy goals thus come in conflict in this instance. Similarly, caps on the aggregate amount of a credit that a taxpayer may claim are presumably designed to limit the credit's use out of some sense of fairness, but again, this conflicts with the goal of pollution reduction.

States," Journal of Public Economics, Vol. 47, No. 2, March 1992.

[245] For example, there would be no need for a targeted tax credit for construction of coffee shops, as most would agree that the operation of the free market leads to a sufficient number of coffee shops.

[246] The cap on the credit for rooftop solar equipment is a per-taxpayer cap. The cap for the energy efficient building equipment is a *per-unit* cap, which could encourage an economically inefficient proliferation of units, rather than use of a single larger unit, in order to take advantage of the credits.

A justification for targeted tax credits that has been offered with respect to some pollution abatement activities, such as home improvements that would produce energy savings (installation of energy saving light bulbs or attic insulation, for example), is that the investment is economically sound at unsubsidized prices, but that homeowners or business owners are unaware of the high returns to the investments.[247] The argument for targeted tax credits in this case is that they are needed to raise the awareness of the homeowner, or to lower the price sufficiently to convince the homeowner that the investment is worthwhile, even though the investment is in their interest even without the subsidy. These arguments have been called into question recently on the grounds that the returns to the investments have been overstated by manufacturers, or are achievable only under ideal circumstances. This view holds that the returns to these investments are not dissimilar to other investments of similar risk profile, and that homeowners have not been economically irrational in their willingness to undertake certain energy saving investments.[248] Of course, to the extent that there are negative externalities from the private energy consumption, these households, though making rational private choices, will not make the most socially beneficial choices without some form of subsidy.

A final justification offered for targeted tax credits in some instances is to "jump start" demand in certain infant industries in the hopes that over time the price of such goods will fall as the rewards from competition and scale economies in production are reaped. However, there is no guarantee that the infant industry would ultimately become viable without continued subsidies. This argument is often offered for production of electric cars--that if the demand is sufficient the production costs will fall enough to make them ultimately viable without subsidies. This justification is consistent with the current proposals in that the credits are available only for a limited period of time.

<u>Production credit for wind and biomass</u>

The wind and biomass tax credit is different from the other tax credits in that the credit amount is based on production, rather than on investment. Some argue that a production credit provides for a stream of tax benefits, rather than an up-front lump sum, and that the stream of

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[247] See Jerry A. Hausman, "Individual Discount Rates and the Purchase and Utilization of Energy-Using Durables," Bell Journal of Economics and Management Science, vol. 10, Spring 1979. Hausman's study concluded that the mean household discount rate for evaluating the purchase of a more efficient room air conditioner was between 15 and 25 percent in 1975 to 1976. These discount rates generally exceeded consumer loan rates at that time. In addition, information about the relative efficiency of different models was available. During this time period, room air conditioners carried information tags reporting the energy efficiency and expected operating costs of various models.

[248] See Gilbert Metcalf and Kevin Hassett, "Measuring the Energy Savings from Home Improvement Investments: Evidence from Monthly Billing Data", Working paper No. 6074, National Bureau of Economic Research, June 1997.

benefits can help provide financing for investment projects that would use wind or biomass facilities. On the other hand, an up-front tax credit provides more certainty, as the future production credits could possibly be curtailed by future Congresses. In general, investors prefer certainty to uncertainty, and thus may discount the value of future production credits. Another difference between a production credit and an investment credit is that the latter provides only a temporary distortion to the market--once the investment is made, normal competitive market conditions will prevail and the rational firm will only produce its end product if it can cover its variable costs. With a production credit, a firm may actually profitably produce even though it cannot cover its variable costs in the absence of the credit. This would generally be considered an economically inefficient outcome unless there are positive externalities to the production of the good that exceed the value of the credit.[249] If it is presumed that the electricity produced from wind or biomass substitutes for electricity produced from the burning of fossil fuels, economic efficiency will be improved so long as the credit does not have to be set so high in order to encourage the alternative production that it exceeds the value of the positive externality. On the other hand, by making some production of electricity cheaper, it is possible that the credit could encourage more electricity consumption. On net, however, there would be less electricity produced from fossil fuels.

With respect to the expansion of the biomass materials eligible for the credit, the basic issues are the same as those outlined above for any tax benefit for energy conservation or pollution abatement. To justify the credit on economic grounds, the positive externalities from the burning of biomass for the production of electricity must outweigh the costs of the tax subsidy. With respect to the waste materials that are proposed to be made eligible for the credit, one positive externality is similar to that of wind power production, namely the reduction in electricity production from the more environmentally damaging coal. Another consideration with the waste products is whether their current disposal is harmful to the environment. If so, an additional positive externality may exist from discouraging such disposal. If the disposal is harmful to the environment and is a partial justification for the credit, then ideally the credit amount should vary for each biomass waste product if their present disposal varies in its harm to the environment. A single credit rate would be justified if the negative externalities are of a similar magnitude, or if administrative considerations would make multiple credit rates problematic.

With respect to the special lower credits for non-closed-loop biomass facilities that are already placed in service and for biomass co-fired with coal, additional justifications for the credits need to be offered. In general, establishing a credit for existing economic activity is inefficient--if the activity already takes place without the credit then establishing the credit only produces a windfall gain for the producers. Establishing the credit for the existing activity would

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[249] In the present case, the positive externality is thought to be pollution abatement. While pollution abatement per se does not occur from the production of electricity from wind, the presumption is that, indirectly, pollution is abated because less electricity is produced from the burning of fossil fuels.

only be efficient if the existing plants would otherwise choose to shut down if the credit were not established, and the cost of the credit was less than the value of the positive external benefits that result from the continued operation of the plant. In the case of the special credit rate for co-firing biomass with coal, establishing the credit for existing facilities that already co-fire would need to meet the same tests for the credit to be efficient and not merely produce windfall gains. To the extent that the credit encourages coal burning facilities to begin to co-fire with biomass, the credit with respect to such co-firing could be efficient to the extent that the positive external benefits from the co-firing exceed the costs of the credit. If it is impractical to separate new co-firing from existing investments in co-firing, then for the credit to be economically efficient the external gains from the newly induced co-firing would need to exceed the costs of the credit with respect to the new co-firing as well as the cost of the credit with respect to any windfall gains to facilities that would co-fire in the absence of the credit.

6. Provide a uniform 15-year depreciable life for all distributed power property

Present Law

A taxpayer is allowed a depreciation deduction 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 cost 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. Section 168 provides specific class lives for certain assets. The class life of other assets is determined by reference to the list of class lives provided by the Treasury Department that was in effect on January 1, 1986.[250] If no class life is provided, the asset is allowed a 7-year recovery period under MACRS.

The rules for the depreciation of property that generates and distributes power for a taxpayer's own use, rather than for sale to others, (commonly referred to as "distributed power property") are not consistent. The recovery period varies depending on the type and amount of power produced and the setting in which it is produced. Distributed power property with a rated total capacity of more than 500 kilowatts of electricity (or more than 12,500 pounds per hour of steam) that is used in a taxpayer's manufacturing business, and is not a structural component of a building is included in asset guideline class 00.4.[251] MACRS depreciation on such property is determined using the 150 percent declining balance method and a 15 year recovery period. A class life of 22 years is applicable if depreciation is determined under section 168(g). Assets that are used in the production of energy for sale to others (other than the production of nuclear energy) generally have a recovery period of 22 years.

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[250] Rev. Proc. 87-56, 1987-2 C.B. 674.

[251] Rev. Proc. 87-56, 1987-2 C.B. 674.

Other types of distributed power property are not assigned their own asset guideline class. Instead, they follow the asset guideline class associated with the business activity to which they relate. Thus, distributed power property with a rated total capacity of 500 kilowatts or less of electricity (or 12,500 pounds per hour or less of steam), property that produces power other than electricity or steam, and property that produces power for use by the taxpayer other than in a manufacturing business, is depreciated in accordance with the asset guideline class applicable to the activity in which the property is used.

Distributed power property does not include buildings and structural components. For example, all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts, and all other components relating to the operation or maintenance of a building, must be depreciated as real property using the straight-line method over a recovery period of 39 years.

Description of Proposal

The proposal would establish a statutory 15-year MACRS recovery period for a revised and expanded category of distributed power property. Generally, the effect of the proposal would be to extend the 15-year recovery period and 150 percent declining balance method to distributed power property that is used in the generation of electricity for primary use in nonresidential real property or residential rental property used in the taxpayer's trade or business. The proposal would also clarify that power will be considered to be generated for a taxpayer's own use, rather than for sale to others, if it is reasonably expected that no more than 50 percent of the electricity produced would be sold to, or used by, unrelated persons. Unlike asset guideline class 00.4, the statutory 15-year recovery period would apply to certain structural components as well as other types of section 1245 and section 1250 property. However, the statutory 15-year recovery period would not apply to assets that are used to transport primary fuel to the generating facility or to distribute energy within or outside of the taxpayer's facility. A uniform 22-year section 168(g) class life would also be provided.

Distributed power property eligible for depreciation under the statutory 15-year recovery period would include (1) property with a rated total capacity in excess of 500 kilowatts that is used in the generation of electricity for primary use in a taxpayer's industrial manufacturing process or plant activity, (2) property used to produce usable thermal energy or mechanical power for use in a heating or cooling application if not less than 40 percent of the total useful energy produced consists of either electrical power or power that is used in the manufacturing process, and (3) property used in the generation of electricity for primary use in nonresidential real property or residential rental property used in the taxpayer's trade or business.

Effective date.--The proposal would be effective for property placed in service after the date of enactment.

Analysis

The proposal would simplify current law and provide a more consistent treatment of distributed power property, including property that is used to produce electricity in a commercial or residential setting. The proposal would also provide a clearer test for the amount of electricity that can be sold to or consumed by others without violating the requirement that the power be produced primarily for the use of the taxpayer.

The proposal could provide a shorter depreciable life for certain distributed power assets. The statutory 15-year would apply to certain structural components, property that is now required to be recovered over 31.5 years if used in residential property and over 39 years if used in non-residential property. This could encourage the greater use of distributed power technologies, which are considered by many to contribute to overall energy efficiency.

On the other hand, the proposed statutory 15-year recovery period may result in a longer depreciable life for other distributed power assets. Under present law, taxpayers take the position that distributed power assets that are not structural components and are not included in asset class 00.4 are depreciated according to the activity they are used in. This could result in the use of a 7-year recovery period and the double declining balance method for those assets. In the case of distributed power assets that are not structural components and are used in a distributive trades and services activity, a 5-year recovery period and the double declining balance method could be used.

Prior Action

No prior action.[252]

[252] An identical proposal was included in S. 1048, the Comprehensive Electricity Competition Tax Act, as introduced in the Senate by Senator Murkowski.

I. Electricity Restructuring

1. Revise rules governing issuance of tax-exempt bonds for electric facilities of public power entities

Present Law

In general

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103). Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person ("private activity bonds") is taxable unless the purpose of the borrowing is approved specifically in the Code or in another provision of a revenue Act. The provision of electric service (generation, transmission, distribution, and retailing) is an activity eligible for financing with governmental tax-exempt bonds when the financed facilities are used by or paid for by a State or local government ("public power"). Except as described below, public power is subject to the same limits on private business use that apply to other governmental functions. Exempt-facility private activity tax-exempt bonds for the provision of electric service (e.g., bonds for investor-owned utilities) may be issued only for facilities used in the local furnishing of electricity.[253]

The general structure of the rules for determining whether a tax-exempt bond is a governmental or a private activity bond was enacted in 1968, at which time State or local government bonds were classified as "industrial development bonds" if private business use and security for debt repayment exceeded 25 percent of the proceeds and debt service.[254] The Tax Reform Act of 1986 (the "1986 Act") further restricted the amount of private business use that may be financed before a State or local government bond is classified as a private activity bond (and therefore in the case of bonds for the provision of electric service, generally lose their tax-exempt status). The principal present-law test for determining whether a State or local government bond is in substance a private activity bond consists of two parts:

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[253] Local furnishing is limited to private facilities serving no more than two counties (or a city and a contiguous county). Further, these tax-exempt bonds may only be issued for the benefit of persons engaged in that activity on January 1, 1997, and in general only for areas served on that date. In addition, certain public power bonds issued as part of the acquisition of existing private electric facilities are treated as local furnishing bonds.

[254] Industrial development bonds were subsumed into the category of "private activity bonds" by the Tax Reform Act of 1986.

(1) More than 10 percent of the bond proceeds is to be used (directly or indirectly) by a private business; and

(2) More than 10 percent of the debt service on the bonds is secured by an interest in property to be used in a private business use or to is be derived from payments in respect of such property.[255]

In the case of public power bonds, the maximum amount of private business use is limited to the *lesser* of 10 percent *of the bond proceeds* or $15 million *per facility*. All outstanding bonds are included in calculating the $15 million limit. This per-facility limit is more restrictive than the general per-bond-issue limit on private business use for bonds for other governmental activities. Because power facilities such as generating plants are costly, the substantive effect of the $15 million limit is to reduce the otherwise permitted amount of private business use of those facilities.

The Statement of Managers accompanying the 1986 Act states that ". . . trade or business use by all persons on a basis different from the general public is aggregated in determining if the 10-percent threshold for being a private activity bond is satisfied." See, H. Rept. 99-841, p. II-688. The *General Explanation of the Tax Reform Act of 1986*[256] further amplified this rule, as follows:

> The determination of who uses bond proceeds or bond-financed property generally is made by reference to the ultimate user of the proceeds or property. . . . [B]ond proceeds used to satisfy contractual obligations undertaken in connection with general governmental operations, such as payment of government salaries, or to pay legal judgments against a governmental unit, are not treated as used in the business of the payee. This is to be contrasted with the indirect nongovernmental use of bond proceeds that occurs when a government contracts with a nongovernmental person to supply that person's trade or business with a service (*e.g.,* electric energy) on a basis different from that on which the service is provided to the public generally or to finance property used in that person's business (*e.g.*, a manufacturing plant). In both of these instances a nongovernmental person is considered to use the bond proceeds other than as a member of the general public.

[255] The 10-percent private use and payment limits are reduced to an amount equal to the lesser of 5 percent or $5 million in the case of loans. Present law further includes a more restrictive rule limiting the amount of governmental bond proceeds that may be used to finance private business activities that are unrelated to governmental activities also being financed with a bond.

[256] Joint Committee on Taxation (JCS-10-87), May 4, 1987, p.1160.

The 1986 Act included only four relevant exceptions to the general rule that all business use by a private person on a basis different from that available to other members of the general public is counted under the private business use test. First, a general exception for all governmental bonds provides that management of governmental facilities by private businesses is disregarded if the management is pursuant to contracts having specified terms limiting the duration of the arrangement and the fees paid to the private business. Second, the legislative history to the 1986 Act provided three exceptions that are unique to public power. These exceptions allow spot sales of excess power capacity for temporary periods not exceeding 30 days, and disregard the presence of a nongovernmental person acting solely as a conduit for power-sharing among governmentally owned and operated utilities. They further allow "power-swapping" arrangements between public power and privately owned electric utilities if (1) the arrangements are designed to enable the respective utilities to satisfy differing peak load demands or to accommodate temporary outages, (2) the swapped power between the parties is approximately equivalent determined over periods of one year or less, and (3) no output-type contracts are involved.

The determination of whether interest on State or local government bonds is tax-exempt initially is made when the bonds are issued. That is, the determination is made by reference to how the bond proceeds are "to be used." Deliberate acts within the control of the issuer that are taken after the date of issuance to use bond-financed facilities (indirectly a use of bond proceeds) in a manner not qualifying for tax exemption may render interest on the bonds taxable, retroactive to the date of issuance (the "change in use rules"). A transaction giving rise to a prohibited change in use may be illustrated by a post-bond-issuance sale of public power electric output to private businesses in a manner not qualifying for tax-exemption (e.g., an output-type contract with a private business for a period in excess of the 30 days provided for in the 1986 Act legislative history).

Both before and after 1986, the Treasury Department administratively has provided alternative sanctions to retroactive loss of tax-exemption for post-issuance changes in use in certain cases when the change was not reasonably expected at the time the bonds were issued. These alternative sanctions require immediate surrender of the benefits of tax-exempt financing by redemption of outstanding bonds, or if immediate redemption is precluded by pre-existing bond terms, by immediate defeasance of the bonds through establishment of an escrow account funded with taxable debt, and generally after 1993, accompanied by redemption on the first possible date.

Temporary and proposed treasury regulations affecting public power bonds

On January 21, 1998, the Treasury Department issued temporary and proposed regulations (T.D. 8757) affecting tax-exempt bonds of public power entities that participate in electric industry open access arrangements. These regulations are scheduled to expire three years after they were issued. The regulations include a general rule that, if an arrangement provides a private business user with rights to bond-financed property that are different from rights of the general public (i.e., transfers the benefits and burdens with respect to the property), the private use is counted under the 10-percent (and $15 million) limits described above. However, in the case of public power bonds, the regulations administratively create special exceptions pursuant to which certain transactions entered into to facilitate an issuer's participation in open access arrangements are not treated as giving rise to private business use or as deliberate actions increasing the amount of private business use beyond that allowed under the Code.

The first such exception provides that contracts of up to three years duration for the sale to a nongovernmental person of excess electric output resulting from participation in an open access arrangement are not treated as private business use under certain circumstances.[257] The purpose of the sale must be to mitigate costs of existing generating plants that the utilities no longer can recover as a result of competition ("stranded costs"). Issuers benefitting from the rule may not make tax-exempt-bond-financed expenditures to increase the generating capacity of their systems during the term of the contract; however, they may continue to benefit both from all of their outstanding tax-exempt bonds and newly issued bonds if the newly issued bonds are not used to increase capacity. Further conditions of this output contract exception are that issuers must offer non-discriminatory open access transmission tariffs for the use of their system under Federal Energy Regulatory Commission ("FERC") rules, and they must use any stranded cost recovery un der the contracts to redeem bonds "as promptly as is reasonably practical."

The regulations also create two new exceptions under which private business use of public power transmission facilities is disregarded in determining whether a prohibited change in use has occurred. The first of these provides that the use of public power transmission facilities pursuant to contracts entered into in response to wheeling required (or expected to be required) under sections 211 and 212 of the Federal Power Act or comparable State laws is not treated as a post-issuance deliberate action violating the private business tests.[258] This regulatory exception mirrors a separate, statutory provision in Code section 142(f)(2). The statutory provision, enacted as part of the Energy Policy Act of 1992[259], applies only to private activity tax-exempt bonds for the local furnishing of electricity. The second exception for transmission facility bonds provides that other actions taken by public power entities to implement non-discriminatory, open access plans of FERC or a State are not treated as deliberate actions in determining whether the private business tests are violated with regard to outstanding tax-exempt bonds.[260] There is no requirement in the second exception that the action be taken in response to or in anticipation of a requirement by the Federal Government or a State government.

[257] Treas. Reg. sec. 1.141-7T(f)(4).

[258] Treas. Reg. sec. 1.141-7T(f)(5)(i).

[259] P.L. 102-486.

[260] Treas. Reg. sec. 1.141-7T(f)(5)(ii).

In addition to preserving tax-exemption for previously issued public power transmission bonds under the circumstances described, the regulations permit public power to refund that debt with new bonds, notwithstanding violation of the general tax-exempt bond rule that tax-exempt refunding bonds may only be issued if the private business tests (and all other requirements for tax exemption) are satisfied on the date the refunding occurs.[261]

Finally, the regulations provide that a "wholesale requirements" contract may violate the private business tests if the contract substantively results in private business use in excess of that allowed under the Code.[262] A wholesale requirements contract is a contract under which the purchaser agrees to purchase all or a portion of its requirements from the seller. The regulations provide three primary factors that are to be used to establish whether requirements contracts violate the private business tests. Two of these factors describe attributes of investor-owned utilities (i.e., diverse customer base (including residential customers) and historical as opposed to projected requirements). Most proposed electric restructuring arrangements anticipate significant sales of electricity by independent power brokers (much like stock or commodities traders). These traders would not be expected to have customer bases similar to those of traditional electric utilities. The regulations specifically provide that use of property by a power broker is treated as private business use under the 1986 Act exception for power-swapping arrangements.[263]

Description of Proposal

In conjunction with legislative consideration of the Administration's Comprehensive Electricity Competition Plan,[264] the Administration would propose that tax-exempt bonds be allowed to be used in certain cases by public power entities participating in open access arrangements to finance new distribution facilities (including functionally related and subordinate property). No new electric generation or new transmission facilities could be financed with tax-exempt bonds by such entities. Distribution facilities would be defined as facilities operating at 69 kilovolts or less (including functionally related and subordinate property).

The proposal also would provide that bonds outstanding on the date of enactment would not lose their tax-exempt status if the bonds were used to finance: (1) transmission facilities the private use of which results from action pursuant to a FERC order requiring non-discriminatory

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[261] Treas. Reg. sec. 1.141-7T(f)(5)(iii).

[262] Treas. Reg. sec. 1.141-7T(c)(4).

[263] Treas. Reg. sec. 1.141-7T(f)(6).

[264] The Comprehensive Electricity Competition Plan was announced on March 24, 1998 by the Department of Energy.

open access to those facilities; or (2) generation or distribution facilities the private use of which results from retail competition or from the issuer entering into a contract for the sale of electricity or the use of its distribution property that will become effective after implementation of retail competition.

Sales of facilities financed with tax-exempt bonds to private entities would continue to constitute a change of use.

The proposal would permit current refunding, but not advance refunding, of bonds issued before the date of enactment.

Effective date.--The proposal would be effective on the date of enactment of the Administration's Comprehensive Electricity Competition Plan.

Analysis

The ability to finance capital and operating costs with tax-exempt bonds may substantially reduce the cost of debt finance. To illustrate, assume the interest rate on taxable debt is 10 percent. If an investor in the 36-percent marginal income tax bracket purchased a taxable debt instrument, his after-tax rate of return would be the 10-percent interest less a tax of 36 percent on the interest received for a net return of 6.4 percent. If as an alternative this investor could purchase a tax-exempt bond, all other things such as credit-worthiness being equal, he would earn a better after-tax return by accepting any yield greater than 6.4 percent.[265] In the market, the yield spread between a tax-exempt bond and comparable taxable bond is determined by the marginal buyer of the bonds; in today's market, yield spreads are generally less than 28 percent.[266] Because the yield spread arises from forgone tax revenue, economists say that tax-exempt finance creates an implicit subsidy to the issuer. However, with many investors in different tax brackets, the loss of Federal receipts is greater than the reduction in the tax-exempt

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[265] More generally, if the investor's marginal tax rate is t and the taxable bond yields r, the investor is indifferent between a tax-exempt yield, r_e, and $(1\text{-t})r$.

[266] For example, while not comparable in security, market trading recently has priced 30-year U.S. Treasuries to have a yield to maturity of approximately 6.09 percent. Prices for an index of long-term tax-exempt bonds have produced a yield to maturity of approximately 5.92 percent. See, *The Bond Buyer*, 331, February 23, 2000, p. 25. Again ignoring differences in risk or other non-tax characteristics of the securities, the yield spread implies that an investor with a marginal tax rate of 3 percent would be indifferent between the Treasury bond and the average high-yield tax-exempt bond. Thus, under present market conditions, yield spreads on long-term bonds are so narrow that all taxpayers investing in those instruments should prefer tax-exempt bonds. Viewed another way, almost the entire Federal subsidy to these bonds goes to bondholders (rather than State or local government issuers) under these market conditions. (Shorter maturity bonds currently have somewhat higher yield spreads.)

issuers' interest saving.[267] The difference accrues to investors in tax brackets higher than those that would be implied by the yield spread between taxable and tax-exempt bonds.

Electric industry restructuring might have two distinct effects on public power and investor-owned utilities ("IOUs") that qualify for tax-exempt financing as local furnishers. First, if these utilities must use taxable bonds to finance generation facilities, their cost of capital is likely to rise.[268] Because competitors attempt to price their services to recover their capital costs, in the long run, prices of electricity provided by these generators might rise. In addition, because tax-exempt financing lowers the cost of debt capital, electric service providers that receive tax-exempt bond financing may rely more heavily on debt finance than other providers. Loss of the ability to use tax-exempt financing may cause the affected entities to adjust their financial structure in the long run. In the short run, investors may view such providers as riskier investments than others because of their higher leverage ratios.

On the other hand, if these electric service providers were permitted to retain their ability to receive tax-exempt financing, they might have a considerable cost advantage over other generators in a deregulated market for generated power. The market share of such generators would expand and the implicit Federal subsidy to electric generation and certain investors might increase. In order to keep these providers from exploiting their capital cost advantage, the scope of restructuring may have to be smaller, perhaps by not permitting such generators to interconnect with the IOUs. Limiting interconnection, however, would limit the scope for exploiting system rationalization, inter-regional power sales, and efficiency gains.

A second effect that restructuring could have on current electric power industry beneficiaries of tax-exempt bonds is the so-called stranded cost problem. Analysts usually refer

[267] The Federal income tax has graduated marginal tax rates. Thus, $100 of interest income forgone to a taxpayer in the 31-percent bracket costs the Federal Government $31, while the same amount of interest income forgone to a taxpayer in the 28-percent bracket costs the Federal Government $28. If a taxpayer in the 28-percent bracket finds it profitable to hold a tax-exempt security, a taxpayer in the 31-percent bracket will find it even more profitable. This conclusion implies that the Federal Government will lose more in revenue than the tax-exempt issuer gains in reduced interest payments.

[268] Restructuring could cause outstanding bonds to lose their tax exemption. In practice, when an outstanding tax-exempt bond becomes taxable the issuer typically pays the Federal Government a negotiated settlement amount. Such payments would not raise the total interest expense to that incurred by an issuer who has issued taxable bonds unless the negotiated settlement amount equals the yield spread between the formerly tax-exempt bond and a comparable taxable bond. Moreover, even in such case, the "tax" recovered when an outstanding tax-exempt bond becomes taxable is less than the amount of tax that would have been paid had the bond initially been sold as a taxable bond offering taxable interest for the reasons explained in the preceding footnote.

to the stranded cost problem in the context of privately owned facilities, but the problem can arise for public power as well. Bonds outstanding today have financed facilities. The prices charged for the electricity produced by these facilities is based on a non-competitive market in which the price is sufficient to meet the debt service demands of the bond. Under restructuring, the wholesale price of electricity may generate revenues insufficient to meet the debt service requirements of the facilities. In such a situation, to avoid possible default on the bonds, the utility may have to draw down reserves or devise some method to recover the original investment in the facilities.

Advocates of the proposal may argue that it ameliorates the stranded costs transition problem by allowing much currently outstanding tax-exempt debt to retain its status but does not give public power the unfair advantage of tax-exempt financing in any expansion. Also, they may argue that, the benefit is limited in duration because the refinancing may not extend the term of the debt beyond 120 percent of the economic life of the property being refinanced. Others may respond that this transition relief gives public power an unfair advantage in the market place by retaining the lower cost of capital resulting from their outstanding tax-exempt debt. They continue that even the limited duration of this financing perpetuates an unequal cost of capital which undermines fair competition On a prospective basis, some may argue that the proposal correctly allows tax-exempt financing for distribution facilities (including functionally related and subordinate property). They believe that these facilities are less likely to be the subject of increased competition so there is no unfair competitive advantage as a result of this limited tax-exemption. Others believe that market competition and the public are the best served by eliminating tax-exemption for all new bond issues.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

2. Modify treatment of contributions to nuclear decommissioning funds

Present Law

Generally, an accrual basis taxpayer may not deduct an item prior to the time the all events test is met and economic performance occurs. Section 468A provides an exception to those rules that allows a taxpayer responsible for nuclear power plant decommissioning to elect to deduct contributions made to a qualified nuclear decommissioning fund for future payment costs. A taxpayer's contributions to such a fund may not exceed the amount of nuclear decommissioning costs included in the taxpayer's cost of service for ratemaking purposes for the taxable year. Additionally, in order to prevent accumulations of funds over the remaining life of a nuclear power plant in excess of those required to pay future decommissioning costs and to ensure that contributions to the funds are not deducted more rapidly than level funding, taxpayers must obtain a ruling from the IRS to establish the maximum contribution that may be made to the fund.

Description of Proposal

The proposal would repeal the requirement that deductible contributions to a qualified nuclear decommissioning fund not exceed the amount of nuclear decommissioning costs included in the taxpayer's cost of service for ratemaking purposes. This would allow taxpayers that are not subject to traditional rate regulation to make deductible contributions to a qualified nuclear decommissioning fund. Deductible contributions would continue to be limited by the requirement that taxpayers obtain a ruling from the IRS establishing the maximum contribution that may be made to the fund.

Effective date.--The proposal would be effective for contributions to a qualified nuclear decommissioning fund made after the date of enactment.

Analysis

The cost of service limitation on the amount of deductible contributions to a qualified nuclear decommissioning fund reflects the regulatory environment that existed when the legislation was originally enacted in 1984 and all taxable entities producing nuclear power were subject to rate regulation. More recently, the process of deregulation of the electric power industry has begun to occur at the State level. Proponents of the proposal argue that the present-law limitation is outdated, and that the rules relating to deductible contributions to nuclear decommissioning funds should be modernized to reflect industry deregulation.

The process of deregulation takes different forms in different jurisdictions. A jurisdiction may choose to eliminate rate regulation and allow rates to be set by the market instead of the public utility commission. Although such market rates may include an element compensating a generator of nuclear power for its anticipated decommissioning costs, there is no regulatory cost of service amount against which to measure a deductible contribution. A line charge or other fee could 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. The taxpayer generating the electricity may not be the same as the taxpayer distributing it. In those cases, the use of line charges and other customer based fees as a vehicle to satisfy the requirement that deductible contributions not exceed cost of service may not be successful.

The exception allowing a taxpayer responsible for nuclear power plant decommissioning to deduct contributions to a qualified nuclear decommissioning fund for future payment costs was enacted in Congress' belief that the establishment of segregated reserve funds for paying future nuclear decommissioning costs was of national importance.[269] In a deregulated future, the continued deduction of such contributions may be prevented unless the cost of service limitation

[269] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, p. 270.

is repealed. The loss of deductibility may reduce the amount of funds available for decommissioning in the future.

Prior Action

Identical proposals were included in the President's Fiscal Year 2000 Budget Proposal and in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President.

J. International Trade Provisions

1. Extend and modify Puerto Rico economic-activity tax credit

Present Law

The Small Business Job Protection Act of 1996 generally repealed the Puerto Rico and possession tax credit. However, certain domestic corporations that had active business operations in Puerto Rico or another U.S. possession on October 13, 1995, may continue to claim credits under section 936 or section 30A for a 10-year transition period. Such credits apply to possession business income, which is derived 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 that were used in such a trade or business. In contrast to the foreign tax credit, the Puerto Rico and possession tax credit is granted whether or not the corporation pays income tax to the possession.

One of two alternative limitations is applicable to the amount of the credit attributable to possession business income. Under the economic activity limit, the amount of the credit with respect to such income cannot exceed the sum of a portion of the taxpayer's wage and fringe benefit expenses and depreciation allowances (plus, in certain cases, possession income taxes); beginning in 2002, the income eligible for the credit computed under this limit generally is subject to a cap based on the corporation's pre-1996 possession business income. Under the alternative limit, the amount of the credit is limited to the applicable percentage (40 percent for 1998 and thereafter) of the credit that would otherwise be allowable with respect to possession business income; beginning in 1998, the income eligible for the credit computed under this limit generally is subject to a cap based on the corporation's pre-1996 possession business income. Special rules apply in computing the credit with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. The credit is eliminated for taxable years beginning after December 31, 2005.

Description of Proposal

The proposal would modify the credit computed under the economic activity limit with respect to operations in Puerto Rico only. First, the proposal would extend the December 31, 2005 termination date with respect to such credit to December 31, 2008. Second, the proposal would eliminate the limitation that applies the credit only to certain corporations with pre-existing operations in Puerto Rico. Accordingly, under the proposal, the credit computed under the economic activity limit would be available with respect to corporations with new operations in Puerto Rico.[270] The proposal would not modify the credit computed under the economic activity limit with respect to operations in possessions other than Puerto Rico. The

[270] An operation would be defined as "new" if established after October 13, 1995, the end of the base period established by the Small Business Job Protection Act of 1996.

proposal also would not modify the credit computed under the alternative limit with respect to operations in Puerto Rico or other possessions.

Effective date.--The proposal would apply to taxable years beginning after December 31, 1999.

Analysis

When the Puerto Rico and possession tax credit was repealed in 1996, the Congress expressed its concern that the tax benefits provided by the credit were enjoyed by only the relatively small number of large U.S. corporations that operate in the possessions and that the tax cost of the benefits provided to these possessions' corporations was borne by all U.S. taxpayers. In light of the then current budget constraints, the Congress believed that the continuation of the tax exemption provided to corporations pursuant to the Puerto Rico and possession tax credit was no longer appropriate.

The proposal to extend and modify the credit computed under the economic activity limit is intended to provide an incentive for job creation and economic activity in Puerto Rico. In this regard, it should be noted that the Puerto Rican government itself has enacted a package of incentives effective January 1, 1998, designed to attract business investment in Puerto Rico. This proposal should be analyzed in light of these local initiatives which recently have gone into force; issues to be considered include whether additional federal tax incentives are necessary or appropriate and whether the proposed credit would interact efficiently with the particular local incentives already in place.

In 1997, the unemployment rate averaged 13 percent in Puerto Rico. By comparison, the United States's unemployment rate averaged 4.9 percent in 1997 and the State with the highest average unemployment rate, Alaska, averaged 7.9 percent unemployment.[271] The incomes of individuals and families are lower in Puerto Rico than in the United States. In the last year for which comparable data are available, 1989, the median family income in the United States was $35,225, and the median family income in Puerto Rico was $9,988. For 1989, the lowest median household income among the States was $26,159 in Alabama.[272] In 1998, per capita GDP in

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[271] The unemployment rate in the District of Columbia averaged 7.9 percent in 1997. Source: Bureau of the Census, U.S. Department of Commerce, *Statistical Abstract of the United States, 1999*.

[272] Bureau of the Census, U.S. Department of Commerce, *Statistical Abstract of the United States, 1999*. The data are drawn from the 1990 Census. Comparison of the income figures reported for Puerto Rico or the United States to the figure for Alabama should be made with some caution as the Alabama figure reports household income rather than family income. For 1989, median household income in the United States was $35,526 and in Puerto Rico median household income was $8,895. U.S. Department of Commerce, Bureau of the Census, *1990*

Puerto Rico was $9,083, while per capita GDP for the United States was $31,487.[273] Puerto Rico has long lagged the mainland by such measures of economic performance. (See Tables 12 and 13 below.) It has been these, or comparable, facts that have motivated efforts to encourage economic development in Puerto Rico.

Table 12. Unemployment Rate in the United States and Puerto Rico, Selected Years, 1970-1998

	1970	1980	1985	1990	1995	1996	1997	1998
United States	4.9	7.1	7.2	5.6	5.6	5.4	4.9	4.5
Puerto Rico	10.0	17.0	21.0	14.0	14.0	14.0	13.0	13.6

Source: U.S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States*, *1999*.

Table 13. Per Capita Gross Domestic Product for the United States and Puerto Rico, Selected Years, 1980 - 1998
(current year dollars)

	1980	1985	1990	1995	1998
United States	12,226	17,529	22,979	27,571	31,487
Puerto Rico	3,475	4,441	6,130	7,640	9,083

Source: U.S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States*, *1999*, and Joint Committee on Taxation staff calculations.

Census of Population, Social and Economic Characteristics, Puerto Rico, 42.

[273] U.S. Department of Commerce, Bureau of the Census, *1990 Census of Population, Social and Economic Characteristics, Puerto Rico.*

The credit computed under the economic activity limit as provided in section 30A reduces the Federal income tax burden on economic activity located in Puerto Rico. By reducing the Federal income tax burden, the credit may make it attractive for a business to locate in Puerto Rico, even if the costs of operation or transportation to or from the United States would otherwise make such an undertaking unprofitable. As such, the credit is a deliberate attempt to distort taxpayer behavior. Generally, distortions of taxpayer behavior, such as those that distort decisions regarding investment, labor choice, or choice of business location reduce overall well-being by not putting labor and capital resources to their highest and best use. However, proponents of the credit argue that such a distortion of choice may increase aggregate economic welfare because Puerto Rico has so many underutilized resources, as evidenced by its chronic high unemployment rate.

Some also have suggested that the credit may offset partially certain other distortions that exist in the Puerto Rican economy. For example, some have suggested that the application of the Federal minimum wage, which generally has been chosen based on the circumstances of the States, to Puerto Rico may contribute to Puerto Rico's relatively high unemployment rate. Others have suggested that the cost of investment funds to Puerto Rican businesses may be higher than is dictated by the actual risk of those investments. If this is the case, there may be an imperfect capital market. The credit, as it applies to wages and capital, may partially offset a distortion created by the minimum wage or a capital market imperfection.

The proposal would extend the credit computed under the economic activity limit with respect to operations in Puerto Rico to new business operations in Puerto Rico. The credit computed under the economic activity limit is based loosely on the value added by a business that occurs within a qualifying Puerto Rican facility. That is, the credit is based upon compensation paid to employees in Puerto Rico and upon tangible personal property located in Puerto Rico. Proponents of the credit note that this design does not bias a business's choice of production between more labor intensive or more capital intensive methods, and thus should not promote an inefficient use of resources in production.[274] Proponents further observe that the economic activity credit under section 30A is based upon the labor employed in Puerto Rico and the equipment located within Puerto Rico which add value to the good or service produced, not the cost of raw materials, land, intangibles, interest, or other expenses. Thus, they argue that the credit directly targets underemployed resources within Puerto Rico.

The economic activity credit only has been available to taxpayers since 1994. There have been no studies of its efficacy to date. However, the tax credit can never be fully efficient. The credit would be available to any business locating in Puerto Rico, regardless of whether the business would have chosen to locate in Puerto Rico in the absence of the credit for other

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[274] The income-based credit of prior law was criticized for encouraging intangible capital intensive business development rather than business development of any type. See the discussion in Department of the Treasury, *The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report*, March 1989.

business reasons. Thus, as with most tax benefits designed to change economic decisions, in some cases, the Federal Government will lose revenue even when there has been no change in taxpayer behavior.

Use of a tightly defined tax benefit as a business development tool may limit Federal Government funds available for other development initiatives that might foster business development in Puerto Rico. For example, a lack of infrastructure (such as roads or waste water treatment facilities) may forestall certain business investments. It is difficult for tax credits to address those sorts of business development initiatives. More generally, one might question the efficacy of using tax benefits in lieu of direct spending to foster economic development. Direct subsidies could be made to certain businesses to encourage location in Puerto Rico, and the subsidies could be tailored to the specific circumstance of the business. A tax credit operates as an open-ended entitlement to any business that is eligible to claim the credit. On the other hand, unlike direct subsidies, under such a credit the marginal investment decisions are left to the private sector rather than being made by government officials.

Prior Action

Similar proposals were included in the President's Fiscal Year 1998, 1999, and 2000 Budget Proposals.

K. Miscellaneous Provisions

1. Exempt first $2,000 of severance pay from income tax

Present Law

Under present law, severance payments are includible in gross income.

Description of Proposal

The proposal would provide a temporary exclusion for up to $2,000 of certain severance payments. The 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 would not be available if the individual becomes employed within 6 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 would not apply if the total severance payments received by the individual exceed $75,000.

Effective date.--The proposal would be effective for severance pay received in taxable years beginning after December 31, 2000, and before January 1, 2004.

Analysis

Like all exclusions from income, the proposal would result in horizontal inequity, i.e., taxpayers with the same economic income could have different tax liability merely because of the form in which the income is received. In this case, a taxpayer who receives income in the form of excludable severance payments could have a lower tax liability than a taxpayer with the same economic income but who does not receive excludable severance payments. The stated rationale for the favorable tax treatment for severance payments is that taxing such payments places an additional burden on displaced workers, especially if the worker is separated from service because of a reduction in work force, in which case it may be difficult for the worker to find new, comparable employment. Some agree that it is appropriate to provide tax relief for individuals in such circumstances. However, others argue that the proposal does not provide relief for all persons in similar circumstances. For example, some argue that relief would be even more necessary in cases in which severance payments are not provided by the employer, and that a more fair approach to providing relief for displaced workers would be to provide that some portion of unemployment benefits are excludable from income. Others argue that there is no clear rationale for distinguishing separations from service in connection with a reduction in the work force from other separations--the hardship on the individual may be just as great in other circumstances.

Some also argue that the proposal is not well-targeted because it provides tax relief for individuals who are not in financial distress as a result of the separation from service. The limit on the exclusion to cases in which the payments do not exceed $75,000, is one way of addressing this concern, as is the restriction that the exclusion does not apply if comparable employment is attained within 6 months. Other methods would also be possible, but would also add complexity to the proposal. The 6-month rule may itself add some complexity, because the new employment may occur in a tax year other than the one in which the payments were received and after the individual's tax return for the year of payment had been filed. An individual may need to file an amended return in such cases in order to accurately report income.

No rationale is provided for the temporary nature of the exclusion (i.e., the fact that it is not available for payments received after December 31, 2003). One possible rationale for making the exclusion temporary is to limit the revenue loss associated with the provision. Another possible rationale is to allow the effects of the exclusion to be determined in order to evaluate whether the exclusion is achieving its purpose and should be continued on a permanent basis.

Present law contains a variety of expiring tax provisions, such as the exclusion for employer provided educational assistance and the research and development credit. These provisions, initially enacted on a temporary basis, have been repeatedly extended, sometimes on a retroactive basis after the provision has expired. Such expiring provisions create uncertainty and complexity, because it is often unclear whether (or when) the provision will be extended. Enacting a new temporary provision would likely involve the same complexity and uncertainty.

The proposal lacks specificity in certain respects. For example, the proposal does not define a "reduction in the employer's work force." Without an adequate definition, almost any termination of employment could be construed as in connection with a reduction in the employer's work force, meaning that up to $2,000 of any payments made upon termination of employment would be excludable from income. While the proposal was not intended to be interpreted so broadly, additional details would be necessary to reflect this intent. The proposal also does not define "severance payments," so it is unclear whether the proposal is intended to be limited to certain types of payments received upon a separation from service, or only some payments. The definition is important not only in determining what payments qualify for the exclusion, but also in determining whether any payments qualify because the $75,000 cap is exceeded.

It is also not clear from the proposal whether the exclusion is a one-time exclusion, an annual exclusion, or whether it applies separately to each qualifying separation from service of the individual.

Prior Action

Similar proposals were included in the President's Fiscal Year 1999 and 2000 Budget Proposals.

2. Exempt Holocaust reparations from Federal income tax

Present Law

Under the Code, gross income is defined as "all income from whatever source derived," except for certain items specifically exempt or excluded by statute. There is no explicit statutory exclusion from gross income for reparations received by Holocaust victims or their heirs.

Beginning in the 1950's, the IRS issued a series of rulings providing that certain Holocaust reparations are exempt from Federal income tax. Under Rev. Rul. 56-518, certain compensation paid by the Federal Republic of Germany on account of persecution by the Nazi regime which resulted in damage to life, body, health, liberty, or to professional or economic advancement is reimbursement for the deprivation of civil or personal rights and thus is not treated as taxable income to the recipient. If the right of property ownership is involved, payments which are measured by the value of property taken from persecuted taxpayers do not constitute taxable income to the extent that the taxpayer has not recovered his basis. If payments measured by the value of property exceed the basis, the question of whether the excess constitutes taxable income is determined on the basis of the facts and circumstances of each case.

Under Article 19(1)(c) of the United States - Federal Republic of Germany Income Tax Convention, August 29, 1989, pensions, annuities and other amounts paid by one of the contracting States or a juridical person organized under the public laws of that State as compensation for an injury or damage sustained as a result of hostilities or political persecution are exempt from tax by the other State.[275] The U.S. and German competent authorities have reached a mutual agreement that monetary compensation or property received by individuals under the German Act Regulating Unresolved Property Claims for property that the National Socialist Regime confiscated or subjected to forced sale represents payments for damages sustained as a result of hostilities or political persecution, and thus are exempt from U.S. taxation under the treaty. Moreover, the IRS has clarified that, to implement this exception where such compensation is provided in the form of property (other than money), the taxpayer's basis for the property received is its fair market value at the time of the receipt.

Description of Proposal

The proposal would provide that gross income would not include any amount received from the Swiss Humanitarian Fund established by the government of Switzerland or as a result of the settlement of the action entitled, "In re Holocaust Victims' Asset Litigation," (E.D. N.Y.) C.A. No. 96-4849, or from any similar Holocaust-related fund or action, and the value of property recovered as a result of a settlement or legislative resolution of a claim arising out of the confiscation of such property in connection with the Holocaust. It would also provide that property would be considered to have been confiscated in connection with the Holocaust if its

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[275] See S. Treaty Doc. No. 10, 101st Cong., 2d Sess. (1990).

loss occurred during the years 1933-1945 and was attributable to government action or hostilities in Nazi Germany or in countries controlled or occupied by the Nazis. Finally, the proposal would provide that the taxpayer's initial basis in the recovered property would be the fair market value of the property on the date of the recovery.

Effective date.--The proposal would be effective for amounts received on or after January 1, 2000. No inference would be intended as to the tax treatment of amounts received prior to that date.

Analysis

In recent years, several countries and organizations within those countries have acknowledged that they have not made adequate compensation or restitution to victims or their heirs or legatees for the deprivations inflicted upon them during the Nazi Holocaust, and have agreed to establish funds or to make direct payments of cash or property to such individuals. Proponents of the proposal argue that it is appropriate to provide a statutory exemption from gross income for such payments and to clarify the basis for tax purposes in such property. They continue that these payments are so closely related to the deprivation of civil or personal rights that equalizing the tax treatment of these amounts (i.e., treating as nontaxable income to the recipient) to other amounts received for the depravation of civil and personal rights is fair and equitable. Opponents may argue that if tax relief is appropriate in this case that it should be expanded to other types of mass confiscations, either in Europe during the post-WWII era or elsewhere.

Prior Action

A similar proposal was included in the Taxpayer Refund and Relief Act of 1999 as passed by Congress and vetoed by the President.

II. PROVISIONS INCREASING REVENUES

A. Corporate Tax Shelters

1. Five corporate tax shelter proposals with general application

Present Law

Definition of tax shelter

Under present law, there is no clear, uniform standard as to what constitutes a corporate tax shelter; however, a number of statutory provisions and judicial doctrines have been developed to police transactions in which the avoidance or evasion of Federal income tax is an essential element. For example, the accuracy-related penalty under section 6662 defines a tax shelter as a partnership or other entity, investment plan or arrangement, or any other plan or arrangement, if a significant purpose is the avoidance or evasion of Federal income tax.[276]

Disallowance of tax benefits from tax shelters

The Code contains a number of provisions that are designed to limit tax benefits arising from transactions that typically are considered tax shelters. One such provision is section 269, which grants the Secretary of the Treasury the authority to disallow tax benefits with respect to certain transactions for which the principal purpose is the avoidance or evasion of Federal income tax. Other situations in which the Secretary has the authority to disallow or reallocate tax benefits include (1) if a taxpayer's method of accounting does not clearly reflect income,[277] (2) if two or more entities are controlled directly or indirectly by the same interests,[278] and (3) in the case of certain multiple-party financing arrangements.[279]

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[276] Section 6662(d)(2)(C)(iii). Other statutory definitions are used in a variety of contexts. For example, section 461(i)(3) defines a tax shelter for purposes of certain tax accounting rules as (1) an enterprise (other than a C corporation), the interests in which have been offered for sale in an offering required to be registered with a Federal or State securities agency, (2) a syndicate (a partnership or other entity, other than a corporation that is not an S corporation, if more than 35 percent of the losses of the entity are allocable to limited partners or limited entrepreneurs), and (3) a tax shelter (as defined in section 6662(d)(2)(C)(iii)).

[277] Section 446(b).

[278] Section 482.

[279] Section 7701(l).

In addition to the statutory provisions, the courts have developed several doctrines to deny certain tax-advantaged transactions their intended tax benefits. There is considerable overlap among the doctrines, and typically more than one doctrine is likely to apply to a given transaction. The general doctrines used to deny such tax benefits are (1) the sham transaction doctrine, (2) the economic substance doctrine, (3) the business purpose doctrine, (4) the substance over form doctrine, and (5) the step transaction doctrine.[280]

A sham transaction refers to a transaction in which the economic activity that is purported to give rise to the desired tax benefits does not actually occur. These transactions have been referred to as "facades" or mere "fictions."[281] Although the sham transaction doctrine generally applies when the purported activity giving rise to the tax benefits does not actually occur, in certain circumstances, a transaction may be found to constitute a sham even when the purported activity does occur.

Closely related to the sham transaction doctrine is the economic substance doctrine. This doctrine has been invoked to deny claimed tax benefits where the transaction giving rise to those benefits lacked economic substance independent of tax considerations -- notwithstanding that the purported activity did actually occur. The Tax Court recently described the doctrine as follows:

> Economic substance, in this context, is determined by objective evaluation of changes in economic position of the taxpayer (economic effects) aside from tax benefits.[282]

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[280] Gregory v. Helvering, 293 U.S. 465 (1935), aff'g 69 F.2d 809 (2d Cir. 1934), is often cited as the seminal case with respect to several of these doctrines, especially the sham transaction, economic substance, and business purpose doctrines. For a general discussion of these doctrines, see Alvin C. Warren, Jr., "The Requirement of Economic Profit in Tax Motivated Transactions", 59 Taxes 985 (1981), and David P. Hariton, "Sorting Out the Tangle of Economic Substance", 52 Tax Law 235 (1999).

Although many of the cases raising these doctrines deal with tax shelters for individuals, several recent cases have applied these doctrines in the corporate context. See, e.g., ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), aff'g 73 T.C.M. (CCH) 2189; ASA Investerings v. Commissioner, 2000-1 U.S.T.C. (CCH) para. 83,439 (D.C. Cir. 2000), aff'g 76 T.C.M. (CCH) 325 (1998); Winn-Dixie Stores v. Commissioner, 113 T.C. No. 21 (Oct. 19, 1999); Compaq Computer Corp. v. Commissioner, 113 T.C. No. 17 (Sept. 21, 1999); United Parcel Service of America, Inc. v. Commissioner, 1999 Tax Ct. Memo LEXIS 304 (Aug. 1999).

[281] See, e.g., Knetsch v. United States, 364 U.S. 361 (1960) (disallowing deduction for prepaid interest on a nonrecourse, riskless loan used to purchase deferred-annuity savings bonds).

[282] Winn-Dixie Stores v. Commissioner, 113 T.C. No. 21 (Oct. 19, 1999).

The economic substance doctrine can apply even if a taxpayer exposes itself to risk of loss and even if there is profit potential, so long as the facts suggest that the economic risks and profit potential were insignificant when compared to the corresponding tax benefits.[283] In other words, the doctrine suggests a balancing of the risks and profit potential as compared to the tax benefits in order to determine whether the transactions had "purpose, substance or utility apart from their anticipated tax consequences."[284]

Another doctrine that overlays and is often considered together with the sham transaction and economic substance doctrines is the business purpose doctrine. This test involves a subjective inquiry into the taxpayer's motives -- that is, whether the taxpayer intended the transaction to serve some useful nontax purpose.[285] In its common application, the courts use business purpose (in combination with economic substance, as discussed above) as part of a two-prong test for determining whether a transaction should be disregarded for tax purposes: (1) in entering into the transaction, the taxpayer was motivated by no business purpose other than obtaining tax benefits, and (2) the transaction lacks economic substance.[286]

The concept of "substance over form" is that the tax results of an arrangement are better determined based on the underlying substance rather than an evaluation of the mere formal steps by which the arrangement was undertaken. For instance, two transactions that achieve the same underlying result should not be taxed differently simply because they are achieved through

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[283] See Goldstein v. Commissioner, 364 F.2d 734, 739-40 (2d Cir. 1966) (disallowing deduction even though taxpayer has a possibility of small gain or loss by owning T-bills); Sheldon v. Commissioner, 94 T.C. 738, 768 (1990) (stating, "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").

[284] Goldstein, 364 F.2d at 740. In certain cases, however, claimed tax benefits could be allowed notwithstanding that the taxpayer would fail the balancing test. For example, taxpayers motivated solely by tax considerations have been permitted by the courts to time their recognition of accrued economic losses, notwithstanding that the IRS attacked such tax-motivated transactions as lacking economic substance. See, e.g., Cottage Savings v. Commissioner, 499 U.S. 554 (1991) (allowing losses, pursuant to section 1001(a), on exchanges of substantially identical mortgages); Doyle v. Commissioner, 286 F.2d 654 (7th Cir. 1961) (allowing losses, pursuant to section 165, with respect to a straddle without the taxpayer disposing of its ownership interest in the stock).

[285] See e.g., Rice's Toyota World v. Commissioner, 752 F.2d 89 (4th Cir. 1985); ACM, 157 F.3d at 231; Peerless Indus. v. Commissioner, 1994-1 U.S.T.C. (CCH) para. 50,043 (E.D. Pa. 1994).

[286] Rice's Toyota World, 752 F.2d at 91.

different legal steps. The Supreme Court has found that a "given result at the end of a straight path is not made a different result because reached by following a devious path."[287]

An extension of the substance over form doctrine is the step transaction doctrine. The step transaction doctrine "treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result."[288] In determining whether to invoke the step transaction doctrine, the courts generally have looked to two primary factors: (1) the intent of the taxpayer,[289] and (2) the temporal proximity of the separate steps.[290]

Disclosure requirements

Taxpayer disclosure.--When required by regulations prescribed by the Secretary of the Treasury, a taxpayer must file a return or statement in accordance with the forms and regulations prescribed by the Secretary, including the information required by the forms or regulations.[291] The Treasury Department recently issued proposed and temporary regulations under section 6011 that require corporate taxpayers to include in their tax return information with respect to certain tax shelter arrangements.[292] The rules also require a copy of the required disclosure statement to be sent to the IRS in Washington, D.C. for the first taxable year for which the transaction is disclosed on the taxpayer's Federal income tax return.

Specifically, the regulations require the disclosure of information with respect to "reportable transactions." Reportable transactions include two categories of transactions. The first category of reportable transactions includes any transaction that is the same as or substantially similar to one of the specified types of tax avoidance transaction that the IRS has identified by published guidance as a "listed" transaction and that is expected to reduce the

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[287] Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938).

[288] Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987).

[289] McDonalds Restaurants of Ill. v. Commissioner, 688 F.2d 520 (7th Cir. 1982).

[290] Cal-Maine Foods, Inc. v. Commissioner, 93 T.C. 181 (1989) (by implication); Martin D. Ginsburg et al., Mergers, Acquisitions, and Buyouts, para.608.2.2 (Nov. 1999 edition).

[291] Section 6011.

[292] Temp. Treas. Reg. sec. 1.6011-4T.

taxpayer's Federal income tax liability by more than $1 million in any single taxable year or by a total of more than $2 million for any combination of taxable years.[293]

The second category of reportable transactions includes transactions that are expected to reduce a taxpayer's Federal income tax liability by more than $5 million in any single year or $10 million for any combination of taxable years and that have at least two of the following characteristics ("filters"): (a) the taxpayer has participated in the transaction under conditions of confidentiality; (b) the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained, including, but not limited to, recission rights, the right to a full or partial refund of fees, fees that are contingent on a taxpayer's realization of tax benefits, or a tax indemnity or similar agreement (other than a customary indemnity provided by a principal to the transaction that did not participate in the promotion of the transaction to the taxpayer); (c) the promoters of the transaction have received or are expected to receive fees or other consideration with an aggregate value in excess of $100,000, and such fees or other consideration are contingent on the taxpayer's participation in the transaction; (d) a book/tax difference in excess of $5 million in any taxable year; (e) the transaction involves a person that the taxpayer knows or has reason to know is in a Federal income tax position that differs from that of the taxpayer (such as a tax-exempt entity or foreign person), and the taxpayer knows or has reason to know that such difference in tax position has permitted the transaction to be structured to provide the taxpayer with more favorable Federal income tax treatment than it could have obtained without the participation of such person; or (f) the expected characterization of any significant aspect of the transaction for Federal income tax purposes differs from the expected characterization of such aspect of the transaction for purposes of taxation in another country of any party to the transaction. A failure to adequately disclose a reportable transaction may jeopardize the taxpayer's ability to claim that any understatement attributable to the arrangement is due to reasonable cause, and that the taxpayer acted in good faith.[294]

A taxpayer can avoid disclosure with respect to the second category of reportable transactions if (1) the taxpayer has participated in the transaction in the ordinary course of the taxpayer's trade or business in a form consistent with customary commercial practice and would have entered into the transaction on substantially the same terms irrespective of the expected Federal income tax benefits; (2) the taxpayer has participated in the transaction in the ordinary course of its business in a form consistent with customary commercial practice and the taxpayer reasonably determines that there is a long-standing and generally accepted understanding that the

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[293] See Notice 2000-15 (scheduled to appear in I.R.B. 2000-12, Mar. 20, 2000) for a listing of tax avoidance transactions included in this category.

[294] As described below, section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith.

expected Federal income tax benefits from the transaction are allowable under the Code; (3) the taxpayer reasonably determines that there is no reasonable basis under Federal tax law for denial of any significant portion of the expected tax benefits from the transaction; or (4) the transaction is identified in published guidance as excepted from disclosure.

The regulations generally are effective for transactions entered into on or after February 28, 2000. With respect to listed transactions, however, disclosure is required with respect to tax returns filed after February 28, 2000 unless the listed transaction has affected the taxpayer's Federal income tax liability as reported on any tax return filed on or before February 28, 2000.

Promoter registration.--The Code requires a promoter of a tax shelter to register the shelter with the Secretary.[295] Registration is required not later than the day on which the tax shelter is first offered to potential users.

The registration requirement also includes certain arrangements offered to a corporation under conditions of confidentiality in which a significant purpose of the arrangement is the avoidance or evasion of Federal income tax and from which the promoters may receive aggregate fees in excess of $100,000.[296] The registration requirement with respect to these confidential arrangements, which was added to the Code as part of the Taxpayer Relief Act of 1997, applies to any tax shelter offered after the date the Treasury Department issues guidance with respect to the filing requirements. On February 28, 2000, the Treasury Department issued proposed and temporary regulations regarding the types of arrangements described by section 6111(d) that will require a promoter to register the arrangement. Under the regulations, an arrangement has a significant purpose of avoiding or evading Federal income tax if (1) it is the same as or substantially similar to one of the specified types of transactions that the IRS has identified in published guidance as a "listed" transaction; (2) (a) the present value of the reasonably expected pre-tax profits from the arrangement is insignificant relative to the present value of the expected net tax benefits attributable to the arrangement or (b) in the case of transactions that in substance are the borrowing of money or acquisition of financial capital, the present value of the income tax deductions of the taxpayer to whom the loan or financial capital is provided significantly exceeds the present value of the pre-tax return of the lender or provider of the financial capital; or (3) the arrangement is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer. With respect to the third category of transactions, however, an exception is provided to the extent that the promoter reasonably determines that the potential participant is expected to participate in the transaction in the ordinary course of its business in a form consistent with customary commercial practice, and that there is a long-standing and generally accepted understanding that the expected Federal income tax benefits from the transaction are allowable under the Code. In addition, if the arrangement

[295] Section 6111.

[296] Section 6111(d).

has not been identified by the Treasury Department as requiring registration, a promoter may avoid the registration requirement if the promoter reasonably determines that there is no reasonable basis under Federal tax law for denial of any significant portion of the expected Federal income tax benefits from the transaction.

The determination of whether an arrangement is offered under conditions of confidentiality is based on all the facts and circumstances surrounding the offer. If the offeree's disclosure of the structure or tax aspects of the transaction are limited in any way by an express or implied understanding or agreement with or for the benefit of a tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding. The regulations generally are effective for offerings made on or after February 28, 2000, (with an 180-day grace period to August 26, 2000).

As part of the registration requirement, a promoter must maintain (for a period of seven years) a list identifying each person who was sold an interest in the tax shelter arrangement (sec. 6112). On February 28, 2000, the Treasury Department issued proposed and temporary regulations under section 6112 that provide guidance regarding the circumstances in which a promoter must maintain a list of taxpayer to whom it sold an interest in a confidential arrangement described by section 6111(d). However, the requirements under section 6111(d) that require confidentiality and aggregate fees in excess of $100,000 do not apply for purposes of defining the types of corporate tax shelters for which a list must be maintained.

Taxpayer penalties

Accuracy-related penalty.--Section 6662 imposes a 20-percent penalty on the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.

In determining whether a substantial understatement exists, the amount of the understatement generally is reduced by any portion thereof attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. Special rules apply for tax shelters. With respect to non-corporate taxpayers, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment. This reduction in the penalty is not available to corporate tax shelters.[297]

The understatement penalty generally is avoided (even in the case of corporate tax shelters) in cases where the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[298] The relevant regulations provide that reasonable cause may exist where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service."[299]

Nontaxpayer penalties

Promoting abusive tax shelters.--Section 6700 imposes a penalty on any person who organizes (or assists), or participates in the sale of, any interest in a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement. A qualifying false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement that the person knows or has reason to know is false or fraudulent as to any material matter. The amount of the penalty equals $1,000 (or, if less, 100 percent of the gross income derived or to be derived by the person from such activity). A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

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[297] For these purposes, a tax shelter is defined as (1) a partnership or other entity, (2) an investment plan or arrangement, or (3) any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax. Section 6662(d)(2)(C)(iii).

[298] Section 6664(c).

[299] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c). Although rare, from time to time accuracy related penalties have been asserted in the context of tax shelters generally. See, e.g., Sheldon v. Commissioner, 94 T.C. 738, 769-70 (1990). In the corporate context specifically, see, e.g., Compaq Computer Corp. v. Commissioner, 113 T.C. No. 21 (Oct. 19, 1999); Leema Enterprises v. Commissioner, 77 T.C.M. (CCH) 1261 (1999)). Because of the lack of clarity of the various economic substance and business purpose doctrines, however, courts are often reluctant to impose penalties in corporate tax shelter cases. See, e.g., Peerless Indus. v. United States, 94-1 U.S.T.C. (CCH) para. 50,043 (E.D. Pa. 1994).

Aiding and abetting understatement of tax liability.--Section 6701 imposes a penalty on any person who (1) aids, assists, procures, or advises with respect to the preparation or presentation of any portion of a return, affidavit, claim, or other document, (2) knows (or has reason to believe) that the document will be used in connection with any material matter arising under the internal revenue laws, and (3) knows that the document would result in an understatement of another person's tax liability. The concept of aiding or abetting requires "direct involvement" in the preparation or presentation of a tax return or other tax-related document.[300] The penalty for aiding and abetting with respect to an individual's tax liability is $1,000; the penalty is $10,000 with respect to a corporation's tax liability.

Failure to register tax shelters.--As discussed above, section 6111 requires a tax shelter organizer to register the shelter with the Secretary. The penalty for failing to timely register a tax shelter generally is the greater of one percent of the aggregate amount invested in the shelter or $500. However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration.

Failure to maintain lists of investors in tax shelters.--The penalty for a promoter's failure to maintain a list of investors to whom it sold an interest in a registered tax shelter (as described in section 6111) is $50 for each person with respect to whom there is such a failure, unless it is shown that the failure was due to reasonable cause and not due to willful neglect. The maximum penalty for any calendar year shall not exceed $100,000.

Description of Proposals

The President's Fiscal Year 2001 Budget Proposal includes five proposals with general application to corporate tax shelters. The description of the proposals begins with the proposed definition of a "corporate tax shelter," which is used throughout the proposals. Following the definition is a description of the five general tax shelter proposals.

Definition of tax shelter

The five proposals generally affect a class of transactions that falls within a proposed statutory definition of a corporate tax shelter. A "corporate tax shelter" would be defined as 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 as any reduction, exclusion, avoidance, or deferral of tax, or an increase in a refund, but would not include a tax benefit clearly contemplated by the

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[300] See Joint Committee On Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS-38-82), Dec. 31, 1982, 220.

applicable provision (taking into account the Congressional purpose for such provision, administrative interpretations of the provision, and the interaction of such provision with other provisions). A "tax avoidance transaction" would be defined as: (1) 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; and (2) in the case of financing transactions, any transaction in which the present value of the tax benefits of the taxpayer to whom the financing is provided are significantly in excess of the present value of the pre-tax profit or return of the person providing the financing.

Disallowance of tax benefits from tax shelters--codifying the economic substance doctrine

The proposal would codify and clarify the economic substance doctrine. It would disallow any tax benefit derived in a tax avoidance transaction. The proposal would apply to any trade or business or activity engaged in for profit or for the production of income, including those that engage in business in non-corporate forms.

The proposal would not apply to disallow any claimed loss or deduction of a taxpayer that had economically been incurred by the taxpayer before the transaction was entered into. The proposal would not alter or supplant any other existing judicial doctrine or anti-abuse rule.

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

Disclosure requirements with respect to certain reportable transactions[301]

The proposal would create a new disclosure regime for any transaction that has significant tax benefits and also possesses some combination of other characteristics (referred to as "filters"), regardless of whether the transaction meets the definition of a corporate tax shelter. The relevant characteristics include: (1) a book/tax difference in excess of a certain amount; (2) a recission clause, unwind provision, or insurance or similar arrangement for the anticipated tax benefits (other than customary representations and warranties found in non-shelter transactions); (3) involvement with a tax-indifferent party; (4) contingent advisor fees or fees in excess of a certain amount; (5) a confidentiality agreement; (6) the offering of the transaction to multiple taxpayers (if known or the taxpayer has reason to know); and (7) a difference between the form

[301] As previously discussed, on February 28, 2000, the Treasury Department issued temporary and proposed regulations on tax shelter disclosure statements. In many respects, the regulations are very similar to the disclosure proposal.

of the transaction and how it is reported (with exceptions for certain specified common transactions where the form and the reporting differ, such as repurchase agreements).[302]

Corporations that enter into transactions which meet the requisite combination of filters would be required to file a short form with the IRS National Office by the unextended due date of the tax return for the taxable year in which the transaction is entered. The form also must be included with the tax return. The form would require the taxpayer to identify which of the filters apply to the transaction and include a description of the facts and the return position. The form must be signed by a corporate officer who has (or should have) knowledge of the factual underpinnings of the transaction, and the corporate officer would be personally liable for misstatements on the disclosure form (with heightened penalties for fraud or gross negligence).[303] Any failure to file the form would result in a $100,000 penalty, regardless of whether the tax benefits of the transaction are ultimately allowed or disallowed.[304]

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

Taxpayer penalties–modify substantial understatement penalty for corporate tax shelters

The proposal would make several modifications to the substantial understatement penalty. The penalty rate would be increased to 40 percent with respect to any understatement that is attributable to a corporate tax shelter. The 40-percent rate would be reduced to 20 percent if the corporation discloses the transaction in a form and manner previously described in connection with the disclosure requirement proposal. The substantial understatement penalty would be eliminated altogether where a taxpayer discloses the transaction and satisfies a strengthened reasonable cause standard (i.e., the taxpayer shows that it had a strong chance of sustaining its tax position and acted in good faith). For purposes of the reasonable cause standard, Treas. Reg. sec. 1.6664-4 would be modified and strengthened.

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

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[302] These filters are essentially the same as those utilized with respect to the disclosure requirements of Temp. Treas. Reg. sec. 1.6011-4T(b)(3), which were promulgated on February 28, 2000.

[303] The corporate officer would be accorded appropriate due process rights.

[304] Under Temp. Treas. Reg. sec. 1.6011-4T(b)(3), a disclosure statement must be filed by a corporate taxpayer with its return if two of six filters (substantially similar to the filters in the proposal) are met. The proposed and temporary regulations, however, do not provide a separate failure to disclose penalty and do not provide for corporate officer attestation.

Nontaxpayer penalties–excise tax on certain fees received from corporate tax shelters

The proposal would impose an excise tax of 25 percent on fees received in connection with the purchase and implementation of corporate tax shelters (including fees related to underwriting or other fees) and the rendering of certain tax advice related to corporate tax shelters. Only persons who perform services in furtherance of a corporate tax shelter would be subject to the proposal. The proposal would not apply to expenses incurred with respect to representing the taxpayer before the IRS or a court. Appropriate due process rights to contest this excise tax would be provided for promoters and advisors.

Effective date.--The proposal would be effective for fees received on or after the date of first committee action.

Tax income from corporate tax shelters involving tax-indifferent parties

The proposal would provide that any income allocable to a tax-indifferent party with respect to a corporate tax shelter is taxable to the tax-indifferent party if it is trading on its tax exemption. Joint and several liability would exist between the tax-indifferent party and the corporate participants. Thus, where a foreign person properly claimed the benefit of a treaty, the tax otherwise owing by such person would be collected from the U.S. corporate participants. Appropriate due process procedures would be provided for parties subject to assessment.

A tax-indifferent party would be defined as a foreign person, a state or local government, a Native American tribal organization, a tax-exempt organization, and domestic corporations with expiring (more than three years old) loss or credit carryforwards.

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

Analysis

The analysis below begins with a discussion of the proposed definition of a "corporate tax shelter," which is used throughout the general tax shelter proposals. Following the discussion of the definition is an analysis of the various elements of the five general tax shelter proposals.

Definition of tax shelter

The proposals rely on a uniform definition of a "corporate tax shelter" that would be applied in connection with (1) a substantive disallowance rule, and (2) the imposition of penalties. A uniform definition would seem desirable because it would provide simplicity and reliability. Crafting a definition that identifies the "bad" transactions without disturbing legitimate business transactions, however, is difficult and relying on such a definition for both a disallowance rule and a penalty may make it more difficult to successfully accomplish the different objectives of each.

Tax benefit.--The first element of the proposed definition of a corporate tax shelter is that a corporate participant must claim a "tax benefit." A tax benefit would be defined to include a reduction, exclusion, avoidance or deferral of tax, or an increase in a refund, though it would not include benefits that are "clearly contemplated" by the applicable provision (taking into account the Congressional purpose, administrative interpretations of the provision, and the interaction of the provision with other provisions). A clearly contemplated exception arguably narrows the scope of tax benefits that otherwise would be subject to the tax shelter proposals.

The proposed definition would place a great deal of emphasis (leading to much interpretive questions and dispute) on what is "clearly contemplated." In the absence of a codified exception, the relevant legislative history would assume a much greater role because it often sets forth Congressional intent. Legislative history generally does not describe all the transactions that could come within a newly-enacted provision. In addition, one common characteristic of corporate tax shelters is that they involve a combination of tax benefits, each of which may have been clearly contemplated as a separate provision, but not in tandem. Thus, the relevant legislative history (and administrative guidance) might not be helpful in making this determination. It should be expected that the courts will be asked to make many of these determinations.

If a list of clearly contemplated tax benefits is to be crafted, there could be concern that such a list would exclude tax benefits that many would believe are clearly contemplated[305] and could create a negative inference with respect to benefits that are not included on the list. Conversely, the list could include benefits that many would believe were not clearly contemplated. In addition, Congress and the Treasury Department may have different understandings of the purpose and proper interpretation of a tax provision and its related legislative history.

Tax avoidance transaction.--The second element of the definition is that the tax benefit must be obtained in a "tax avoidance transaction," which would be defined as: (1) 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; and (2) in the case of financing transactions, any transaction in which the present value of the tax benefits of the taxpayer to whom the financing is provided are significantly in excess of the present value of the pre-tax profit or return of the person providing the financing.

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[305] For example, the list found in Treas. Reg. sec. 1.6662-4(g)(2)(ii) does not include the low-income housing tax credit.

The proposed definition is intended to represent the current judicially-developed definition of the economic substance doctrine (discussed below). The Treasury Department and the IRS also have applied this test in recent administrative guidance.[306] A common characteristic of corporate tax shelters is that they generate little (if any) economic profit, but at the same time produce significant Federal income tax benefits. Conversely, transactions that generate significant positive cash flows in relation to the tax benefits tend to indicate that a nontax business motive exists with respect to the transaction and, therefore, the arrangement would likely be undertaken irrespective of tax benefits. Prospective investors generally evaluate the benefits of a transaction based on, among other things, a present-value analysis of the net cash flows. Therefore, some would argue that a similar analysis should apply to identify tax shelter transactions.

Because the pre-tax profit test relies on a cash-flow analysis, there may be some question regarding its application to transactions in which cash flow is not a critical element. Arrangements that involve the inappropriate creation or duplication of tax basis in assets, for example, would be more difficult to analyze using a cash-flow model. It may be difficult to apply a "profit" test to transactions such as mergers, acquisitions and hedging transactions, all of which may be legitimate business activities but may not produce "profit." It is similarly unclear how the pre-tax profit test would apply to transactions that involve the receipt of economic income that is excluded from taxable income ("exclusion transactions"). For example, in the "liquidating REIT" transaction, in which the real estate investment trust ("REIT") earns a market rate of return on its assets, the pre-tax profit from the transaction arguably could be significant in relation to the net tax benefit.[307] However, if the transaction is viewed as the establishment and liquidation of the REIT, there may be little (if any) pre-tax profit.

The proposal provides a special test with respect to financing transactions. The separate rule arguably is necessary because financing transactions do not readily lend themselves to a profit or income test – there generally is no intention to profit or generate income through a financing transaction; therefore, a profit or income test is inapposite. The test focuses on shelter-type activities through which excess deductions may be claimed in a financing transaction. The proposal essentially requires a matching of the deduction claimed by the borrower and the economic return of the lender. This matching arguably ensures that the tax attributes are economical and that the transaction is not a shelter. Some might argue that the proposal does not provide any guidance as to what ratio of tax benefits to economic return would be considered sufficient. Moreover, it may be difficult for a borrower to evaluate or calculate a lender's

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306 See e.g., Rev. Rul. 99-14, 1999-13 I.R.B. 3; Notice 98-5, 1998-3 I.R.B. 49.

307 Some argue that exclusion transactions should be beyond the reach of corporate tax shelter legislation in any event because of the difficulty in differentiating between exclusion transactions that involve legitimate tax planning and those that do not.

economic return.[308] The lender's return is dependent upon other things besides the borrower's payment, and the borrower may lack sufficient information to make such a determination.

Disallowance of tax benefits -- codification of the economic substance doctrine

The codification of the economic substance doctrine is premised on the belief that, while increased disclosure and changes to the penalty regime are necessary elements to curb the use of corporate tax shelters, such changes are not enough to curb corporate tax shelters if taxpayers continue to believe that they will prevail on the underlying substantive issues under present law. The proposal is based on the fundamental proposition that corporate taxpayers should not be able to claim tax benefits from non-economic transactions. Indeed, advocates of the proposal would argue that it is merely a codification of the "best" of common law. On the other hand, opponents of the proposal would argue that, because it would apply to all transactions, the proposal would cause some transactions to be scrutinized under the economic substance doctrine where they otherwise would not be under present law. In addition, for certain cases, the proposal would have the effect of increasing the standard from where it is today. As such, the proposal goes beyond codifying present law.

Opponents of the proposal further contend that because of the difficulty in precisely defining a corporate tax shelter, any success achieved through a substantive law change comes at a significant cost -- the loss of the tax system's reliance on objectivity. A substantive rule that disallows tax benefits from a tax avoidance transaction could inject a new level of uncertainty into the tax law. Some have argued that rather than attempting to define a tax shelter and then disallow benefits associated therewith, the tax system may be better served by developing a more targeted and effective penalty structure. Others argue that the corporate tax shelter problem could be properly addressed by providing the IRS more resources to enforce existing law.

As previously discussed with respect to the definitions, the proposal would place considerable pressure on the definition of a corporate tax shelter and its components. To the extent the definition is over-inclusive, tax benefits to which a taxpayer would be entitled under current law would automatically be disallowed; to the extent it is under-inclusive, the proposal would not achieve the desired effect. Ambiguity in the definition could be viewed as providing IRS agents with too much discretion to formulate their own interpretations, and may result in increased litigation. This ambiguity also could result in the uneven application of the proposal among similarly-situated taxpayers. However, the IRS recently announced that it plans to establish an Office of Tax Shelter Analysis, which (among other things) will review all disclosures relating to corporate tax shelters, and provide a centralized point of review for IRS

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[308] The comparison of the deduction to the economic return of the lender required under the proposal may be difficult in connection with contingent debt obligations.

field personnel, IRS Chief Counsel, and the Treasury Department in dealing with corporate tax shelters.[309] Such a coordinated strategy should help minimize these concerns.

The proposal would expand the scope of the provision to apply to all business activities of taxpayers, including those that engage in business in non-corporate form. Thus, its focus is on all transactions that could be viewed as lacking economic substance. However, the new disclosure regime and the increased substantial understatement penalty would only apply to corporations. The lack of coordination with other elements of the proposals may diminish the effectiveness of the proposal with respect to non-corporate tax shelter transactions. In response, it could be said that starting with legislation addressing corporate tax shelters addresses the principal problem under current law, and the rules could be expanded later to address future problems as they arise.

Disclosure requirements with respect to certain reportable transactions

The proposed new disclosure regime would require disclosure with respect to any transaction that has significant tax benefits and exhibits a combination of certain enumerated characteristics (referred to as "filters"). The disclosure requirements would apply only to corporations. The disclosure form, which must be signed by a corporate officer with knowledge of the facts, would include information regarding the facts and the return position with respect to the transaction. Any failure would result in a flat penalty of $100,000, regardless of whether the tax benefits of the transaction are ultimately allowed or disallowed.

The requirement that the disclosure statement be signed by a corporate officer who has (or should have) knowledge of the facts has the support of a number of professional organizations.[310] The attestation function is designed to ensure that the person who ultimately commits the corporation to engage in the transaction is also made aware of the tax risks associated with the arrangement.

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309 IRS Announcement 2000-12 (Feb. 28, 2000).

310 For example, both the American Bar Association Section of Taxation and the Tax Division of the American Institute of Certified Public Accountants have testified in favor of the corporate attestation requirement. See, Statement of Paul J. Sax, Chairman, Section of Taxation, American Bar Association, *Hearing on Corporate Tax Shelters before the House Committee on Ways and Means*, 106th Cong. (Nov. 10, 1999); Statement of David A. Lifson, Chairman, Tax Executive Committee, American Institute of Certified Public Accountants, *Hearings on Corporate Tax Shelters before the House Committee on Ways and Means*, 106th Cong. (Nov. 10, 1999).

Some argue that requiring the attestation of a corporate officer, and making the officer personally liable for any misstatements, may give the IRS another issue to pursue in audit (i.e., was the attestation proper). Other commentators question the utility of the attestation function.[311]

Greater disclosure of corporate tax shelters should result in improved enforcement by the IRS, as well as greater reluctance on the part of corporate participants to engage in tax shelter arrangements. But to be effective, the disclosure requirements arguably should be narrow so that they result in the disclosure of transactions that government officials should be aware of, while minimizing the burdens on taxpayers and the IRS regarding information that is irrelevant.

The proposed disclosure regime could require disclosure of transactions that otherwise would not meet the proposed definition of a corporate tax shelter. Conversely, transactions that otherwise might be thought of as tax shelters could avoid disclosure. For example, assuming that the existence of two filters is required to mandate disclosure, the involvement of a tax-indifferent party coupled with a temporary book/tax difference would require disclosure of a transaction, even though the transaction may not constitute a "tax avoidance transaction." Yet an exclusion transaction (which may be a tax-avoidance transaction) that creates a permanent book/tax difference but exhibits no other filter would not trigger disclosure. Similarly, because the new disclosure regime applies to transactions that have "significant tax benefits," the concerns previously discussed with respect to the definition of a tax benefit, most notably the application of the clearly contemplated exception, would cause similar uncertainties regarding when a particular transaction must be disclosed.

The proposal would impose a penalty for failing to file of $100,000 per failure. Some argue that there is merit to having an independent penalty for failure to disclose in order to encourage disclosure. In addition, to the extent that corporations are penalty averse, the size of the penalty should not matter -- the mere fact that a penalty would be imposed may be a sufficient deterrent. On the other hand, some might question the appropriateness of imposing a new disclosure penalty with respect to a transaction that may not constitute a tax shelter.

On February 28, 2000, the Treasury Department issued temporary and proposed regulations requiring disclosure with respect to tax avoidance transactions and potential tax shelter transactions. These rules would seem to make the disclosure proposal unnecessary. However, it is worth noting that, unlike the proposal, the temporary and proposed regulations do

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[311] See Lee Sheppard, "News Analysis: Courts Combat Cross-Border Corporate Tax Shelters," 85 *Tax Notes* 137, 138 (Oct. 11, 1999) ("The behavior of Compaq's assistant treasurer has got to give one pause about the utility of enacting a law that requires a corporate financial officer to sign a sworn statement accompanying the tax return to the effect that all the asserted facts in the tax shelter transaction are just that, facts. . . .One gets the impression that the sort of financial officer who would deploy nearly a billion dollars of the company's money for use in a tax dodge without asking basic questions would also sign a tax return without asking questions.")

not include (1) corporate officer attestation, or (2) a flat penalty for failing to file the required disclosure.

<u>Taxpayer penalties -- modify substantial understatement penalty for corporate tax shelters</u>

The proposal would increase the penalty rate to 40 percent to the extent that an understatement is attributable to a corporate tax shelter. Some would argue that an increased penalty rate is necessary in order to alter the taxpayer's cost-benefit analysis with respect to entering into corporate tax shelter arrangements. The cost-benefit analysis under the current rules, taking into account variables such as audit selection, issue identification, favorable disposition of the issue, and lack of a meaningful penalty structure, is skewed heavily in favor of participating in tax shelters. As a consequence, the corporate tax shelter phenomenon can be expected to continue and grow unless there is a meaningful shift in the cost-benefit calculus. This would argue for a rate that is higher than the rate otherwise applicable to understatements of tax not associated with corporate tax shelters. The proposed penalty structure for corporate tax shelters is consistent with the penalty structure that is used with respect to valuation misstatements.[312] Others would argue that a 40-percent penalty is too harsh, particularly if one accepts the premise that corporate taxpayers are penalty-averse.[313]

The proposal would waive the 40-percent penalty if the corporation shows that it had a strong chance of sustaining its tax position and that it acted in good faith (in addition to satisfying the disclosure requirements previously discussed). In connection with applying this standard, the Treasury Department has suggested codifying the requirements presently found in Treasury regulations as to what constitutes reasonable cause. The effect of codifying present law is unclear.[314] Moreover, a test that is dependent upon a showing of a "strong chance" would be inherently vague and will vary among taxpayers and tax advisors. Others argue that to the extent an understatement results from a corporate tax shelter, a penalty should apply without regard to a strengthened reasonable cause exception – i.e., the penalty should be a "no-fault" penalty. The equity of such a rule, however, would depend on the ability to precisely define corporate tax shelters in a way that would distinguish between legitimate business activity and improper tax avoidance.

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[312] A taxpayer whose underpayment of tax is attributable to a valuation misstatement is subject to a multi-tiered penalty structure: the rate is 20 percent if the valuation misstatement is "substantial;" the rate increases to 40 percent if the underpayment is attributable to a "gross misstatement."

[313] Under this rationale, the proposal's reduced 20-percent rate provides little actual incentive to disclose.

[314] It appears that these regulations are not being enforced (at least in part) because of uncertainties regarding their application.

As previously discussed in connection with the definitions, a narrower definition of a corporate tax shelter presents concerns with respect to the application of the proposed substantial understatement penalty. Because the penalty proposal relies on the proposed definition of a corporate tax shelter, a narrowing of the definition translates into a reduced scope (and possible limited effectiveness) of the penalty. It is also unclear how the proposal would interact with present-law section 6662.

Even with respect to transactions that would meet the proposal's definition of a corporate tax shelter, the corporation nevertheless would avoid the imposition of an understatement penalty so long as the understatement is not "substantial" (i.e., in excess of 10 percent of the tax required to be shown on the tax return). Thus, a corporation could avoid the imposition of a substantial understatement penalty if it can effectively manage its tax liability (by not exceeding the 10 percent threshold).[315] For those corporations, a penalty would be imposed under section 6662 only if the corporation's underpayment is due to negligence.

Another prerequisite to the imposition of the proposed section 6662 penalty is the existence of an underpayment of tax. Thus, a corporation could avoid the imposition of a penalty if it avoids having an underpayment based on all items on its tax return (i.e., by overpaying the tax or offsetting the understatement with an overstatement of tax from other items). Depending on the specific facts, the proposal could have the effect of encouraging corporations to overpay their tax and not disclose the tax shelter, and subsequently file a refund claim with respect to the overpayment (assuming the tax shelter arrangement is not detected). Such an approach could eliminate any exposure to an understatement penalty but would have an economic cost (i.e., the opportunity cost with respect to the overpayment of tax). It also could limit the taxpayer's choice of judicial for if the matter is litigated.

Nontaxpayer penalties -- excise tax on certain fees received from corporate tax shelters

The proposal would impose a 25-percent excise tax on those persons who perform services in furtherance of the corporate tax shelters. Limiting the excise tax to those persons who perform services "in furtherance of the corporate tax shelter" is consistent with the policy objectives, though some will raise questions regarding the meaning of the quoted language.

Imposing an excise tax may be a way to discourage behavior that is viewed as undesirable. Excise taxes have been used in other areas of the tax law to deter specific types of activities that are disfavored (such as greenmail payments under section 5881). An excise tax provides a front-end disincentive to the development of corporate tax shelters by persons who are not parties to the transaction. What is unclear is what legal standing the person subject to the excise tax would have to enter into disputes between the corporate participant and the IRS as to

[315] The President's Fiscal Year 2001 Budget Proposal includes a separate proposal (discussed below at Part II.I.1) that would tighten the substantial understatement penalty for corporations with large understatements.

the substance of the transaction, such as whether a transaction is or is not a corporate tax shelter. The proposal states that "appropriate due process procedures" would be provided with respect to an assessment. What these procedures might be and whether they can be administered effectively is unclear.

Tax income from corporate tax shelters involving tax-indifferent parties

This proposal highlights another common feature of modern corporate tax shelter arrangements -- the involvement of a party that is indifferent with respect to the Federal income tax consequences of a particular transaction. Typically, the tax-indifferent party's involvement is structured to minimize (if not completely eliminate) the tax-indifferent party's exposure to any economic risk from the tax shelter. Imposing tax on income allocated to tax-indifferent parties could be expected to limit their participation in corporate tax shelter transactions. In addition, requiring the corporate participant to be jointly and severally liable for the tax would create further disincentives to participate in such transactions, as well as facilitate the collection of the tax.

The tax-indifferent party proposal uses the previously-discussed definition of corporate tax shelter. Thus, the proposal suffers from similar scope and definitional issues. Moreover, while limiting the proposal to a tax-indifferent party that "trades on its exemption" targets the proposal to tax-indifferent parties that abuse their special tax status, the proposal offers no guidance regarding how one "trades on its exemption."

A related concern regarding the definition of a tax-indifferent party is the inclusion of domestic corporations with loss or credit carryforwards of more than three years. Some might question the appropriateness of treating such corporations as tax-indifferent parties, particularly in the case of losses or credits where Congress specifically provided a twenty-year carryforward period (e.g., net operating losses and business credits). It may seem inconsistent to exclude from the definition of a tax benefit those benefits that are clearly contemplated by Congress while at the same time to limit a domestic corporation's use of its loss or credit carryforwards during the time period in which Congress clearly contemplated its usage. In addition, the definition of a tax-indifferent party includes any foreign person. This would apparently cover foreign entities in which U.S. shareholders might be subject to tax (such as controlled foreign corporations or passive foreign investment companies) and foreign entities with effectively connected income from the transaction that would be subject to U.S. tax. The scope of the definition of a tax-indifferent party, therefore, arguably is too broad.

A more significant concern is the interaction of this proposal with the proposal to codify the economic substance doctrine. The lack of coordination creates the impression that the two proposals could apply to a single transaction. In fact, the tax-indifferent proposal will never apply in a situation in which the economic substance doctrine proposal does not apply because both proposals depend on the same threshold inquiry -- whether there is a corporate tax shelter as defined by the proposal. From a policy matter, therefore, the tax-indifferent party proposal may be considered superfluous; the economic substance doctrine proposal alone is sufficient disincentive. The additive nature of the two proposals, however, could result in disproportionate tax consequences. By way of example, assume that a corporate tax shelter involves a current deduction of $100 by a domestic corporation and a corresponding income inclusion of $100 by a tax-indifferent party (trading on its tax-exempt status). Under the economic substance doctrine proposal, the domestic corporation's $100 current deduction would be disallowed, resulting in $35 in additional tax. In addition, by virtue of the tax-indifferent proposal, the domestic corporation would be jointly and severally liable for $35 in additional tax attributable to the tax-indifferent party. With the addition of the 40 percent penalty on the understatement, the sum of the tax and penalty would almost equal the original $100 deduction claimed.

Prior Action

Similar proposals were included in the President's Fiscal Year 2000 Budget Proposal.

2. Require accrual of the time value element on forward sale of corporate stock

Present Law

A corporation generally recognizes no gain or loss on the receipt of money or other property in exchange for its own stock (including treasury stock).[316] Furthermore, a corporation does not recognize gain or loss when it redeems its stock, with cash, for less or more than it received when the stock was issued. In addition, no gain or loss is recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock (including treasury stock).

In general, a forward contract means a contract to deliver at a set future date (the "settlement date") a substantially fixed amount of property (such as stock) for a substantially fixed price. Gains or losses from forward contracts generally are not taxed until the forward contract is closed. A corporation does not recognize gain or loss with respect to a forward contract for the sale of its own stock. A corporation does, however, recognize interest income upon the current sale of its stock for a deferred payment.

With respect to certain "conversion transactions" (transactions generally consisting of two or more positions taken with regard to the same or similar property, where substantially all of the taxpayer's return is attributable to the time value of the taxpayer's net investment in the transaction), gain recognized that would otherwise be treated as capital gain may be recharacterized as ordinary income.[317]

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[316] Section 1032.

[317] Section 1258.

Description of Proposal

The proposal would require a corporation that enters into a forward contract for the sale of its own stock to treat a portion of the payment received with respect to the forward contract as a payment of interest.

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

Analysis

Under a traditional forward contract, the purchase price generally is determined by reference to the value of the underlying property on the contract date and is adjusted (1) upward to reflect a time value of money component to the seller for the deferred payment (i.e. for holding the property) from the contract date until the settlement date and (2) downward to reflect the current yield on the property that will remain with the seller until the settlement date.

Strategies have been developed whereby a corporation can obtain favorable tax results through entering into a forward sale of its own stock, which results could not be achieved if the corporation merely sold its stock for a deferred payment. One such strategy that might be used to exaggerate a corporation's interest deductions could involve a corporation borrowing funds (producing an interest deduction) to repurchase its own stock, which it immediately sells in a forward contract at a price equal to the principal and interest on the debt for settlement on the date that the debt matures. Taxpayers may be taking the position that the interest on the debt is deductible, while the gain and loss from the forward contract (including any interest component) is not taxable to the corporation. Although the leveraged purchase illustrates the problem, the borrowing is not necessary to achieve the tax benefits. A corporation could simply use excess cash (which otherwise would be earning a taxable return) to purchase its own outstanding stock and contemporaneously enter into a forward contract to sell the same amount of its stock at a price that reflects a return that is substantially based on the time value of money. In either case, the corporation arguably has achieved a tax-free return on investment.

Advocates of the proposal argue that there is little substantive difference between a corporation's current sale of its own stock for deferred payment (upon which the corporate issuer would accrue interest) and the corporation's forward sale of the same stock. The primary 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 on the settlement date. In both cases, a portion of the deferred payment economically compensates the corporation for the time-value element of the deferred payment. Proponents of the proposal argue that these two transactions should be treated the same. Additionally, some would argue that the proposal is a logical extension of the conversion rules of section 1258 which treat as ordinary income the time value component of the return from certain conversion transactions.

Opponents of the proposal argue that there is, in many cases, a substantive difference between a corporation's forward sale of its stock and a current sale for a deferred payment. Under a forward sale, the stock is not outstanding until it is issued on the settlement date. The purchaser does not actually own stock that it can transfer free of its obligation to make payment under the forward contract. The purchaser has no current dividend rights, voting rights or rights in liquidation. The forward price may reflect expected dividends on the underlying stock, but that price is generally established in advance and actual dividends may vary from expected dividends. The purchaser of stock for a deferred payment, on the other hand, actually owns the stock and the attendant rights thereto. Therefore, the current sale of stock for deferred payment and the forward sale of stock for future delivery may not be equivalent transactions, but the proposal would treat them the same. Conversely, the proposal would treat differently a forward sale of stock and an issuance in the future of stock for the same price on the same date as the settlement date, which in many respects may be viewed as similar transactions.

In addition, any forward sale by its very nature has a time value component: that feature is not unique to a corporate issuer of its own stock. The time value component should compensate the holder for its carrying costs with respect to the property. One could argue that if it is appropriate to impute interest on a forward contract, it should be done for all forward contracts and not just forward contracts involving a corporation's own stock. In other words, as a policy matter it may be inappropriate to address forward sales of a corporation's own stock without addressing the broader question of taxation of the time value component of forward contracts in general.

The conversion rules of section 1258 provide the closest analog under present law to the proposal. There are, however, several important distinctions between section 1258 and the proposal. Unlike the proposal, the conversion rules (1) do not affect the timing of recognition of the ordinary income and (2) apply only to forward contracts that are part of a "conversion transaction." In addition, some also might argue that the policy rationale underlying the conversion rules is not present with respect to the issuance of corporate stock because there is no conversion of ordinary income to capital gain. For example, assume a taxpayer buys gold today for \$100 and immediately enters into a forward contract to sell that gold in the future for \$110 (\$10 of which represents the time value of money). Upon closing of the forward sale, the taxpayer (and its shareholders if it is a corporation) would recognize an economic gain of \$10. Absent the conversion rules,[318] the \$10 gain on that transaction may be treated as capital gain notwithstanding that substantially all of the taxpayer's return is with respect to the time value of money. The taxpayer is in the economic position of a lender with an expectation of a return from the transaction that is in the nature of interest and with no significant risks other than those typical of a lender. That arguably is not the case (at least with respect to the economic position of the existing shareholders) with respect to a corporation that enters into a forward sale of its own stock (or certainly not all forward sales of a corporation's own stock). A corporation's ownership of its own stock arguably has no economic significance to the corporation or its

[318] Section 1258.

shareholders. The purchase or issuance by a corporation of its own stock at fair market value does not affect the value of the shareholders' interests in the corporation. The economic gain or loss, if any, to the existing shareholders of the corporation on the forward sale of its stock would depend on the fair market value of the corporation's stock on the settlement date. If the fair market value of the corporation's stock on the settlement date equals the contract price under the forward sale, then there is no economic gain or loss to the corporation or its shareholders. On the other hand, if the forward price does not equal the fair market value, there could be situations in which the corporation suffers an economic loss (because, for example, the value of the stock is greater than the forward price). Even in situations in which there is an economic loss, however, the proposal would tax the corporation on the imputed time value element.[319]

Opponents to the proposal also would object to the asymmetry created by the proposal between the forward seller and the forward purchaser. Under present law, if the corporation sold stock for a note, the corporation would have income inclusions with respect to the note, but the purchaser would have corresponding deductions. Under the proposal, if the corporation instead enters into a forward contract to sell its stock, the corporation would have income inclusions, but the forward purchaser would have no corresponding deductions. The result arguably is inappropriately unbalanced.

Some have suggested that a more narrowly tailored solution could be developed to address the perceived abuse of a corporation in essence being able to make a tax-free, fixed-income investment in its own stock (i.e., the "cash and carry transaction"). Under such an approach, the corporation would recognize taxable gain only if it acquired its own stock and on a substantially contemporaneous basis entered into a forward contract to sell its own stock and substantially all of its expected return from the transaction was attributable to the time value of money invested.[320]

Finally, some would argue that the provision narrowly focuses on one type of derivative contract with respect to a corporation's own stock and that a broader approach addressing the treatment under section 1032 of derivative contracts and other techniques for using a corporation's own stock would be more appropriate. Otherwise, the inconsistent treatment of economically equivalent transactions under section 1032 and the uncertainty as to its scope, in particular with respect to its applications to derivative contracts in a corporation's own stock,

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[319] Advocates of the proposal would observe that so long as the forward price is higher than the market price on the contract date, there is at least a "profit" established in the forward contract (representing the time value component of the contract) that should be taxable regardless of whether that profit is higher or lower than in it otherwise would be in the absence of the contract.

[320] See New York State Bar Association, *Report on Section 1032*, 1999 TNT 199-22 (Jun. 22, 1999). H.R. 3283, 106th Cong., 1st Sess. (1999), introduced by Representative Neal in November 1999, adopts a similar approach with respect to such cash and carry transactions.

could result in whipsaw against the government. Those who espouse this view would argue that consideration should be given to a range of alternative approaches for addressing the issue of derivatives and section 1032, including (1) expanding the scope of section 1032 to cover all derivatives in a corporation's stock, or (2) contracting the scope of section 1032 to cover only transactions in which a corporation issues or purchases its own stock for fair market value.[321] In November 1999, Representative Neal introduced a bill that would expand the scope of section 1032 to cover all derivatives.[322]

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

3. Modify treatment of ESOP as S corporation shareholder

Present Law

The Small Business and Job Protection Act of 1996 ("1996 Act") allowed qualified retirement plan trusts described in Code section 401(a) to own stock in an S corporation. The 1996 Act treated the plan's share of the S corporation's income (and gain on the disposition of the stock) as includible in full in the trust's unrelated business taxable income ("UBTI"). The provision was effective for taxable years beginning after December 31, 1997.

The Tax Relief Act of 1997 ("1997 Act") repealed the provision treating items of income or loss of an S corporation as unrelated business taxable income in the case of an employee stock ownership plan ("ESOP"), effective for taxable years to which the 1996 legislation applied. Thus, the income of an S corporation allocable to an ESOP is not subject to current taxation. Distributions made to the participants of the ESOP are generally taxable.

Description of Proposal

The proposal would require ESOPs that are not broad based to pay UBIT on S corporation income (including capital gains on the sale of stock) as the income is earned and allow the ESOP a tax deduction for distributions of amounts previously subject to tax. An ESOP would be considered broad based if, for the plan year ending with or within the S corporation year, the ESOP account balances allocated to highly compensated employees or 2 percent shareholders (as defined in sec. 1372(b)) are less than 10 percent of allocated account balances and, during the S corporation year, the total number of shares of "synthetic equities" do not exceed 10 percent of the S corporation's other outstanding shares.

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[321] New York State Bar Association, *Report on Section 1032.*

[322] H.R. 3283.

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

In calculating UBIT for an ESOP that is not broad based, amounts distributed to participants and beneficiaries would be deductible in the year paid. This deduction would apply only to the extent that distributions exceed undistributed amounts allocated to the ESOP that previously were not subject to UBIT (e.g., earnings in taxable years after 1997 in which the ESOP was not broad based reduced by distributions attributable to those years determined on a pro rata basis). Net operating loss rules would be modified to the extent necessary in order for ESOP distribution deductions that exceed net unrelated business income to be carried back or carried forward 20 years to offset S corporation income subject to UBIT pursuant to this rule.

Effective date.--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 after that date and for S corporation elections made on or after that date.

Analysis

The 1996 Act permitted ESOPs (and certain other tax-exempt entities) to hold stock in an S corporation. That Act provided that the S corporation income was taxable to the tax-exempt shareholders in keeping with the underlying premise of subchapter S that all income is subject to tax.[323]

Under the 1996 Act, the income of an ESOP attributable to S corporation stock would have been subject to tax in the hands of an ESOP when earned by the S corporation and again in the hands of the participants when distributions were made from the ESOP. This method of taxation generally would have meant that ESOPs holding S corporation stock would have been subject to a similar tax burden as ESOPs holding C corporation stock--a business tax would have been imposed when income was earned by the corporation and another tax would have been imposed on participants when distributions were made by the ESOP. This would have denied the ESOP and its participants the advantages of an S corporation election.[324] However, the taxable shareholders of the S corporation would have retained the benefits of subchapter S, allowing more corporations to establish ESOPs.

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[323] See H. Rept. 104-281, p. 61.

[324] To the extent the employer securities are distributed to participants, any untaxed appreciation may be taxed as long-term capital gain.

The 1997 Act eliminated the tax on the income when earned by the S corporation in order to reduce the tax burden on the ESOP's share of the S corporation's income. However, the elimination of the tax on the ESOP has resulted in the ability to attain tax deferral unlike that available to other taxable income of an S corporation or a C corporation. For example, some S corporations may be wholly owned by an ESOP, so that none of the S corporation's income is subject to current tax. For companies with just one or two employees, transactions using the ESOP/S corporation provisions have been described as "just a way to take advantage of the law".[325] It is also possible that the taxable shareholders of the S corporation may use restricted stock or stock options to deflect income to the ESOP, thereby reducing their current tax liability. In such cases, the economic benefit of the income may be received in later years and taxed at capital gain rates. Transactions have been described as providing for a "five-year tax holiday" using these techniques.[326] The 1997 Act provision encouraged more corporations to establish ESOPs. However, commentators have pointed out that the provision may have opened up unwarranted tax shelter opportunities.

The President's Budget Proposal is a middle ground between the provision originally enacted in the 1996 Act and the provision in the 1997 Act. It may be viewed as an attempt to balance the concerns regarding tax avoidance with the desire to encourage employee ownership. The proposal would retain present law with respect to broad based ESOPs and allow the deferral of S corporation income in those cases. In the case of ESOPs that are not broad based, it would provide a single tax on the earnings of the S corporation that are eventually distributed to the ESOP participants. Unlike present law, the tax would be paid currently by the ESOP as the S corporation earns income, rather than deferred until benefits are paid to participants. When it makes a distribution, the ESOP would be allowed a deduction which may allow for a refund of the previously paid tax. The participant would include the distribution in income as under present law.

Prior Action

The President's Fiscal Year 2000 Budget Proposal contained a proposal that would have required ESOPs (whether or not broad based) to pay UBIT on S corporation income (including capital gains on the sale of stock) as the income is earned and allow the ESOP a tax deduction for distributions of amounts previously subject to tax. A provision relating to ESOPs of S corporations was included in the Taxpayer Refund and Relief Act of 1999 as passed by the Congress and vetoed by the President. That provision would have provided that, if there is a

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[325] Employee Ownership Report, November/December 1998, 11. The article was set forth under the title "Outrages".

[326] See, for example, Ginsburg, "The Taxpayer Relief Act of 1997: Worse Than You Think," 76 Tax Notes 1790 (September 29, 1997). The article describes how tax planning can convert the ESOP provision of the 1997 Act into a long-term tax holiday for the S corporation's taxable shareholders.

prohibited allocation of stock to a disqualified person under an ESOP maintained by an S corporation for a nonallocation year: (1) an excise tax would be imposed on the employer equal to 50 percent of the amount involved in the prohibited allocation; and (2) the stock allocated in the prohibited allocation would be treated as distributed to the disqualified individual. A provision similar to that in the Taxpayer Refund and Relief Act of 1999 was included in the Tax Relief Extension Act of 1999 as passed by the Senate. That provision would have provided that, in the case of a nonallocation year with respect to an S corporation ESOP: (1) the amount allocated in a prohibited allocation to a disqualified person would be treated as distributed and includible in gross income; (2) an excise tax would be imposed on the S corporation equal to 50 percent of the amount involved in a prohibited allocation; and (3) an excise tax would be imposed on the S corporation with respect to any synthetic equity owned by a disqualified person.

4. Limit dividend treatment for payments on self-amortizing stock

Present Law

Distributions of property by a corporation to its shareholders are treated as dividends to the extent of current or accumulated earnings and profits of the corporation. The Treasury Department previously became aware of certain abusive transactions involving so-called "fast-pay" stock. Under a typical "fast-pay" arrangement, a corporation that is subject to tax only at the shareholder level (a conduit entity) issued preferred stock to one class of investors and common stock to a second class of investors. The preferred stock would be held by investors that were generally not subject to federal income tax and would be structured so that during an initial period, the dividends paid with respect to the preferred stock were significant (representing all or nearly all the income earned by the conduit entity) and relatively certain. During this period, the common shareholders would receive no or only nominal dividends from the corporation. After the initial period, the dividend rate of the preferred stock would decline dramatically, and the stock could be redeemed for a nominal amount. As the result, the preferred shareholders have an economic interest in the corporation that declines over time to a nominal amount, while the economic interest of the common shareholders increases over time. As an economic matter, the preferred stock in such an arrangement is self-amortizing because the distributions with respect to the stock are, in effect, a return on the investors' investment and also a partial return of their investment. To limit abuses involving fast-pay stock, the Treasury Department has issued regulations that automatically recharacterize a fast-pay arrangement involving a domestic conduit entity (i.e., a RIC or REIT) and provide for recharacterization at the Commissioner's discretion in the case of a fast-pay arrangement if the Commissioner determines that a principal purpose of the structure is the avoidance of tax.[327]

Section 1059 of the Code requires the holder of stock to reduce the basis of that stock by the amount of the dividends received deduction (i.e., the amount of the dividend received tax-

[327] Treas. Reg. sec. 1.7701(l)-3(c)(1).

free) in the case of dividends on certain self-amortizing stock (as well as on stock that otherwise pays “extraordinary dividends”). That provision addresses the potential for the creation of artificial losses with respect to such stock as a result of the dividends received deduction, but does not otherwise address the types of concerns that self-amortizing stock can present.

Description of Proposal

Under the proposal, in the case of a distribution with respect to self-amortizing stock issued by a conduit entity, the amount treated as a dividend would not exceed the amount of the distribution that would have been characterized as a payment of interest if the self-amortizing stock had been a debt instrument.

Effective date.--The proposal would be effective for distributions with respect to self-amortizing stock made after the date of enactment.

Analysis

The present-law regulations recharacterize fast-pay stock transactions using a conduit (such as a RIC or REIT) as transactions directly between the preferred stock investors and the owners of the common stock interests in the conduit entity.[328] Thus, all the payments characterized by the parties as dividends paid by the conduit entity are recharacterized as nondeductible dividends paid by the common stock owner of the conduit. This treatment would curb the problem transactions using those types of entities.

However, in the case of other nontaxable entities that may be used in place of a pass-through RIC or REIT to accomplish similar fast-pay results, such as controlled foreign corporations (CFC’s), it may be difficult for regulations to apply this approach without opening the door to other undesirable results where parties wish to characterize as a dividend an amount greater than the economic return on investment. The regulations addressing fast-pay stock would recharacterize amounts paid through CFC’s or certain other entities only in the discretion of the Commissioner.

The proposal represents an attempt more accurately to measure the economic return to the investor that is a return on capital, and to distinguish this from the return of capital to the investor. Thus, the proposal would identify the amount that would have been treated as interest (return on capital) if the instrument had been a debt instrument.

In some instances it may be difficult to determine the amount that would have been interest, because it may be necessary to determine an expected life of the instrument in order to apply rules comparable to the debt rules. However, in many of the typical fast-pay situations it may be possible to identify an expected maturity of the instrument based on all the facts and

[328] Treas. Reg. sec. 1.7701(l)-3.

circumstances, including put and call rights and the apparent likelihood that such rights would be exercised.

Prior Action

No prior action.

5. Prevent serial liquidations of U.S. subsidiaries of foreign corporations

Present Law

A U.S. corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, when dividends are paid to the corporation's shareholders.

In general, dividends paid by a U.S. corporation to nonresident alien individuals and foreign corporations that are not effectively connected with a U.S. trade or business are subject to a U.S. withholding tax on the gross amount of such income at a rate of 30 percent.[329] The 30-percent withholding tax may be reduced pursuant to an income tax treaty between the United States and the foreign country where the foreign person is resident.

In addition, the United States imposes a branch profits tax on U.S. earnings of a foreign corporation that are shifted out of a U.S. branch of the foreign corporation. The branch profits tax is comparable to the second-level taxes imposed on dividends paid by a U.S. corporation to foreign shareholders. The branch profits tax is 30 percent (subject to possible income tax treaty reduction) of a foreign corporation's dividend equivalent amount.[330] The "dividend equivalent amount" generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business.[331]

In general, U.S. withholding tax is not imposed with respect to a distribution of a U.S. corporation's earnings to a foreign corporation in complete liquidation of the subsidiary, because the distribution is treated as made in exchange for stock and not as a dividend. In addition, detailed rules apply for purposes of exempting foreign corporations from the branch profits tax for the year in which it completely terminates its U.S. business conducted in branch form.[332] The exemption from the branch profits tax generally applies if, among other things, for three years

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[329] Sections 871(a) and 881(a).

[330] Section 884(a).

[331] Section 884(b).

[332] Temp. Treas. Reg. sec. 1.884-2T).

after the termination of the U.S. branch, the foreign corporation has no income effectively connected with a U.S. trade or business, and the U.S. assets of the terminated branch are not used by the foreign corporation or a related corporation in a U.S. trade or business.

Regulations under section 367(e) provide that the Commissioner may require a domestic liquidating corporation to recognize gain on distributions in liquidation made to a foreign corporation if a principal purpose of the liquidation is the avoidance of U.S. tax.[333] Avoidance of U.S. tax for this purpose includes, but is not limited to, the distribution of a liquidating corporation's earnings and profits with a principal purpose of avoiding U.S. tax.

Description of Proposal

The proposal generally would treat as a dividend any distribution of earnings by a U.S. holding company to a foreign corporation in a complete liquidation, if the U.S. holding company was in existence for less than five years.

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

Analysis

The proposal is intended to prevent taxpayers from creating and subsequently liquidating U.S. corporations with an intention of escaping U.S. withholding taxes. For example, foreign corporations with U.S. subsidiary operations may establish a U.S. holding company (to receive tax-free dividends from U.S. operating companies), liquidate the U.S. holding company (to distribute the U.S. earnings free of U.S. withholding tax), and then reestablish another U.S. holding company. In this manner, taxpayers might take the position that the earnings of U.S. operating subsidiaries could be repeatedly distributed in serial tax-free liquidations of U.S. holding companies to foreign corporations, even though the U.S. subsidiary producing the earnings continues in operation.

Proponents of the proposal argue that the instances of withholding tax abuse would be significantly restricted by requiring the imposition of U.S. withholding taxes upon liquidations of U.S. holding companies created within five years of the liquidation. It is unclear, however, how a U.S. holding company would be defined for purposes of these rules. The lack of specificity as to the scope of the proposal may provide uncertainty to taxpayers in complying with the rules.

Critics of the proposal note that the proposal would not be limited to abusive tax avoidance situations, but would apply equally to liquidations of U.S. corporations done for valid business reasons, but within five years of their creation. Such an approach could be criticized as

[333] Treas. Reg. sec. 1.367(e)-2(d).

inflexible and unduly harsh. In addition, some argue that the present-law judicial doctrine of liquidation-reincorporation[334] adequately polices this form of withholding tax abuse.[335]

The proposal does not address potentially similar avoidance of the branch profits tax through terminations of U.S. businesses conducted in branch form. Certain rules under present law provide that the exemption from the branch profits tax generally applies if, among other things, for three years after the termination of a U.S. branch, the foreign corporation has no income effectively connected with a U.S. trade or business, and the U.S. assets of the terminated branch are not used by the foreign corporation or a related corporation in a U.S. trade or business. However, the exemption from the dividend withholding tax under the proposal would apply only if the U.S. holding company was in existence for five or more years. Thus, the proposal would require a corporation to remain in existence for a certain period (five years) before liquidating, while present law would require absence of U.S. activity for a certain period (three years) after a branch termination. It is unclear why the proposal would result in different treatment for a liquidation of a U.S. corporation as compared to the termination of a U.S. branch.

Prior Action

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal, except that such proposal included a coordination rule that would treat the termination of a U.S. branch in a similar manner.

6. Prevent capital gains avoidance through basis shift transactions involving foreign shareholders

Present Law

A shareholder that receives a distribution in redemption of stock generally is treated as having sold such stock for the amount of the distribution, thereby recognizing either gain or loss on the transaction (sec. 302). However, if the redemption is essentially equivalent to a dividend, the shareholder must report the distribution as dividend income, rather than gain or loss. A redemption of stock is considered essentially equivalent to a dividend if it does not result in a

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[334] See, e.g., Telephone Answering Service Co. v. Commissioner, 63 T.C. 423 (1974), aff'd, 546 F.2d 423 (4th Cir. 1976), in unpub. opinion, cert. denied, 431 U.S. 914 (1977) and American Mfg. Co. v. Commissioner, 55 T.C. 204 (1970). Under the liquidation-reincorporation doctrine, a distribution of assets in liquidation that is followed by a recontribution of a portion of such assets to another corporation may be recharacterized as a tax-free reorganization with boot. One purpose of this doctrine is to prevent the tax-free bailout of corporate earnings.

[335] It is also noted that section 367(e) provides certain disincentives for taxpayers to engage in outbound tax-free liquidations for tax avoidance purposes; however, the rule applies to gains and not earnings and, thus, does not operate to deny withholding tax benefits.

meaningful reduction in the shareholder's proportionate interest (determined by reference to stock held directly, indirectly, or constructively) in the distributing corporation. In determining whether a shareholder's proportionate interest in the distributing corporation has been meaningfully reduced, an option to acquire stock is treated as stock actually issued and outstanding.

Under Treasury regulations, if an amount received in redemption of stock is treated as a dividend, the basis of the remaining stock is adjusted (as appropriate) to reflect the basis of the stock redeemed.[336]

A shareholder generally is not required to reduce stock basis upon the receipt of a dividend. However, corporate shareholders that receive an extraordinary dividend are required to reduce their stock basis by the nontaxed portion of such dividend.[337]

Whether a dividend is "extraordinary" is determined by, among other things, reference to the size of the dividend in relation to the adjusted basis of the shareholder's stock. A dividend resulting from a non-pro rata redemption or a partial liquidation is automatically considered an extraordinary dividend, as is a dividend resulting from a redemption that is treated as a dividend due to options being treated as stock. The nontaxed portion of a dividend effectively equals the amount of the dividend that is reduced by a dividends received deduction. If the reduction in stock basis exceeds the total basis in the stock with respect to which an extraordinary dividend is received, the excess is taxed as gain on the sale or disposition of such stock.

Nonresident aliens and foreign corporations (collectively, "foreign persons") generally are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons.[338] Foreign persons also are subject to a 30-percent gross basis tax, collected by withholding, on certain U.S.-source income, such as interest and dividends, that is not effectively connected with a U.S. trade or business. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable tax treaty. In the case of dividends, on portfolio investments, U.S. income tax treaties commonly provide for a withholding tax rate of at least 15 percent.

Dividends generally are treated as U.S.-source income if the payor is a U.S. corporation. Thus, foreign persons generally are subject to U.S. withholding tax on dividends from a U.S. corporation. A foreign person generally is not required to reduce its stock basis in a U.S. corporation with respect to such dividend distributions.

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[336] Treas. Reg. sec. 1.302-2(c).

[337] Section 1059.

[338] Sections 871(b) and 882.

The United States generally does not tax capital gains of a foreign corporation that are not connected with a U.S. trade or business. Capital gains of a nonresident alien individual that are not connected with a U.S. business generally are subject to U.S. withholding tax only if the individual was present in the United States for 183 days or more during the year.[339]

Tax-exempt organizations (such as sec. 501(c) nonprofit organizations and pension plans) generally are not subject to Federal income tax, for example, on dues and contributions they receive from their members, as well as other income from activities that are substantially related to the purpose of their tax exemption. However, tax-exempt organizations are subject to the unrelated business income tax ("UBIT") on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions.[340] In addition, Native American Indian tribes, as well as wholly owned tribal corporations chartered under Federal law, generally are not subject to Federal income taxes.[341]

<u>Description of Proposal</u>

The proposal would provide that for purposes of section 1059, the nontaxed portion of a dividend includes the amount of a dividend received by a shareholder that is not subject to current U.S. tax. Thus, shareholders (e.g., a foreign person or a tax-exempt organization such as a section 501(c) nonprofit organization) generally would be required to reduce their stock basis in a corporation upon receiving extraordinary dividends from such corporation that are not subject to current U.S. tax.

In the event that a treaty between the United States and a foreign country reduces (but does not fully exempt) U.S. tax imposed on a dividend (and the dividend is not otherwise subject to U.S. tax), the proposal would provide that the nontaxed portion of a dividend would be determined based on 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. For example, if a foreign person with a stock basis in a U.S. corporation of $100 receives an extraordinary dividend of $100 that is subject to a 15 percent reduced withholding rate under a tax treaty, the foreign person would be required to reduce its stock basis by 50 percent of the

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[339] Section 871(a)(2).

[340] Sections 511-514.

[341] See Rev. Rul. 94-65, 1994-2 C.B. 14; Rev. Rul. 94-16, 1994-1 C.B. 19; Rev. Rul. 81-295, 1981-2 C.B. 15; Rev. Rul. 67-284, 1967-2 C.B. 55. The IRS recently clarified that tribal corporations chartered under tribal law also can qualify for exemption as section 501(c)(3) organizations. See General Information Letter to First Nations Development Institute (September 8, 1998).

dividend (the 15 percent reduction from the 30 percent withholding tax, divided by 30 percent), or $50.

For these purposes, the nontaxed portion of a dividend would not include dividends that are currently subject to U.S. tax, such as dividends that are subject to the full 30-percent U.S. withholding tax, UBIT, or the portion of dividends received by a controlled foreign corporation, passive foreign investment company or a foreign personal holding company that are currently included in a U.S. shareholder's taxable income. Thus, such dividends generally would not cause a reduction in stock basis in a corporation.

Similar rules would apply in the event that a shareholder is not a corporation. No inference is intended as to the treatment of such transactions under present law.

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

Analysis

The proposal would address transactions that might allow U.S. persons to create built-in losses in stock through certain redemption transactions involving foreign persons. For example, assume that a foreign parent corporation owns 100 percent of the stock of a foreign subsidiary. Also assume that an unrelated U.S. corporation acquires a minimal (e.g., one percent) interest in the foreign subsidiary, and an option to acquire a majority interest in the foreign parent. If the foreign subsidiary subsequently redeems all of its stock held by the foreign parent, the amount received by the foreign parent in redemption of such stock would be treated as dividend (because as a result of the option, the foreign parent is treated as owning the stock of the foreign subsidiary held by the U.S. corporation). The dividend generally would not be subject to U.S. tax; however, taxpayers might take the position that the foreign parent's basis in the stock would “shift” to the U.S. corporation and be added to its stock basis, creating a built-in loss with respect to such stock (i.e., a basis in excess of fair market value). The U.S. corporation could then sell such stock at a loss to offset other U.S. income (e.g., capital gains). Variations to this type of transaction might achieve the same or similar results.

Some argue that it is inappropriate to allow U.S. persons to create built-in loss property in this manner that may be used to reduce U.S. taxable income (e.g., upon a subsequent sale of the stock). The proposal would prevent this potential result by requiring a shareholder to reduce its stock basis in a corporation upon receiving an extraordinary dividend from such corporation that is not subject to current U.S. tax. Thus, the basis of any remaining shares following such a dividend would not be increased to the extent of the dividend amount that is not subject to current U.S. tax. In the example above, the redemption of the foreign parent's stock in the foreign subsidiary generally would be treated as an extraordinary dividend that is not subject to current U.S. tax. Under the proposal, such a dividend would reduce the foreign parent's basis in the foreign subsidiary stock such that the basis could not be "shifted" to the U.S. corporation as a result of the transaction.

Some have observed that the proposal would apply to legitimate business transactions. Such an approach of requiring basis adjustments in all such cases would provide greater certainty but could be criticized as inflexible.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

7. Prevent mismatching of deductions and income inclusions in transactions with related foreign persons

Present Law

As a general rule, there is allowed as a deduction all interest paid or accrued within the taxable year with respect to indebtedness.[342] With respect to debt instruments issued after July 1, 1982, this generally includes the aggregate daily portions of original issue discount ("OID") of the issuer for the days during such taxable year.[343] If a debt instrument with is held by a related foreign person, however, any portion of such OID is not allowable as a deduction to the issuer until paid ("related-foreign-person rule").[344] This related-foreign-person 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). Treasury regulations further modify the related-foreign-person rule by providing that in the case of a debt owed to a foreign personal holding company ("FPHC"), controlled foreign corporation ("CFC") or passive foreign investment company ("PFIC"), a deduction is allowed for OID as of the day on which the amount is includible in the income of the FPHC, CFC, or PFIC, respectively.[345]

In the case of unpaid interest and expenses of related persons, where, by reason of a payee's method of accounting, an amount is not includible in the payee's gross income until it is paid but the unpaid amounts would be deductible currently by the payor, the amount generally is

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342 Section 163(a).

343 Section 163(e)(1).

344 Section 163(e)(3).

345 Treas. Reg. sec. 1.163-12(b)(3).

allowable as a deduction when such amount is includible in the gross income of the payee.[346] Treasury has been instructed to issue regulations to apply this matching principle in the case of payments to related foreign persons.[347] With respect to interest that is not OID and other expenses owed to related foreign corporations, Treasury regulations provide a general rule that requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to such related foreign persons (with an exception for income of a related foreign person that is effectively connected with the conduct of a U.S. trade or business and that is not exempt from taxation or subject to a reduced rate of taxation under a treaty obligation).[348] Additionally, as in the case of OID, the regulations provide that in the case of amounts owed to a FPHC, CFC, or PFIC, a deduction is allowed as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC.

Description of Proposal

The proposal would provide that deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) to related FPHCs, CFCs, or PFICs would be allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently included in the income of the direct or indirect U.S. owners of the related foreign person. Deductions that have accrued but are not allowable under this provision would be allowed when the amounts are paid. The proposal would provide an exception for amounts accrued 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 proposal would grant the Secretary regulatory authority to provide exceptions to these rules.

No inference is intended as to the treatment of such payments under present law.

Effective date.--The proposal would be effective for payments accrued on or after the date of first committee action.

Analysis

Advocates of the proposal argue that there is no justification for mismatching in the case of related party OID and similar expenses. The mismatching is created because, under Treasury regulations, both U.S. payors and U.S.-owned foreign payors arguably might be able to accrue deductions for amounts owed to related FPHCs, CFCs or PFICs without the U.S. owners of such related entities taking into account for U.S. tax purposes a corresponding amount of income.

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346 Section 267(a)(2).

347 Section 267(a)(3).

348 Treas. Reg. sec. 1.267(a)(3).

These deductions can be used to reduce U.S. income or, in the case of a U.S.-owned foreign payor, to reduce earnings and profits which, for example, could reduce a CFC's income that would be currently taxable to its U.S. shareholders under subpart F.

The special rules in the Treasury regulations for FPHCs, CFCs and PFICs are an exception to the general rule in those regulations that unpaid interest and similar expenses owed to a related foreign person are deductible when paid (i.e., under a cash method). The relief was deemed appropriate in the case of FPHCs, CFCs and PFICs because it was thought that there would be little material distortion in matching of income and deductions with respect to amounts owed to a related foreign corporation that is required to determine its taxable income and earnings and profits for U.S. tax purposes pursuant to the FPHC, subpart F or PFIC provisions.[349] This premise fails to take into account the situation where amounts owed to the related foreign corporation are included in the income of the related foreign corporation but are not currently included in the income of the related foreign corporation's U.S. shareholders.

Opponents of the proposal might argue that any potential for mismatching of income and deductions with respect to accrued but unpaid interest and expenses owed to FPHCs, CFCs, and PFICs has been facilitated by Treasury regulations and, therefore, a regulatory rather than legislative solution is appropriate. Additionally, some might observe that present law properly requires FPHCs, CFCs, and PFICs and related persons to use the same method of accounting with respect to transactions between themselves. The potential for mismatching may result, for example, from a disproportionate allocation of income among shareholders rather than from the use of different accounting methods to which sections 163(e)(3) and, in particular, 267(a)(3) are targeted. On the other hand, the proposal would treat amounts owed to a related FPHC, CFC or PFIC that are not included in the income of a U.S. shareholder consistently with amounts owed to other related foreign persons (i.e., the amounts are deductible when paid) while at the same time retaining an exception for accrued amounts owed to FPHCs, CFCs and PFICs that are includible in their income and in the income of their U.S. shareholders.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

8. Prevent duplication or acceleration of loss through assumption of certain liabilities

Present Law

Generally, no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons

[349] See Notice of Proposed Rulemaking, 56 FR 11531 (Mar. 19, 1991) (Preamble to Proposed Treasury Reg. secs. 1.163-12 and 1.267(a)-3; T.D. 8465, 58 FR 235 (Jan. 5, 1993) (Preamble to Final Treasury Reg. secs. 1.163-12 and 1.267(a)-3).

control the corporation. However, a transferor recognizes gain to the extent it receives money or other property ("boot") as part of the exchange.[350]

The assumption of liabilities by the controlled corporation generally is not treated as boot received by the transferor,[351] except that the transferor recognizes gain to the extent that the liabilities assumed exceed the total of the adjusted basis of the property transferred to the controlled corporation pursuant to the exchange.[352]

The assumption of liabilities by the controlled corporation generally reduces the transferor's basis in the stock of the controlled corporation that assumed the liabilities. The transferor's basis in the stock of the controlled corporation is the same as the basis of the property contributed to the controlled corporation, increased by the amount of any gain (or dividend) recognized by the transferor on the exchange, and reduced by the amount of any money or property received, and by the amount of any loss recognized by the transferor.[353] For this purpose, the assumption of a liability is treated as money received by the transferor.

An exception to the general treatment of assumptions of liabilities applies to liabilities that would give rise to a deduction, provided the incurrence of such liabilities did not result in the creation or increase of basis of any property. The assumption of such liabilities is not treated as money received by the transferor in determining whether the transferor has gain on the exchange. Similarly, the transferor's basis in the stock of the controlled corporation is not reduced by the assumption of such liabilities. The IRS has ruled that the assumption by an accrual basis corporation of certain contingent liabilities for soil and groundwater remediation would be covered by this exception.[354]

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350 Section 351.

351 The assumption of liabilities is treated as boot if it can be shown that "the principal purpose" of the assumption is tax avoidance on the exchange, or is a non-bona fide business purpose (sec. 357(b)).

352 Section 357(c).

353 Section 358.

354 Rev. Rul. 95-74, 1995-2 C.B. 36. The ruling addressed a parent corporation's transfer to a subsidiary of substantially all the assets of a manufacturing business, in exchange for stock and the assumption of liabilities associated with the business, including certain contingent environmental remediation liabilities. These liabilities arose due to contamination of land during the parent corporation's operation of the manufacturing business. The transferor had no plan or intention to dispose of (or to have the subsidiary issue) any subsidiary stock. The IRS ruled that the contingent liabilities would not reduce the transferor's basis in the stock of the subsidiary because the liabilities had not been taken into account by the transferor prior to the transfer and

Description of Proposal

Under the proposal, if the basis of stock received by a transferor as part of a tax-free exchange with a controlled corporation exceeds the fair market value of the stock (determined without regard to this provision), then the basis of the stock received would be reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any liability that (1) is assumed in exchange for such stock, and (2) did not otherwise reduce the transferor's basis of the stock by reason of the assumption. Except as provided by the Secretary of the Treasury, the proposal would not apply where the trade or business with which the liability is associated is transferred to the corporation as part of the exchange, or where substantially all the assets with which the liability is associated are transferred to the corporation as part of the exchange.

The exceptions for transfers of a trade or business, or of substantially all the assets, with which a liability is associated would be intended to obviate the need for valuation or basis reduction in such cases. The exceptions would not be intended to apply to situations involving the selective transfer of assets that may bear some relationship to the liability, but that do not represent the full scope of the trade or business, (or substantially all the assets) with which the liability is associated.

For purposes of the proposal, the term "liability" includes any fixed or contingent obligation to make payment, without regard to whether such obligation or potential obligation is otherwise taken into account under the Code. The determination whether a liability, (as more broadly defined for purposes of this provision) has been assumed would be made in accordance with the provisions of section 357(d)(1) of the Code. Under the standard of section 357(d)(1), a recourse liability is treated as assumed if, based on all the facts and circumstances, the transferee has agreed to and is expected to satisfy such liability (or portion thereof), whether or not the transferor has been relieved of the liability. For example, if a transferee corporation does not formally assume a recourse obligation or potential obligation of the transferor, but instead agrees and is expected to indemnify the transferor with respect to all or a portion of a such an obligation, then the amount that is agreed to be indemnified would be treated as assumed for purposes of the proposal, whether or not the transferor has been relieved of such liability. Similarly, a nonrecourse liability is treated as assumed by the transferee of any asset subject to such liability.[355]

The application of the proposal is illustrated in the following example: Assume a taxpayer transfers assets with an adjusted basis and fair market value of $100 to its wholly-

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had not given rise to deductions or basis for the transferor.

[355] Section 357(d)(2) contains a limitation in the case of certain nonrecourse liabilities. Also, under section 357, regulations, if issued, may provide for different results.

owned corporation and the corporation assumes $40 of liabilities (the payment of which would give rise to a deduction). Thus, the value of the stock received by the transferor is $60. Under present law, the basis of the stock would be $100. The proposal would require that the basis of the stock be reduced to $60 (i.e., a reduction of $40). Except as provided by the Secretary, no basis reduction would be required if the transferred assets consisted of the trade or business, or substantially all the assets, with which the liability is associated.

The proposal would not change the tax treatment with respect to the transferee corporation.

The Secretary of the Treasury would be directed to prescribe rules providing appropriate adjustments to prevent the acceleration or duplication of losses through the assumption of liabilities (as defined in the proposal) in transactions involving partnerships. The Secretary may also provide appropriate adjustments in the case of transactions involving S corporations. In the case of S corporations, such rules may be applied instead of the otherwise applicable basis reduction rules.

Effective date.--The proposal would be effective for assumptions of liabilities on or after October 19, 1999, the date a substantially similar proposal was released for markup by the Chairman of the Senate Committee on Finance. Except as provided by the Secretary, the rules addressing transactions involving partnerships are effective for assumptions of liabilities on or after October 19, 1999. Any rules addressing transactions involving S corporations may likewise be effective for assumptions of liabilities on or after October 19, 1999, or such later date as may be prescribed in such rules.

Analysis

The proposal addresses a concern that the present-law rules related to the assumption of liabilities may be inadequate to address situations in which taxpayers attempt to accelerate or duplicate losses associated with the assumption of liabilities or potential liabilities.

The present-law rules permitting certain liabilities or potential liabilities to be excepted from the basis reduction rules were intended to facilitate the transfer of businesses together with associated liabilities in situations where the transferor had not yet obtained the benefits of the deduction associated with the liability. As one example, these rules facilitate the incorporation of a cash-basis business with accounts payable that would be deductible when paid, as well as accounts receivable. The IRS has ruled that in certain circumstances, a transferor's stock basis need not be reduced for certain contingent liabilities transferred along with substantially all the assets of the business with which they were associated.[356]

[356] Rev. Rul. 95-74, *supra*.

There is concern that under present law, taxpayers may take the position that liabilities or potential liabilities may be economically separated from the associated business or assets in a manner that permits the acceleration or duplication of the loss attributable to the liabilities without a commensurate disposition of the associated business or assets. For example, a transferor corporation may transfer assets with a fair market value basis (as one example, a note of another member of the corporate group) in exchange for preferred stock of the transferee corporation, plus the transferee's assumption of a contingent liability that is deductible in the future but that is currently estimated at the time of the transfer. In some instances, the transferor may assert that the obligation or potential obligation should not even be considered a liability at all, due to its contingent nature. The transferor claims a basis in the stock received equal to the basis of the assets transferred and contends that the assumed liability does not reduce stock basis under present law. However, the value of the transferee stock in the hands of the transferor is depressed, and may even be nominal, because of the liability that offsets the value of the assets. The transferor may then attempt to accelerate the deduction that would be attributable to the liability, by selling or exchanging the transferee stock received in the exchange and claiming a loss.[357] In some cases, the transferee (which may still be a member of the consolidated group filing a tax return with the transferor) might take the position that it is entitled to deduct the payments on the liability when actually paid, effectively duplicating the deduction attributable to the liability.

Opponents may contend that it is inappropriate to require valuation of certain contingent potential liabilities at the time of a transfer, for purposes of reducing the basis of the transferor's stock. They may contend that valuation disputes may result. Furthermore, they may contend that if the liability ultimately proves to be less than the amount valued at the time of the transfer, the transferor may be overtaxed if it sells the stock, due to a basis in the stock less than the stock's value. They also contend that the scope of the exceptions for transfers of the trade or business, or substantially all the assets, may be unclear in certain fact situations.

Proponents contend that the proposal would not apply where the entire trade or business or substantially all the assets with which the liability is associated are transferred. Thus, the need to engage in valuation and basis reduction would be minimized. They contend that existing concepts are available to identify the scope of these exceptions. Furthermore, they contend that if less than the entire trade or business, or less than substantially all the assets, are transferred, valuation is appropriate. They also contend that valuation in fact occurs when unrelated transferors engage in the transfer, for purposes of allocating stock ownership after the transfer. The basis adjustment will be relevant only if there is a subsequent disposition of the stock. Proponents contend that if the value of the stock at disposition proves to be different than at the time of the transfer, that should not require the tax law to disregard the values placed by the parties at the time of the transfer.

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[357] The IRS has indicated that it may challenge the position that a loss can be taken with respect to this basis, for example, in cases where the basis results from an intercompany note in a consolidated return context. See TAM 20006014.

Prior Action

A similar proposal was included in the Tax Relief Extension Act of 1999, as passed by the Senate. A related proposal was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President.

9. Amend 80/20 company rules

Present Law

In general, U.S.-source interest and dividends paid to nonresident alien individuals and foreign corporations ("foreign persons") that are not effectively connected with a U.S. trade or business are subject to a U.S. withholding tax on the gross amount of such income at a rate of 30 percent.[358] The 30-percent withholding tax may be reduced or eliminated pursuant to an income tax treaty between the United States and the foreign country where the foreign person is resident. Furthermore, an exemption from this withholding tax is provided for certain items of U.S.-source interest income (e.g., portfolio interest). The United States generally does not impose withholding tax on foreign-source interest and dividend payments.

Interest and dividend income generally is sourced in the country of incorporation of the payor. Thus, interest or dividends paid by a U.S. corporation to foreign persons generally are subject to U.S. withholding tax. However, if a U.S. corporation meets an 80-percent active foreign business income test (the "80/20 test"), all or a portion of any interest or dividends paid by that corporation (a so-called "80/20 company") effectively is exempt from U.S. withholding tax. Interest paid by an 80/20 company is treated as foreign-source income (and, therefore, exempt from the 30-percent withholding tax) if paid to unrelated parties. Interest paid by an 80/20 company to related parties is treated as having a prorated source based on the source of the income of such company during the three-year testing period (a so-called "look-through" approach). Dividends paid by an 80/20 company are treated as wholly or partially exempt from U.S. withholding tax under a similar look-through approach.

In general, a U.S. corporation meets the 80/20 test if at least 80 percent of the gross income of the corporation during a specified testing period is derived from foreign sources and is attributable to the active conduct of a trade or business in a foreign country (or a U.S. possession) by the corporation or a 50-percent owned subsidiary of the corporation. The testing period generally is the three-year period preceding the year in which the interest or dividend is paid.

Description of Proposal

[358] Sections 871(a) and 881(a).

The proposal would limit annually the amount of interest and dividends that is otherwise exempt from U.S. withholding tax under the 80/20 regime. The annual limitation would equal the foreign active business income received by the U.S. corporation during the three-year testing period, reduced by any such amounts from which 80/20 company benefits were enjoyed with respect to distributions in prior tax years. The amount of the exemption from U.S. withholding tax would be applied first to the earliest amounts of dividend distributions or interest payments made during the tax year and then in the order of any subsequent payments. The proposal would not be intended to alter the rules of section 316, relating to the determination of earnings and profits with which a dividend is associated.

Effective date.--The proposal would apply to interest or dividends paid or accrued more than 30 days after the date of enactment.

Analysis

The 80/20 test generally is applied based on the gross income of a "tested" U.S. corporation (i.e., the corporation paying the interest or dividend) during a three-year lookback period. In some cases this three-year lookback period may be subject to manipulation and can result in the avoidance of U.S. withholding tax with respect to certain distributions attributable to the U.S.-source earnings of a U.S. subsidiary of the payor corporation. Under present law, once a U.S. company satisfies the three-year test to qualify as an 80/20 company, the corresponding benefits are not limited to any time period. As a result, dividends paid by a "tested" U.S. corporation attributable to the U.S.-source earnings of a U.S. subsidiary of such corporation can be timed in such a manner that the earnings are not included in the three-year lookback period. For example, assume a U.S. holding company (owned by a foreign shareholder) owns a foreign subsidiary and a U.S. operating subsidiary. For the years 1997, 1998, and 1999, the U.S. holding company receives foreign-source dividends from its foreign subsidiary but no dividends from its U.S. subsidiary (although the U.S. subsidiary earns significant U.S.-source operating profits annually). Under present law, the U.S. holding company satisfies the 80/20 test for the year 2000 (due to 100 percent foreign-source earnings during the prior three-year testing period). In 2000, the U.S. subsidiary pays a dividend, representing several years of its accumulated U.S.-source earnings, to the U.S. holding company. As a result, under present law, the U.S. holding company's dividend to its foreign shareholder, which includes significant U.S.-source earnings, generally would be exempt from U.S. withholding tax. Under the proposal, however, the exemption from U.S. withholding tax with respect to the dividend would be limited to only the amount of foreign-source income received by the U.S. holding company during the prior three years.

Advocates of the proposal argue that limiting the 80/20 company benefits only to foreign active business income received during the three-year testing period will significantly restrict the avoidance of U.S. withholding tax through manipulation of the three-year lookback rule. The proposal would measure both qualification for 80/20 company status and the amount of corresponding benefits during the same testing period, thus preventing the ability to manipulate the rules in many cases.

Because the proposal would provide withholding tax exemptions based on a rolling three-year testing period, it could have the effect of encouraging the acceleration of some distributions of funds out of the United States. Present law permits a corporation to make a qualifying distribution of any size regardless of current (or three-year average) gross income. Thus, if a corporation planned at some future date to distribute a certain amount of funds to foreign persons, it may keep the funds invested in the United States until that future date. Under the proposal, the magnitude of such a future distribution may be limited by the recent three-year gross income experience. Thus, if the corporation wants to be certain to distribute a specified amount of funds to foreign persons by a certain future date, the corporation may now find it more advantageous to distribute the funds sooner and invest them abroad rather than keep them invested in the United States until needed. This could occur even if the funds would earn a higher rate of return in temporary investments in the United States.

Likewise, to preserve the option of distributing funds free of withholding tax, some corporations may make distributions that they would not otherwise have made at all. As a foreign shareholder is always able to transfer funds into the United States free of tax, the corporation may distribute funds to the foreign shareholder annually to realize the benefits of the annual exemption limit from the withholding tax. The shareholder could then hold these investments abroad until determining whether to place the funds for subsequent investments in the United States or elsewhere. If the shareholder retained the funds in the U.S. corporation and later determined to use the funds to make an investment outside of the United States, part of the distribution may be taxable under the proposal. Annual distributions free of withholding tax could provide the foreign person with a more valuable option for the future allocation of funds than would retaining the same funds in the United States where, although they might earn a higher return, they also may be subject to withholding tax upon distribution.

Opponents of the proposal may argue that an income limitation approach by its nature may not be sufficiently targeted to the specific timing issues raised by the three-year lookback rule. By simply regulating the timing of dividend payments from underlying foreign and U.S. subsidiaries, it would still be possible for a U.S. corporation to qualify for 80/20 company status through testing period manipulation. However, the benefits of such strategies would be significantly reduced from those available under present law.

The proposal would limit the exemption from withholding taxes for dividends and interest under the revised 80/20 company rules to the foreign active business income received during the testing period. Some may question why withholding tax benefits should be limited by reference to foreign active business income rather than earnings and profits since dividends are necessarily measured by reference to earnings and profits. On the other hand, interest payments are not measured by either income or earnings and profits and thus reference to any limitation of withholding tax exemption for interest would be somewhat arbitrary.

The proposal also may affect U.S. income tax treaties that contain provisions that incorporate the 80/20 test (e.g., the U.S.-UK income tax treaty which provides that the reduced rates of tax on dividends, interest, and royalties do not apply to certain 80/20 companies); the interaction of this proposal with the affected treaties would require further clarification.

<u>Prior Action</u>

A related proposal was included in the President's Fiscal Year 2000 Budget Proposal that would have applied the 80/20 corporation qualification test on a group-wide basis with respect to at least 50-percent owned subsidiaries.

10. Modify company-owned life insurance ("COLI") rules

<u>Present Law</u>

<u>Exclusion of inside buildup and amounts received by reason of death</u>

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup").[359] Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[360]

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[359] This favorable tax treatment is available only if the policyholder has an insurable interest in the insured when the contract is issued and if the life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includable in income, to the extent that the amounts distributed exceed the taxpayer's investment in the contract; such distributions generally are treated first as a tax-free recovery of the investment in the contract, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than 7 annual level premiums (sec. 7702A). Certain amounts received under a life insurance contract on the life of a terminally or chronically ill individual, and certain amounts paid for the sale or assignment to a viatical settlement provider of a life insurance contract on the life of a terminally ill or chronically ill individual, are treated as excludable as if paid by reason of the death of the insured (sec. 101(g)).

[360] Section 101(a).

Interest deduction disallowance

Generally, no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance contracts or annuity or endowment contracts owned by the taxpayer covering any individual.

An exception to this interest disallowance rule is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) 5 individuals, or (2) the lesser of 5 percent of the total number of officers and employees of the taxpayer, or 20 individuals. For purposes of determining who is a 20-percent owner, all members of a controlled group are treated as one taxpayer. Interest paid or accrued on debt with respect to a contract covering a key person is deductible only to the extent the rate of interest does not exceed Moody's Corporate Bond Yield Average--Monthly Average Corporates for each month beginning after December 31, 1995, that interest is paid or accrued.

Pro rata disallowance of interest on debt to fund life insurance

In addition, in the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values with respect to any life insurance policy or annuity or endowment contract issued after June 8, 1997. Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance policies, and annuity and endowment contracts, issued after June 8, 1997, to (2) the sum of (a) in the case of assets that are life insurance policies or annuity or endowment contracts, the average unborrowed policy cash values, and (b) in the case of other assets, the average adjusted bases for all such other assets of the taxpayer.

An exception is provided for any policy or contract[361] owned by an entity engaged in a trade or business, which covers one individual who (at the time first insured under the policy or

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[361] It was intended that if coverage for each insured individual under a master contract is treated as a separate contract for purposes of sections 817(h), 7702, and 7702A of the Code, then coverage for each such insured individual is treated as a separate contract, for purposes of the exception to the pro rata interest disallowance rule for a policy or contract covering an individual who is a 20-percent owner, employee, officer or director of the trade or business as the time first covered. A master contract does not include any contract if the contract (or any insurance coverage provided under the contract) is a group life insurance contract within the meaning of Code section 848(e)(2). No inference was intended that coverage provided under a master contract, for each such insured individual, is not treated as a separate contract for each such individual for other purposes under present law. A technical correction so providing was enacted in section 6010(o) of the Internal Revenue Service Restructuring and Reform Act of 1998.

contract) is (1) a 20-percent owner of the entity, or (2) an individual (who is not a 20-percent owner) who is an officer, director or employee of the trade or business. The exception for 20-percent owners also applies in the case of a joint-life policy or contract under which the sole insureds are a 20-percent owner and the spouse of the 20-percent owner. A joint-life contract under which the sole insureds are a 20-percent owner and his or her spouse is the only type of policy or contract with more than one insured that comes within the exception. Any policy or contract that is not subject to the pro rata interest disallowance rule by reason of this exception (for 20-percent owners, their spouses, employees, officers and directors), or by reason of the exception for an annuity contract to which section 72(u) applies, is not taken into account in applying the ratio to determine the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values.

Description of Proposal

The proposal would eliminate the exception under the pro rata disallowance rule for employees, officers and directors. The exception for 20-percent owners would be retained, however.

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

Analysis

The proposal is directed to an aspect of the issue addressed by Congress in 1996 and 1997: the issue of borrowing against life insurance contracts to achieve tax arbitrage. Businesses that own life insurance on employees and borrow from a third-party lender or from the public may still be able to achieve tax arbitrage by deducting interest that funds the tax-free inside buildup on the life insurance (or the tax-deferred inside buildup of annuity and endowment contracts). This continued opportunity for tax arbitrage results from the exception under the pro rata interest deduction limitation for insurance covering employees and others, it is argued. Businesses have been able to substitute third-party debt for debt that would have been subject to the 1996 Act limitations on interest deductibility with respect to insurance on employees. This tax arbitrage opportunity is being utilized by financial intermediation businesses (and could be utilized by other leveraged businesses), which often have a relatively large amount of debt in the ordinary course of business. Thus, it is argued, the exception should be repealed.

It can be argued, however, that retaining an exception from the pro rata interest disallowance rule for employees, officers, and directors is important for small businesses. Small businesses might argue that they need access to cash, in particular the cash value of life insurance on key employees, and that it would be inappropriate to reduce the tax subsidy stemming from the exception in their case. They might also argue that the proposal should be more targeted, perhaps to financial intermediaries or to large employers, or should provide for a narrower employee exception structured like the 20-key-person exception under the 1996 legislation, so as to address the tax arbitrage concern without negatively impacting their cash needs. On the other hand, it could be countered that in most cases the cash needs of small businesses have already been addressed by the proposal's continuation of the exception for 20-percent owners. In addition, it can be argued that insuring the lives of key employees can be accomplished by purchasing term life insurance, which is not affected by the proposal, and that cash needs arising from loss of a key employee can be addressed without the purchase of cash value life insurance. Further, because of the extension of the average person's expected life span in recent decades, it is argued that the purchase of term life insurance on a key employee through his or her likely retirement age is no longer difficult or expensive.

Opponents of the proposal argue that the funds borrowed under the life insurance contracts are used for tax-advantaged pre-funding of expenses such as retiree health benefits and supplemental pension benefits. On the other hand, Congress has already provided special tax-favored treatment specifically to encourage businesses to provide health and pension benefits. It was not intended that tax arbitrage with respect to investments in COLI be used to circumvent statutory limits that Congress enacted for these tax-favored health and pension benefits.

Some might criticize the proposal as somewhat ineffective because it would not impose any dollar limitation on the amount of insurance an employer would be permitted to purchase with respect to a 20-percent owner, nor on the amount of interest expense allocable to unborrowed policy cash values with respect to such insurance that would remain deductible under the proposal. It could be argued that the proposal would not effectively deter undesirable tax arbitrage in many cases, without any such limitations. On the other hand, it could be argued that State law concepts of insurable interest could operate as limits (but some might say these concepts would not impose any significant limit). It could also be argued that businesses with 20-percent owners might tend to be small businesses, and that encouraging the economic success small businesses is more important than limiting their tax arbitrage opportunities. Some might respond that a test based on the ownership percentage of shareholders is not actually targeted to small businesses, and that a more appropriate test would be focussed on the assets or income of the business. Another response might be that 20-percent owners do not necessarily have any connection to the business, so the death of such a person might have no significant impact that would create a business need to insure the person’s life. Further, it could be argued that any tax incentives provided to a sector of the economy, such as small business, should not be structured as arbitrage opportunities denied to other taxpayers, but rather as positive incentives towards socially or economically desirable goals.

Opponents of the proposal might argue that the proposed effective date may be too harsh. The proposal would limit the deduction for interest even in the case of insurance contracts that were purchased before the effective date, with no explicit phase-in rule. By contrast, the 1996 COLI limitations provided a phase-in rule, and the 1997 COLI limitations generally applied only to contracts issued after the effective date. On the other hand, it could be argued that purchasers of COLI that would be impacted by the proposal were aware of Congress' concern about tax arbitrage through leveraging life insurance because of the 1996 and 1997 legislative activity in the area. It could be said that recent COLI purchasers in particular assumed the risk of further Congressional action on leveraged life insurance products, as well as those whose contractual arrangements include provisions to “unwind” the transaction in the event unfavorable tax rules are enacted. Further, arguably the effective date for the proposal merely puts COLI purchasers with non-traceable third party debt in the same position they would have been in had they been subject to the phase-in rules under the 1996 legislation, which is fully phased in by 1999.

Prior Action

An identical proposal was included in the President's Fiscal Year 1999 and 2000 Budget Proposals.

11. Increase depreciation life by service term of tax-exempt use property leases

Present Law

Under current law, "tax-exempt use property" must be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life or 125 percent of the lease term. For purposes of this rule, "tax-exempt use property" is property that is leased (other than under a short-term lease) to a tax-exempt entity. For this purpose, the term "tax-exempt entity" includes Federal, state and local governmental units, charities, and, foreign entities or persons.

In determining the length of the lease term for purposes of the 125 percent calculation, a number of special rules apply. In addition to the stated term of the lease, the lease term includes: (1) any additional period of time in the realistic contemplation of the parties at the time the property is first put in service; (2) any additional period of time for which either the lessor or lessee has the option to renew the lease (whether or not it is expected that the option will be exercised); (3) any additional period of any successive leases which are part of the same transaction (or series of related transactions) with respect to the same or substantially similar property; and (4) any additional period of time (even if the lessee may not continue to be the lessee during that period), if the lessee (a) has agreed to make a payment in the nature of rent with respect to such period or (b) has assumed or retained any risk of loss with respect to such property for such period.

Tax-exempt use property does not include property that is used by a taxpayer to provide a service to a tax-exempt entity. So long as the relationship between the parties is a bona fide service contract, the taxpayer will be allowed to depreciate the property used in satisfying the contract under normal MACRS rules, rather than the rules applicable to tax-exempt use property.

Description of Proposal

The proposal would require lessors of tax-exempt use property to include the term of optional service contracts and other similar arrangements in the lease term for purposes of determining the recovery period.

Effective date.--The proposal would be effective for leases and other similar arrangements entered into after the date of first committee action. No inference is intended with respect to the tax treatment of leases and other similar arrangements entered into before such date.

Analysis

The special rules applicable to the depreciation of tax-exempt use property were enacted to prevent tax-exempt entities from using leasing arrangements to transfer the tax benefits of accelerated depreciation on property they used to a taxable entity. In certain circumstances, a taxpayer leasing tax-exempt use property may seek to shorten the depreciable life of the asset by combining a shorter lease term with a subsequent service contract. Including the service contract in the term of the lease for depreciation purposes will prevent this.

On the other hand, there are many bona fide service contracts between taxable and tax-exempt entities. Such bona fide service contracts may exist in situations where the service provider also leases property for use by the tax-exempt entity. Where the provision of services is the primary concern of the parties, such contracts should not be disturbed in order to prevent the avoidance of the tax-exempt leasing rules.

Prior Action

No prior action.

B. Financial Products

1. Require cash-method banks to accrue interest on short-term obligations

Present Law

The taxable income of a taxpayer is computed under the method of accounting on the basis which the taxpayer regularly computes his income in keeping his books so long as it clearly reflects income. A taxpayer generally is permitted to use the cash receipts and disbursement method (the "cash method") or an accrual method of accounting).[362] Under the cash method, an amount is includible in gross income when the amount is actually or constructively received by the taxpayer. Under an accrual method, an amount is includible income in gross income when all events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy.

All taxpayers regardless of their method of accounting are required to accrue currently interest attributable to original issue discount on all debt instruments issued after July 1, 1982, with certain exceptions.[363] One of the exceptions is with respect to any debt instrument that has a fixed maturity date not more than one year from the date of issue ("short-term obligations").[364]

With respect to obligations acquired after July 18, 1984, certain taxpayers are required to accrue currently as interest acquisition discount on short-term governmental obligations and original issue discount on short-term nongovernmental obligations. The taxpayers required to accrue currently discount on short-term obligations are (1) accrual basis taxpayers, (2) taxpayers holding the obligations primarily for sale to customers, (3) banks, (4) regulated investment companies (mutual funds) or common trust funds, (5) taxpayers holding the obligation as part of a hedging transaction or (6) taxpayers who stripped the bond or coupons on the bond.[365]

Some courts have held that banks using the cash method of accounting are not required to accrue income on discount on short-term loans to customers made in the ordinary course of the bank's business on the grounds that loans originated by the bank did not have acquisition

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[362] Section 446. Certain corporations engaged in farming (sec. 447) and C corporations with average gross receipts of $5 million or more are required to use an accrual method of accounting (sec. 448).

[363] Section 1272.

[364] Section 1272(a)(2)(C).

[365] Section 1281(b)(1).

discount and therefore, section 1281 does not apply.[366] The IRS is litigating this issue in other courts.[367]

Description of Proposal

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

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

Analysis

The proposal would affect small banks[368] that are using the cash method of accounting with respect to loans originated by the bank that have a maturity of one year or less.

Proponents would argue it would provide identical tax treatment to banks that both originate or purchase short-term loans. In both cases, the discount (either original issue or acquisition) serves as a substitute for stated interest, which a bank should be required to accrue.

Others may contend that adoption of the proposal may hurt small rural banks and their farmer customers. Many of the affected taxpayers would be small rural banks that make crop loans to farmers. Such loans often provide for a lump-sum repayment of principal and interest early the following year after the farmer has had time to harvest and sell the crop. Under the proposal, a cash method bank making such a loan would be required to pay tax on the interest accruing during the year even if it does not receive any cash with which to pay the tax until the following year. Banks facing such a situation may require the farmer to pay interest during that year or raise their interest rate on such loans to compensate for the earlier payment of tax.

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366 See e.g., Security Bank of Minnesota v. Comm., 994 F. 2d 432 (8th Cir. 1993).

367 See Notice 95-57, 1995-2 C.B.337 ("The Service disagrees with the Eighth Circuit's interpretation of section 1281 and intends to pursue this issue in other circuits."); see e.g., Security State Bank v. Commissioner, 111 T.C. 210 (1998), appeal pending, 10th Circuit Court of Appeals.

368 Banks with average gross receipts of $5 million or more are required to use an accrual method of accounting under section 448.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

2. Require current accrual of market discount by accrual method taxpayers

Present Law

A debt instrument has "market discount" if it is acquired other than at original issue for a price that is less than the principal amount of the debt instrument.[369] Market discount generally arises when a debt instrument has declined in value subsequent to its issuance (for example, because of an increase in interest rates or a decline in the credit-worthiness of the borrower).

In general, a holder of a debt instrument with market discount does not have to recognize income with respect to the market discount until the debt instrument matures or is disposed. On the disposition of the debt instrument, the holder must treat any gain as ordinary income to the extent of the accrued market discount (sec. 1276).[370] However, when a holder receives a partial principal payment on the debt instrument, the payment is treated as ordinary income to the extent of any accrued market discount. A holder also may elect to include the market discount in income as it accrues.[371]

Description of Proposal

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

Effective date.--The proposal would be effective for debt instruments acquired on or after the date of enactment.

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[369] Under a de minimis rule, the market discount is considered to be zero if it is less than 1/4 of 1 percent of the stated redemption price of the bond multiplied by the number of complete years to maturity after the taxpayer acquired the bond (sec. 1278(a)(2)(C)). In the case of a debt instrument issued with OID, market discount exists when the debt instrument is acquired at a price that is less than its adjusted issue price.

[370] In determining the amount of accrued market discount, the holder can elect between treating the discount as accruing (1) ratably, or (2) on a constant yield basis.

[371] Section 1278(b). Revenue Procedure 92-67, 1992-2 C.B. 429, sets forth the procedures for making this election.

Analysis

Present law provides a more favorable tax treatment for a holder of a debt instrument with market discount than a debt instrument with OID, notwithstanding that they are economically indistinguishable (i.e., both forms of discount represent substitutes for stated interest). First, the holder of a debt instrument with market discount can defer including any accrued market discount until the debt instrument matures or is disposed (whereas the holder of an OID debt instrument must include the OID in income as it accrues). Second, in the case of a debt instrument with market discount that declines in value, the holder would recognize a capital loss (and no market discount); by contrast, the holder of an OID debt instrument in the same situation is required to accrue OID in income, which generates a corresponding capital loss when the OID debt instrument is disposed. The proposal would eliminate these disparities.

The proposal would cap the yield by which the market discount would accrue at the greater of (1) the original yield-to-maturity of the debt instrument plus five percentage points, or (2) the applicable Federal rate at the time the holder acquired the debt instrument plus five percentage points. The cap is consistent with the policy reflected in the high-yield discount obligation rules (that a portion of the holder's return from such an instrument, if realized, is more properly viewed as gain on an equity investment). However, it is unclear how the proposal would apply in situations where a debt instrument is acquired at a deep discount (e.g., because the borrower is in a distressed economic position). Some courts and commentators have stated that, in situations where the amount of realizable discount is uncertain, the taxpayer may recover his basis in the debt instrument before recognizing any market discount (i.e., an open-transaction approach).[372]

One concern with the proposal is the additional complexity it may cause. When the market discount rules were enacted as part of the Deficit Reduction Act of 1984, Congress recognized the economic equivalence of market discount and original issue discount, yet it enacted a different set of rules for market discount. Indeed, "the Congress appreciated that the theoretically correct treatment of market discount, which would require current inclusion in the income of the holder over the life of the obligation, would involve administrative complexity."[373]

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[372] See, e.g., Liftin v. Comm'r, 36 T.C. 909 (1961), aff'd, 317 F. 2d 234 (4th Cir. 1963) ("Where a taxpayer acquires at a discount contractual obligations calling for periodic payments of parts of the face amount of principal due...where it is shown that the amount of the realizable discount gain is uncertain or that there is 'doubt whether the contract [will] be completely carried out,' the payments should be considered as a return of cost until the full amount thereof has been recovered, and no allocation should be made as between such cost and discount income."); Underhill v. Comm'r, 45 T.C. 489 (1966) (same). See also, David Garlock, *Federal Income Taxation of Debt Instruments*, ch. 10, 13-16 (Aspen Law & Business, 1998 Supp.).

[373] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, 93.

The administrative complexity may be a particular concern with respect to the computation of market discount on an OID debt instrument; the market discount and the OID amounts could involve different computations.[374] Recognizing that the proposal could create significant administrative complexity, one professional organization has recommended increasing the de minimis rule to one percent of the stated redemption price of the bond for each complete year to maturity as measured on the date of acquisition.[375] However, because the proposal is limited to holders using an accrual method of accounting, its impact would be confined to a class of taxpayers that is more familiar with the complexities of reporting income under an accrual method.

Another concern with the proposal is that, to the extent an accrual method holder is required to include market discount in income as it accrues, such income may, in fact, never materialize. The proposal thus extends to these taxpayers the character mismatch problem that exists with respect to OID debt instruments (i.e., interest income in early years that is later offset by a capital loss).

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.[376]

3. Modify and clarify certain rules relating to debt-for-debt exchanges

Present Law

Repurchase premium

A debt instrument has OID when the amount to be repaid at maturity (the "stated redemption price at maturity") exceeds the amount borrowed (the "issue price"). An issuer of a debt instrument with OID generally deducts as interest a portion of the OID that is allocable to

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[374] Many of the complexities and uncertainties of the proposal exist in present law for taxpayers with OID instruments that elect current accrual of market discount. To date, no regulations have been issued under the market discount rules.

[375] See New York State Bar Association Tax Section, "Report on Proposed Legislation to Amend the Market Discount Rules of Sections 1276-78," 1999 TNT 124-36 (June 22, 1999). The report also recommended limiting the yield on a debt instrument with market discount to the relevant applicable Federal rate when the holder acquires the debt instrument plus 6 percent.

[376] In addition, the House of Representatives included a similar proposal in the Omnibus Budget Reconciliation Act of 1987 (section 10118), but the proposal was not adopted by the conference.

that period based on a constant yield.[377] Conversely, a debt instrument is treated as having "bond issuance premium" when the issue price of the debt instrument exceeds its stated redemption price at maturity (stated another way, the amount borrowed exceeds the amount to be repaid at maturity).[378] An issuer of a debt instrument with bond issuance premium generally reduces its interest deduction by the amount of bond issuance premium allocable to that period based on a constant yield.[379]

In general, if a debt instrument is repurchased by the issuer for a price in excess of its adjusted issue price, the excess ("repurchase premium") is deductible as interest for the taxable year in which the repurchase occurs. If the issuer repurchases a debt instrument in a debt-for-debt exchange, the repurchase price is the issue price of the new debt instrument (reduced by any unstated interest under section 483). If there is repurchase premium in a debt-for-debt exchange and either the new debt instrument or the old debt instrument is publicly traded, then the general rule applies and the repurchase premium is immediately deductible. Where neither debt instrument is publicly traded, however, any repurchase premium is amortized over the term of the new debt instrument as if it were OID.[380]

Contingent payments and discharge of indebtedness

If a debt instrument is repurchased by the issuer for a price that is less than its adjusted issue price, the issuer recognizes income from the discharge of indebtedness. If the debtor issues a new debt instrument in satisfaction of the indebtedness, the debtor is treated as having satisfied the indebtedness with an amount of money equal to the issue price of the new debt instrument.[381] If the new debt instrument provides for contingent payments, and neither the new debt instrument nor the old debt instrument is publicly traded, then the holder includes the fair market value of the contingent payments in determining the amount realized in the exchange.[382] The

[377] Section 163(e)(1).

[378] Treas. Reg. sec. 1.163-13(c).

[379] Treas. Reg. sec. 1.163-13(a).

[380] Treas. Reg. sec. 1.163-7(c). The regulation overturned the result in Great Western Power Company of California v. Commissioner, 297 U.S. 543 (1936), in which the Supreme Court held any repurchase premium in a debt-for-debt exchange must be amortized over the term of the new debt rather than deducted immediately.

[381] Section 108(e)(10).

[382] Treas. Reg. sec. 1.1001-1(g)(2)(ii).

issuer, however, does not include the value of the contingent payments in determining the issue price of the new debt instrument.[383]

Reorganization exchanges

In a tax-free reorganization (or a distribution under section 355), gain is recognized by a shareholder or securityholder only to the extent that property other than stock or securities in a corporation that is a party to the reorganization is received. For purposes of this rule, "other property" includes the fair market value of the excess of the principal amount of securities received over the principal amount of any securities surrendered (if any).[384] If the principal amount of the securities received and the principal amount of the securities surrendered are the same, no gain is recognized.

Description of Proposals

Repurchase premium

The proposal would require an accrual basis issuer in a debt-for-debt exchange to reduce the issue price of a new debt instrument by the amount of any repurchase premium for purposes of determining the amount of any original issue discount or bond issuance premium. Thus, under the proposal, an issuer can no longer deduct the repurchase premium in the year of the repurchase. Rather, solely for purposes of determining the issuer's Federal income tax consequences, the amount of the repurchase premium either creates OID that is amortized over the term of the new debt instrument, or reduces the amount of bond issuance premium that affects the interest deduction over the term of the new debt instrument. No reduction is made with respect to any portion of the repurchase premium for which a deduction is disallowed under section 249 (relating to premium on convertible debt). The proposal would not affect the holder's tax treatment with respect to the debt instrument.

Contingent payments and discharge of indebtedness

The proposal would clarify that where a new debt instrument provides for contingent payments, and neither the new debt instrument nor the old debt instrument is publicly traded, in applying the debt-for-debt exchange rule to the debtor, the fair market value of any contingent payments is added to the issue price of the new debt instrument.

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383 Treas. Reg. sec. 1.1274-2(g).

384 Section 356(d)(2)(B).

Reorganization exchanges

The proposal would provide that for purposes of determining the amount of gain recognized to a securityholder in a reorganization (or a section 355 distribution), the excess of the fair market value of the securities received over the fair market value of the securities surrendered would be treated as "other property." If securities are received and none are surrendered, the fair market value of the securities received would be treated as other property.

Effective date

The proposals would apply to exchanges occurring on or after the date of enactment.

Analysis

Repurchase premium

The proposal would require an accrual basis issuer to amortize any repurchase premium in a debt-for-debt exchange over the life of the new debt. This proposal is consistent with the rationale in the U.S. Supreme Court decision in Great Western Power which ruled that these expenses are properly allocated to the cost of obtaining a new loan rather than a cost of terminating the old loan, and thus amortizable over the life of the new loan. This differs from the result that would occur if the transactions are viewed as separate transactions in which the old debt is first repurchased for money and then new debt is separately incurred (in which case the repurchase premium would be immediately deductible).

The proposal would result in the asymmetrical treatment of repurchase premium -- the holder would include the premium as income in the year of the exchange, while the issuer would amortize the premium over the life of the new debt. Opponents of the proposal may question the appropriateness of this treatment. However, present law already provides inconsistent treatment as to the character of the repurchase premium (i.e., the holder deducts the repurchase premium as interest while the holder treats the premium as capital gain).

The following examples illustrate the effect of this proposal on the issuer of a debt instrument:

Example 1.--Assume that an accrual basis corporation issued for $90 a publicly-traded bond with a stated principal amount of $100. At a time when $3 of original issue discount had been deducted by the corporation with respect to the bond (so that the adjusted issue price is $93), the corporation issues a new bond worth $95 with a redemption price of $100 in exchange for the old bond. Under present law, the corporation is allowed a $2 deduction for the repurchase premium attributable to the exchange ($95 value of the new bond less $93 adjusted issue price of the old bond), and the issue price of the new bond is $95. Under the proposal, no deduction is allowed with respect to the repurchase premium, and the issue price of the new bond is $93 ($95 less the $2 of repurchase premium). Over the life of the new bond, the corporation may deduct $7 as original issue discount based on a constant yield.

Example 2.--Assume the same facts as in Example 1, except that the original bond was issued for $110. At a time when $3 of premium had been amortized (so that the adjusted issue price of the original bond is $107), a new bond worth $109 is issued with a redemption price of $100 in exchange for the old bond. Under present law, the corporation is allowed a $2 deduction for the repurchase premium attributable to the exchange ($109 value less $107 adjusted issue price), and the issue price of the new bond is $109. Under the proposal, no deduction is allowed with respect to the repurchase premium, and the issue price of the new bond is $107 ($109 less the $2 repurchase premium). Over the life of the new bond, the issuer may amortize $7 as bond issuance premium.

Contingent payments and discharge of indebtedness

Where a contingent payment debt instrument is issued in exchange for a debt instrument and neither the new debt nor the old debt is publicly traded, the debtor excludes this amount for purposes of determining the issue price of the debt instrument under section 108(e)(10). This treatment could result in an overstatement of the debtor's discharge of indebtedness income and thereby fail to reflect the true economics of the exchange. The proposal would require both parties to take into account the fair market value of the contingent payments.

Reorganization exchanges

Although the amount of property received in an exchange generally is measured by the fair market value, the present-law rules measuring the amount of "other property" received in an exchange of securities rely on the principal amount of the securities. The principal amount rule acts as a safe harbor; the securityholder does not have to determine the fair market value of the securities unless the principal amount of securities received exceeds the principal amount of any securities surrendered. However, because the principal amount may include amounts otherwise treated as interest for other purposes of the Code, the "principal amount" may not properly measure whether a creditor receives additional debt in an exchange. Using fair market value is a more meaningful measure and should not result in significant valuation problems.

The proposal presumably would not alter the nonrecognition treatment for issuances of rights to acquire stock in a reorganization (or sec. 355 distribution).[385]

Prior Action

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal.

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[385] Treas. Reg. secs. 1.354-1(e), 1.355-1(c), and 1.356-3(b).

4. Modify and clarify straddle rules

Present Law

A "straddle" generally refers to offsetting positions (sometimes referred to as "legs" of the straddle) with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. A "position" is an interest (including a futures or forward contract or option) in personal property. When a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for any taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle.[386] Deferred losses are carried forward to the succeeding taxable year and are subject to the same limitation with respect to unrecognized gain in offsetting positions.

The straddle rules generally do not apply to positions in stock. However, the straddle rules apply to straddles where one of the positions is stock and at least one of the offsetting positions is either (1) an option with respect to the stock or (2) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. In addition, the straddle rules apply to stock of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder.

When one position with respect to personal property offsets only a portion of one or more other positions (the "one leg larger than the other" problem), the Treasury Secretary is directed to prescribe by regulations the method for determining the portion of such other positions that is to be taken into account for purposes of the straddle rules.[387] To date, no such regulations have been promulgated.

Taxpayers are required to capitalize certain otherwise deductible expenditures allocable to personal property which is part of a straddle.[388] Such amounts must be charged to the capital account of the property to which the expenditures relate. Expenditures subject to this requirement are interest on indebtedness incurred or continued to purchase or carry property that is part of the straddle (including any amount paid or incurred in connection with personal property used in a short sale) as well as all other amounts paid or incurred to carry the property, including insurance, storage, or transportation charges ("carrying charges"). The amount of the expenditures to be capitalized is reduced by (1) any interest income from the property (including original issue discount) which is includible in gross income for the taxable year, (2) certain amounts of acquisition and market discount treated as ordinary income with respect to such

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[386] Section 1092.

[387] Section 1092(c)(2).

[388] Section 263(g).

property for the taxable year, (3) the excess of dividends includible in gross income over any dividends-received deduction with respect to such property for the taxable year, and (4) an amount which is payment with respect to a security loan includible in gross income with respect to such property for the taxable year. There is no direct authority interpreting the phrase "indebtedness incurred or continued to purchase or carry" for section 263(g) purposes. Similar concepts, however, are used elsewhere in the Code such as with respect to interest relating to tax-exempt income under section 265(a)(2).

Description of Proposal

The proposal would modify and clarify the straddle rules in five respects: (1) repeal the stock exception; (2) clarify that a taxpayer's obligation under certain debt instruments with payments linked to the value of personal property may constitute a leg of a straddle; (3) provide a capitalization rule to address the one leg larger than the other problem; (4) provide a special rule with respect to physically settled legs of a straddle; and (5) clarify the situations in which interest and carrying charges are considered properly allocable to a straddle and, therefore, must be capitalized.

Repeal of the stock exception

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.

Treatment of debt instruments linked to the value of personal property

The proposal would provide that if a taxpayer issues a debt instrument calling for one or more payments which are linked to the value of personal property, the taxpayer's obligations under the debt instrument is an interest in personal property that may constitute a leg of a straddle. Thus, if a taxpayer holds a long position in actively-traded stock and issues a debt instrument that contains an embedded short position in the same stock, the long position and the debt instrument would be offsetting positions in actively traded personal property and, therefore, would constitute a straddle.

One leg larger than the other

The proposal would provide that loss recognized on one leg of a straddle would be capitalized into the other leg of the straddle. The capitalization rule would require a loss leg to be allocated between two or more positions that, together, constitute a single leg of the straddle (i.e., because the loss leg is offsetting two or more positions in personal property). Where the losses must be so allocated between two or more offsetting positions, the proposal would require the loss to be allocated first to the positions that would generate the most gain (or income) if terminated for its fair market value. In the case where losses exceed the unrealized gain or income) in the other leg of the straddle, the excess losses would be recognized currently.

Physically settled legs of a straddle

The proposal would require a taxpayer that settles an option or forward contract by delivering property to treat the settlement as a two-step transaction for purposes of applying the straddle rules. First, the taxpayer would be required to treat the option or forward contract as if it were terminated for its fair market value immediately before the settlement. Any loss would be required to be capitalized into the offsetting positions that comprise the other leg of the straddle. The taxpayer then would be treated as selling the property used to physically settle the option or forward contract.

Capitalization of interest and carrying charges

The proposal would provide that interest is considered properly allocable to a straddle if the interest accrues on a "straddle-related debt instrument." For this purpose, a straddle-related debt instrument would be: (1) a debt instrument the proceeds from which are used directly or indirectly to purchase an interest in property that constitutes all or part of one leg of the straddle; (2) a debt instrument that is secured by an interest in property that constitutes all or part of one leg of the straddle; (3) a debt instrument that is secured by an interest in property that is issued in connection with the creation of an interest in property that constitutes all or part of one leg of the straddle (for example, debt that is separated from a swap contract under Treas. Reg. sec. 1.446-3(g)(4)); or (4) a debt instrument that is itself an interest in property that constitutes all or part of one leg of the straddle.

Effective date

The proposal generally would be effective for straddles entered into on or after the date of enactment. The expense capitalization rules would be effective for interest accruals after the date of enactment. No inference would be intended with respect to the tax treatment of transactions entered into before the effective date.

Analysis

Repeal of the stock exception

The repeal of the exception from the straddle rules for stock arguably is consistent with the policy of those rules, which is to prevent deduction of losses in situations where a taxpayer has entered into an offsetting transaction that has unrecognized gain, until such time as the gain on the offsetting position is recognized. Advocates of the proposal also would observe that the offsetting appreciated stock positions are subject to the constructive sale rules added by the

Taxpayer Relief Act of 1997,[389] which arguably have more onerous results than loss deferral under the straddle rules. Additionally, it must noted that proposed Treasury regulations would severely limit the stock exception even if the proposal is not adopted.[390] Nonetheless, because stock is widely held, the repeal of the stock exception would potentially subject many more taxpayers to the complicated straddle rules. Opponents of the proposal would also argue that because repeal of the stock exception would also effectively repeal certain standards that are part of the special straddle rules for stock, such as the "substantially similar or related property" standard, uncertainties as to the potential scope and application of the straddle rules to stock would be created.

Treatment of debt instruments linked to the value of personal property

Advocates of the proposal are of the view that when a debt instrument calls for payments that are linked to the value of personal property, such instruments create a "position" in personal property. The proposal is intended to clarify the treatment of such debt instruments for those who may take a different view.[391] The proponents of the proposal would maintain that to the extent that a debt instrument calls for payments linked to the value of personal property, the obligor has an interest (generally equivalent to a short position) in that personal property. Others would argue that such treatment may not be the case under present law, and that the proposal therefore represents an expansion (rather than a clarification) of present law in a way that, when combined with other aspects of the proposal discussed below, would adversely affect relatively common debt instruments that are exchangeable into common stock and would have the effect of raising capital costs for the issuers.

One leg larger than the other

The one leg larger than the other problem exists whenever one or more positions offset only a portion of one or more other positions. For example, assume the taxpayer holds two shares of stock (i.e., is long) in XYZ stock corporation: share A with a $30 basis and share B with a $40 basis. When the value of the XYZ stock is $45, the taxpayer enters into a forward

[389] Section 1259.

[390] Prop. Treas. Reg. sec. 1.1092(d)-2.

[391] A similar clarification was made by section 1261(b) of the Tax Reform Act of 1986 with respect to positions in foreign currency. That amendment clarified that an obligor's interest in a nonfunctional currency denominated debt obligation is treated as a position in the nonfunctional currency (sec. 1092(d)(7)). The rationale for this treatment was that a foreign currency borrowing was economically equivalent to a short position in the foreign currency. Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 1108 (JCS-10-87), May 4, 1987.

contract to sell one share of the XYZ stock for $50.[392] The issue arises as to whether the short sale is a straddle with respect to share A, share B, or both. Assume when the value of the XYZ stock is $100, taxpayer closes the short sale for a loss of $50, and sells share B for a $60 gain. On a literal reading of section 1092(a), the $50 loss would be deferred because the loss ($50) does not exceed the unrecognized gain ($70) in share A, which is an offsetting position to the short sale -- notwithstanding that the taxpayer recognized more gain than the loss through the sale of share B.

Aware of this problem, Congress directed the Treasury Secretary to promulgate regulations that prescribe the method for determining the portion of such other positions (i.e., the larger leg) which should be taken into account for purposes of the straddle rules. The legislative history to the Economic Recovery Tax Act of 1981 provides:

> If there is more than one position with unrealized gain which was acquired prior to the loss disposition, which offsets the loss position and which does not belong to an identified straddle, the bill authorizes the Secretary of the Treasury to prescribe regulations for allocating the loss among the unrealized gain in such positions and for allocating unrealized gain among loss positions. The committee intends that allocation of unrealized gain positions to unrealized losses be done in a consistent manner that does not distort income. Regulations issued under this bill should provide that one dollar of unrealized appreciation at the end of any year defer at most only one dollar of realized loss.[393]

Although 18 years have passed since the enactment of section 1092, no such regulations have been issued. A private letter ruling, however, was issued by the IRS in February 1999, which addressed the one leg larger than the other issue.[394] Under the facts of the ruling, a taxpayer entered into a costless collar with respect to a portion of shares of his stock.[395] Other shares were held in an account as collateral for a loan and still other shares were held in excess of the shares used as collateral and the number of shares specified in the collar. The ruling concluded that the collar offset only a portion of the stock consisting of the number of shares

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[392] For purposes of this example, assume that the constructive sale rules of section 1259 are not applicable.

[393] S. Rep. No. 97-144, 97th Cong. 1st Sess. (1981).

[394] P.L.R. 199925044 (Feb. 3, 1999).

[395] A costless collar generally is the purchase of a put option and the sale of a call option with the same trade dates and maturity dates and set such that the premium paid and the premium received are substantially equal. The collar can be considered as economically similar to a short position in the stock.

specified in the costless collar because the payoff under each option comprising the collar was determined by that number of shares. The ruling further concluded that:

> In the absence of regulations under section 1092(c)(2)(B), we conclude that it is permissible for Taxpayer to identify which shares of Corporation stock are part of the straddles and which shares are used as collateral for the loans using appropriately modified versions of the methods of section 1.1012-1(c)(2) [providing rules for adequate identification of shares of stock sold or transferred by a taxpayer] and or section 1.1092(b)-3T(d)(4) [providing requirements and methods for identification of positions that are part of a section 1092(b)(2) identified mixed straddle].[396]

The proposal does not follow the approach taken in the private letter ruling. Rather, the proposal would provide a capitalization approach under which the loss on the smaller leg is generally capitalized on a pro rata basis to the positions in the larger leg, modified such that the loss is first allocated to the position with the greatest unrealized gain. To continue with the above example, assume that when the value of the stock is \$100, taxpayer closes the short sale for a \$50 loss. Under the proposal the first \$10 of the loss must be capitalized into share A, which would generate \$10 more gain if sold than would share B. The remaining \$40 loss would be allocated equally between share A and share B. Thus, share A would have a \$60 basis (\$30 original basis, plus allocation of \$10 to equalize the built-in gain between A and B, plus \$20 which represents half of the remaining \$40 loss). Share B would have a \$60 basis (\$40 original basis plus \$20 not allocated to share A). If the taxpayer sold share B alone for \$100, under the proposal it would have a \$40 gain (\$100 - \$60 basis). The proposal permits the taxpayer to effectively recover \$20 of the loss through the disposition of share B, but defers the remaining \$30 of loss until share A is disposed. In other words, under the proposal, both shares A and B would have to be sold for the taxpayer to recover its entire loss.

Supporters of the proposal would argue that the pro rata approach is a reasonable ordering rule for recognizing the loss and avoids the need for an identification rule, which, in some circumstances, could be complicated. Advocates of the proposal would further argue that a straddle is properly viewed as reducing the risk of loss, in part, with respect to the entire offsetting position, as opposed to in whole with respect to a portion of the offsetting position. In other words, the short sale in the above example is better viewed as a hedge with respect to a portion of A <u>and</u> B, as opposed to a hedge of all of A <u>or</u> B.

Opponents of the proposal argue that it economically distorts income by deferring losses that are economically unrelated to the position held. Opponents would argue that (continuing with the above example) by entering into the short sale, a single share of XYZ stock is hedged,

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[396] P.L.R. 199925044.

not a portion of two shares. Prior to entering into the straddle the taxpayer economically held two positions; upon entering into the straddle one position is completely hedged so that the taxpayer economically holds on to one long position. When the taxpayer closes the short position and disposes of one long position, the taxpayer still economically holds only one long position. The taxpayer is in the same place as he would have been in had the straddle remained in place. The loss should not be associated with that position; rather it should be associated with the position which it offset and which was sold for a gain.

Moreover, opponents of the proposal would argue that the policy underlying the straddle rules is not advanced by the proposal. The straddle rules are designed to curb abuses involving the deferral of income and the conversion of ordinary income and short-term capital gain into long-term capital gain.[397] When a loss is recognized and the offsetting gain is recognized at the same time, opponents of the proposal would argue that there is no deferral or conversion opportunity; therefore, the loss should be able to be recognized to the extent that gain is also recognized. Advocates of this approach likely would support an identification regime, perhaps similar to that in the private ruling discussed above, under which a taxpayer could identify the components of the straddle and therefore recognize loss to the extent that gain is recognized in the offsetting position that is identified as a component of the straddle.[398]

Physically settled legs of a straddle

The proposal provides a special rule with respect to physically settled contracts that are part of a straddle. Advocates of the proposal argue that this rule is intended to prevent circumvention of the straddle rules through delivery of the underlying property, and thereby, effectively combining the gain and loss. The proposal prevents this result by treating a

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397 See Joint Committee on Taxation, *General Explanation of the Economic Recovery Act of 1981,* 282 (JCS-71-81), Dec. 31, 1981.

398 See "Wall Street Seeks Guidance on Vexing Straddle Issue" (Letter of Thomas A. DeGennaro, President of the Wall Street Tax Association, Inc. to Jeffrey Maddrey, Associate Tax Legislative Counsel, and Michael S. Novey, Counsel to Assistant Chief Counsel (Financial Institutions and Products), dated January 31, 2000), 86 Tax Notes 1018 (Feb. 14, 2000); Written Statement of the U.S. Securities Markets Coalition Submitted to The Committee on Ways and Means, U.S. House of Representatives, June 23, 1999. Identification could take a number of forms including: (1) up-front identification; (2) taxpayer identification at the time of sale under rules similar to Treas. Reg. sec. 1.1012-1(c)(2) and (3); or (3) a presumption (in favor of the government) that the loss leg is identified with the offsetting position with the most potential gain (i.e., lowest basis). In addition to advocating an identification rule, some have argued that gain and loss that accrues prior to the formation of the straddle should not be treated as associated with the straddle. In other words, a position should be marked to market at the time the straddle comes into existence (without altering the timing of the recognition of any such gain or loss resulting from the marking). See *id.*

physically settled option or forward contract as if it were terminated for its fair market value immediately before the settlement. For example, a taxpayer holds 100 shares of actively traded stock with a basis of $30 per share (for an aggregate basis of $3,000), and a value of $100 per share (for an aggregate value of $10,000). The taxpayer enters into a two-year contingent forward contract with respect to the stock. Under the terms of the contract, at the end of the two years, the taxpayer is to receive $1,500, and is to deliver the excess, if any, of the value of 100 shares over $120 per share (or $12,000 in the aggregate). At settlement, assume the stock is worth $150 a share. The taxpayer is to receive $1,500 and deliver $3,000 ($30 a share x 100 shares), for a $1,500 loss on the contract. On cash settlement, the taxpayer would pay $1,500. The taxpayer could instead collect $1,500 and deliver 20 shares worth $3,000 ($150 each). The taxpayer would recognize a $900 gain ($1,500 amount realized less $600 basis), effectively absorbing the entire $1,500 loss (i.e., because the value of $3,000 less the basis of $600 would have given rise to a $2,400 gain). Under the proposal, the taxpayer would be required to recognize a $1,500 loss on the realization of the contract. The loss would be capitalized into the basis of the stock, increasing the basis by $15 per share ($1,500 divided by 100 shares) to $45. The taxpayer then would be treated as separately disposing of the 20 shares for the fair market value of $3,000, less a basis (at $45 per share) of $900 for a $2,100 gain. Thus, the proposal allowed the taxpayer to recover only $300, or 20 percent, of the $1,500 loss, which percentage represents the percentage of the offsetting position of which the taxpayer disposed.

Opponents to this approach would contend that it simply exacerbates issues raised in connection with the pro rata capitalization rule, discussed above, and may question whether the existence of a straddle offers sufficient justification for alteration of the tax treatment of physically settled contracts. On the other hand, advocates of the proposal would maintain that the physically settled contracts rule would operate as an anti-abuse rule, which would be necessary in order to give full effect to the intent of the pro rata capitalization rule.

Capitalization of interest and carrying charges

Under present law, when one of the positions that is part of a straddle consists of a debt or a debt-like component, some taxpayers have taken the position that (even assuming that the debt instrument can be treated as a "position" in personal property) interest expense or similar periodic payments with respect to that component are not costs incurred to purchase or carry personal property that is part of the straddle and, therefore, do not have to be capitalized. Advocates of the proposal argue that it is inappropriate for a taxpayer to deduct expenses associated with one position in a straddle to the extent that there is unrecognized gain in the offsetting position in the straddle. When a straddle includes a straddle-related debt instrument, the related interest expense should be viewed as a cost of the straddle.

Opponents of the proposal would argue, on the other hand, that this extension of the straddle rules is unwarranted and interest expense or similar periodic payments should be capitalized only when the proceeds from the debt component of the straddle are used to purchase or carry a position in the straddle. To the extent that the proceeds from the straddle-related debt instrument are not used to fund a position in personal property that is part of the straddle (e.g., to fund a long position that is offset by a forward contract) and therefore are available for other purposes, it arguably is inappropriate to capitalize the expenses related to the debt or debt-like component. Moreover, they would argue, that the anomaly is not the deduction of the interest with respect to the debt, but rather the lack of taxation on the appreciation of the equity component of the straddle.

In addition, the expense capitalization rules under the proposal would be effective for interest accruals after the date of enactment. Opponents to the proposal would argue that there is sound legal theory under present law supporting the position that interest paid with respect to a straddle-related debt instrument that is not incurred to purchase or carry a long position in personal property does not have to be capitalized under section 263(g). The proposal changes this result. The effective date would then apply this change to interest accruals with respect to outstanding debt instruments, in essence having a retroactive effect. Any outstanding debt instruments that are exchangeable into common stock held by the issuer would be affected by this new rule. Opponents of the proposal argue that such treatment is unfair and unwarranted.

Prior Action

The proposal to repeal the exception for stock was included in the President's tax simplification proposals released in April 1997, in the President's Fiscal Year 1999 Budget Proposal, and in the President's Fiscal Year 2000 Budget Proposal. With respect to the provision to clarify situations in which interest and carrying charges would be considered properly allocable to a straddle and, therefore, capitalized, somewhat similar proposals were included in the President's tax simplification proposals released in April 1997, and in the President's Fiscal Year 2000 Budget Proposal. There is no prior action on the remaining aspects of the proposal.

5. Provide generalized rules for all income-stripping transactions

Present Law

Assignment of income in general

In general, an "income stripping" transaction involves a transaction in which the right to receive future income from income-producing property is separated from the property itself. In such transactions, it may be possible to separate income from the related deductions associated with particular property.

The common law has developed the concept (referred to as the "assignment of income" doctrine) that income may not be transferred without transferring the underlying property. A leading judicial decision relating to the assignment of income doctrine involved a case in which a taxpayer made a gift of detachable interest coupons before their due date while retaining the bearer bond. The Supreme Court ruled that the donor was taxable on the entire amount of interest when paid to the donee on the grounds that the transferor had "assigned" the right to receive the income to the donee.[399] Both the scope of this decision and the extent to which this decision has been overruled by the enactment of specific income stripping rules (such as the stripped bond rules discussed below) is far from clear. In addition to general common law assignment of income principles, specific rules have been enacted to address certain specific stripping transactions. These rules include provisions for addressing (1) certain production payments with respect to mineral property; (2) stripped bonds; (3) stripped preferred stock; (4) lease stripping transactions; and (5) investment trusts.[400]

Mineral production payments

A mineral production payment is a right to a specified share of the production from a mineral property (or a sum of money in lieu of the production) when that production occurs. The right to receive such payment typically is secured by an interest in the minerals, the right to the production typically is for a period of time shorter than the expected life of the property, and the production payment usually bears interest. In general, present law treats a production payment as a loan transaction; that is, a loan by the owner of the production payment to the owner of the mineral property.[401] Depending on how a production payment is created, it may be classified as a carved-out production payment or a retained production payment. Specific rules are provided for each type of production payment.

A carved-out production payment is created when the owner of a mineral property sells -- or "carves out" -- a portion of the future production. Under present law, a carved-out production payment is treated as if it were a mortgage loan on the property, and does not qualify as an economic interest in property (and therefore does not qualify for tax benefits associated with an interest in the property such as cost depletion).[402] Thus, the proceeds received by the owner of the

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[399] Helvering v. Horst, 311 U.S. 112 (1940).

[400] Depending on the facts, the IRS could also determine that a variety of other Code-based and common-law based authorities could apply to income stripping transactions including: (1) sections 269, 382, 446(b), 482, 701, or 704 and the regulations thereunder; (2) authorities that recharacterize certain assignments or accelerations of future payments as financings; (3) business purpose, economic substance, and sham transaction doctrines; (4) the step transaction doctrine; and (5) the substance-over-form doctrine. See Notice 95-53, 1995-2 C.B. 334 (accounting for lease strips and other stripping transactions).

[401] Section 636.

[402] Section 636(a). This treatment does not apply to a production payment carved out for exploration or development of a mineral property if gross income would not otherwise be realized by the person creating the production payment.

mineral property upon a sale of a carved-out production payment are not taxable to him. As income is derived from the property subject to the carve out, however, that income is taxable to the owner of the mineral property, subject to the depletion allowance. The cost of producing minerals used to satisfy carved-out production payments are deductible when incurred.

A retained production payment is created when the owner of a mineral interest sells the working interest, but reserves a production payment for himself. Under present law, a retained production payment is treated as a purchase money mortgage loan and does not qualify as an economic interest in the mineral property.[403] Accordingly, the income derived from the property which is used to satisfy the payment is taxable to the owner of the mineral property, subject to the depletion allowance. In addition, the production costs attributable to producing the minerals used to satisfy the production payment are deductible by the owner of the working interest in the year incurred. In effect, the owner of the working interest is placed in essentially the same position as persons in other industries who purchase business assets subject to a mortgage.

In the case of a lease of mineral property in which a production payment is retained by the lessor, the payment is treated by the lessee as if it were a bonus granted by the lessee to the lessor that is payable in installments.[404] The lessee therefore is required to capitalize the payments and recover them through depletion. In the hands of the lessor, the production payment is treated as derived from an economic interest in the mineral property and thus includible in income subject to the deduction for percentage depletion.

Stripped bonds

A "stripped bond" is a debt instrument in which there has been a separation in ownership between the underlying debt instrument and any interest coupon that has not yet become payable. Special rules are provided with respect to the purchaser and "stripper" of stripped bonds, applicable to purchases and strips effected after July 1, 1982.[405] In essence, upon the disposition of the stripped corpus or the detached, unmatured coupons, both the retained portion and the portion disposed of represent the right to a fixed amount payable at a future date that is purchased at a discount. Accordingly, section 1286 treats both the stripped corpus and the detached coupons as OID bonds issued by a corporation on the date of disposition and effectively subjects each component to the OID periodic income inclusion rules.

Thus, a purchaser of a stripped bond or stripped coupon is treating as holding a bond issued on the purchase date with OID equal to the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date) over the bond's or

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403 Section 636(b).

404 Section 636(c).

405 Section 1286.

coupon's ratable share of the purchase price, determined on the basis of the respective fair market values of the elements on the purchase date.[406] This OID would have to be included in income under the OID periodic income rules.

The person who strips the bond and disposes of either the stripped corpus or one or more coupons must allocate the basis, immediately before the disposition, of the bond (with the coupons attached) between the items retained and the items disposed (sec. 1286(b)).[407] Special rules apply to require that interest or market discount accrued on the bond prior to such disposition must be included in the stripper's gross income (to the extent that it had not been previously included in income) at the time the stripping occurs, and the taxpayer increases his basis in the bond by the amount of that accrued interest. This adjusted basis is then allocated between the corpus and the coupons in relation to their respective fair market values. Proceeds from the sale of stripped coupons or bonds constitute income to the seller only to the extent they exceed the basis allocated to the stripped coupons or bond. With respect to retained items (either the detached coupons or stripped corpus), to the extent that the price payable on maturity, or on the due date of the coupons, exceeds the portion of the seller's basis allocable to such retained items, the difference is treated as OID required to be included under the OID periodic income rules.[408]

Stripped preferred stock

Stripped preferred stock is preferred stock in which there has been a separation in ownership between such stock and any dividend on such stock that has not become payable.[409] A purchaser of stripped preferred stock is required to include in gross income, as ordinary income, the amounts that would have been includible if the stripped preferred stock were a bond issued on the purchase date with OID equal to the excess of the redemption price of the stock over the purchase price.[410] This treatment is extended to any person whose basis in the stock is determined by reference to the basis in the hands of the purchaser. The person stripping the preferred stock and disposing of the dividend rights is treated as having purchased the preferred

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[406] Section 1286(a).

[407] Similar rules apply in the case of any person whose basis in any bond or coupon is determined by reference to the basis in the hands of a person who strips the bond.

[408] Special rules are provided with respect to stripping transactions involving tax-exempt obligations that treat OID (computed under the stripping rules) in excess of OID computed on the basis of the bond's coupon rate (or higher rate if originally issued at a discount) as income from a non-tax-exempt debt instrument (sec. 1286(d)).

[409] Section 305(e).

[410] Section 305(e)(1).

stock on the date of such disposition for a purchase price equal to such person's adjusted basis in the stripped preferred stock.[411]

There are no specific rules in the Code addressing stripping transactions with respect to common stock.

Lease stripping transactions

Pursuant to authority under section 7701(l) to prescribe regulations to recharacterize multiple-party financing where the Treasury Secretary determines that such recharactization is necessary to prevent avoidance of tax, the Treasury Department has issued proposed regulations to address certain obligation-shifting transactions which, in particular, address lease stripping.[412] These proposed regulations are intended to prevent tax avoidance by parties participating in multiple-party financing transactions that involve an assumption of obligations under a lease or similar arrangement.

The Treasury Department has identified certain fact patterns that are typical of lease stripping transactions. One such fact pattern includes a transferred basis transaction. For example, a lessor (typically a party that is indifferent to U.S. taxation) assigns the right to receive future payments under a lease of tangible property to a third party for cash. The lessor treats the amount realized from the assignment as its current income. The lessor then transfers the underlying property in a carryover basis transaction, such as a transfer described in section 351, to a transferee that is owned predominantly by persons other than the transferor and who are subject to U.S. tax. The transferee enjoys the benefits of the high basis in the property and the deductions attendant thereto, notwithstanding that the value has been stripped.[413]

Other transactions identified by the Treasury Department include transactions that may be effected through a transfer of an interest in a partnership or other pass-through entity. For example, in exchange for cash, a partnership assigns its right to receive future payments under a lease of tangible property and allocates the amount realized from the assignment to its current partners (many of whom are indifferent to U.S. taxation). The partnership retains the underlying property with a high basis. There is then a redemption or transfer of a partnership interest by one or more partners to whom the partnership allocated the income from the assignment, without a reduction in basis in the underlying property. The remaining partners (or transferee partner),

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[411] Section 305(e)(3).

[412] Prop. Treas. Reg. sec. 1.7701(l)-2.

[413] Notice 95-53.

who typically would be subject to U.S. tax, enjoy the benefits of the high basis in the partnership property.[414]

The proposed regulations under section 7701(l) operate to recharacterize transactions in which the transferee (the "assuming party") assumes obligations or acquires property subject to obligations under an existing lease or similar agreement and the transferor (the "property provider") or any other party has already received or retains the right to receive amounts that are allocable to periods after the transfer. The recharacterization is intended to reflect the principle that a taxpayer who is treated for tax purposes as the owner of rental property must recognize income that accrues during its period of ownership.

Under the proposed regulations, the assuming party is required to recognize rental income for the period in which it owns the property or the leasehold interest. In addition, the transaction is recharacterized to include additional consideration in the form of a note provided by the assuming party to the property provider for the transfer of the property, resulting in interest income and expense for which the parties must account as appropriate.[415] To account for any differences in timing or amount between payments the property provider actually receives after the transaction and payments treated as being made to the property provider under the note from the assuming party, the property provider can be treated as an obligor (or, if appropriate, an obligee) under a second loan for which the property provider must account accordingly.

The proposed lease stripping rules do not apply to service contracts that do not involve the use or enjoyment of property. They also generally do not address transactions in which a person assigns rights to future income but does not transfer the underlying property to another taxpayer, except with respect to special rules regarding pass-through entities and consolidated groups.[416]

Investment trusts

Through the issuance of multiple classes of ownership interests in an investment trust, an investment trust can be utilized to divide cash flows from an asset among multiple classes of investors holding non-pro rata interests in the asset. The investment trust classification regulations under section 7701 restrict the ability to do this by treating certain multiple-class investment trusts as business entities, which may be taxable as corporations.[417] Under the

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[414] *Id.*

[415] The rent-leveling concepts of section 467 and the regulations thereunder would apply to both the assuming party and the property provider.

[416] See Preamble to Prop. Treas. Reg. sec. 1.7701(l)-2, 61 F.R. 68175.

[417] Treas. Reg. sec. 301.7701-4(c).

regulations, an investment trust with multiple classes of ownership interests will be treated as a business entity unless there is no power under the trust agreement to vary the investment of the certificate holders and the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.

The investment trust classification regulations provide the following example that illustrates their effect on a type of stripping transaction:

> A promoter forms a trust in which the shareholders of a publicly traded corporation can deposit their stock. For each share of stock deposited with the trust, the participant receives two certificates that are initially attached, but may be separated and traded independently of each other. One certificate represents the right to dividends and the value of the underlying stock up to a specified amount. The other certificate represents the right to appreciation in the stock's value above the specified amount. The separate certificates represent two different classes of ownership interest in the trust, which effectively separate dividend rights on the stock held by the trust from a portion of the right to appreciation in the value of the stock. The multiple classes of ownership interests are designed to permit investors, by transferring one of the certificates and retaining the other, to fulfill their varying investment objectives of seeking primarily either dividend income or capital appreciation from the stock held by the trust. Given that the trust serves to create investment interests with respect to the stock held by the trust that differ significantly from direct investment in such stock, the trust is not formed to facilitate direct investment in the assets of the trust. Accordingly, the trust is classified as a business entity . . . .[418]

<u>Description of Proposal</u>

In general, the proposal would characterize a strip of a right to receive future income from income-producing property as a secured borrowing, not a separation in ownership (a "deemed-financing approach"). Thus, the person that assigns a right to future income for cash would be treated as borrowing the funds from the assignee, with the underlying property securing the borrowing. To ensure that income-stripping transactions are not used to create inappropriate foreign tax credit opportunities, the proposal would limit or prohibit the owner from crediting taxes paid or deemed paid with respect to the property.

[418] Treas. Reg. sec. 301.7701-4(c), Example (3).

In certain cases, the proposal would not apply a deemed-financing approach. In those cases, the proposal would characterize the stripping arrangement as an entity and the holders of the purported income strip and underlying property as holding interests in the entity. More specifically, the proposal would characterize the stripping arrangement as an entity in cases in which (1) the characterization of the purported income-strip as debt is inappropriate because the purported strip represents substantially all of the value of the underlying property, or (2) the deemed-financing approach would fail to reflect clearly the income of one or more participants to the transaction. The proposal does not provide any further specifics as to the determination of when this alternative classification would apply.

The proposal would require a taxpayer that enters into a stripping transaction to recognize gain, if any, on the underlying income-producing property. A pro rata approach would apply. Therefore, for example, if the value of the strip was equal to 60 percent of the value of the underlying property, the owner of the underlying property would recognize 60 percent of the gain that would be recognized were the underlying property sold for its fair market value. This rule is intended to prevent income-stripping transactions to utilize the deemed-financing approach as a means of constructively selling appreciated property.

The proposal would apply to income-stripping transactions involving leases, service contracts, stock, and, to the extent provided in regulations, other forms of income-producing property.

Effective date.--The proposal would be effective for income-stripping transactions entered into on or after the date of enactment.

Analysis

The proposal reflects a concern with the use of income-stripping transactions to achieve tax results that do not clearly reflect income of one or more participants in the transaction. Although there are several separate provisions of present law addressing income-stripping transactions, the proposal is intended to apply a more uniform approach at income stripping transactions. The proposal's approach is to treat any specified income stripping transaction as a deemed-financing transaction. This approach is consistent with the principle that a taxpayer who is the owner of property should recognize for tax purposes the income and expenses that accrue during its period of ownership. The approach recognizes that a transaction in which the taxpayer sells the right to future income for its present value may be functionally equivalent to a nonrecourse loan made by the "purchaser" to be repaid by the "seller" with interest in the form of the future income. The deemed-financing approach is similar to the approach taken with respect to production payments in connection with mineral interests and the treatment of lease stripping transactions.

The proposal does not take the approach, which some argue is a more simple and straightforward approach, of the rules with respect to stripped bonds, which require an allocation of basis. Advocates of the proposal would argue that the allocation of basis rules are somewhat simple to apply in the context of a bond stripping transaction because in those cases measurement of basis (and the corresponding creation of separate OID instruments) is typically not particularly complex. In other cases, however, the measurement and allocation of basis could be significantly more challenging, making an approach that does not rely on the allocation of basis the preferable alternative. By characterizing the stripping transaction as a deemed-financing transaction, ownership remains with the stripper, thereby avoiding the need for potentially complicated basis allocation rules. This approach also has the benefit of avoiding the need to allocate tax ownership (and corresponding tax benefits and burdens) among different owners. The ownership question is resolved by keeping the entire ownership with the underlying property from which the future income stream is stripped.

Some would contend that the clear reflection of income problem that the proposal is intended to address is created by artificial rules that treat prepaid income as includible in income entirely in the year of receipt. They would argue that, regardless of whether the future income stream is stripped, recognition of income in circumstances where there is an advance receipt of income should be deferred. Advocates of the proposal, on the other hand, might contend that a broader rule that permits the receipt of advance payments while deferring the tax thereon in all cases may go too far and create new planning opportunities. The proposal's more narrow scope, limited to stripping transactions, is targeted to particular transactions that give rise to certain known abuses.

A significant aspect with respect to the scope of the proposal is the expansion of income-stripping concepts to stripped common stock. Although special rules apply under present law to stripped preferred stock (which treat the stripped preferred stock as an OID instrument), there is no analog in the Code with respect to stripped common stock.[419] Thus, for example, common stock of a mutual fund or money market fund could be stripped in a manner that would effectively separate the income stream of the fund from the principal. In this way, a taxpayer could hold the "income-only" component, and dispose of the "principal-only" component. The value of the principal-only component would be small compared to the basis, potentially resulting in a current capital loss. The taxpayer would have ordinary income over time on the income component. For some taxpayers, the current capital loss would be a significant benefit. Under the proposal, the up-front capital loss would not be allowed because the stripping of the principal component would be treated as a loan, with deductions taken over time. Advocates of the proposal would argue that such stripping transactions with respect to common stock give rise to the same concerns as those with respect to preferred stock, and that the proposal would eliminate anomalous disparate treatment between preferred and common stock. On the other hand, with respect to preferred stock for which stripping rules are provided under section 305(e)

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[419] In Estate of Stranahan v. Commissioner, 472 F.2d 867 (6th Cir. 1973), for example, the court held that where a taxpayer sold a carved-out interest of stock dividends, with no personal obligation to produce the income, the transaction was treated as a sale of an income interest.

of present law, there is a requirement that the preferred stock have a fixed redemption price, so that OID can be calculated. Although a fixed redemption price may not be necessary for loan treatment (the loan presumably would equal the proceeds from the stripping transaction), with respect to common stock that could be held indefinitely, it is not altogether clear how the term of the loan would be calculated.

The proposal provides in general terms that it would limit or prohibit the owner from crediting taxes paid or deemed paid with respect to the property. This limitation is intended to ensure that income-stripping transactions are not used to create inappropriate foreign tax credit opportunities. Neither the scope of this aspect of the proposal nor the mechanism for applying the limitation are specified.[420]

The proposal provides that in cases in which (1) the characterization of the purported income strip as debt is inappropriate because the purported strip represents substantially all of the value of the underlying property, or (2) the deemed-financing approach would fail to reflect clearly the income of one or more participants in the transaction, the deemed-financing approach would not apply. Rather, the proposal would characterize the stripping arrangement as an entity and the holders of the purported income strip and underlying property as holding interests in the entity. The premise here appears to be that in certain circumstances, the stripper actually has given up ownership of the property and, thus, loan treatment is not the appropriate characterization. It is unclear precisely what circumstances would trigger the shift in characterization. It is also unclear how this deemed entity would be characterized for tax purposes and whether the issuance of the interests in the entity to the purchaser of the stripped property would give rise to a taxable event. Moreover, the second characterization arguably is inconsistent with the goal of formulating a uniform, generalized rule broadly applicable to income-stripping transactions. On the other hand, advocates of the proposal would maintain that the two-characterization approach is uniform and consistent; it merely provides for a different set of rules to apply depending on some measure (that remains to be specified) of when substantially all the value of the underlying property has been transferred or the deemed-financing result would fail to reflect income clearly. Some would maintain, however, that, at a minimum, those criteria should be specified in detail in order for the provision to provide certainty as to which characterization would apply and that merely requiring that the deemed-financing result would fail to clearly reflect income is too vague a standard for this purpose.

The proposal has a self-contained constructive sale rule to prevent abuse of its provisions. The perceived abuse would be utilizing the deemed-financing treatment to effect a monetization of an appreciated position without creating a taxable event. This rule takes a pro rata approach, such that if the value of the strip was equal to 60 percent of the value of the appreciated property, the owner of the appreciated property would recognize 60 percent of the gain that would be

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[420] Although the scope of this aspect of the proposal is not clear, it is possible that the targeted foreign tax credit opportunities would be similar to those described in Notice 98-5, 1998-1 C.B. 334. See also section 901(k).

recognized were the underlying property sold for its fair market value. This constructive sale rule, although arguably necessary as a backstop to the general rule, seems fundamentally at odds with the notion that the payment is a deemed loan.

Prior Action

No prior action.

6. Require ordinary treatment for options dealers and commodities dealers

Present Law

In general, gain or loss on the sale of stock in trade of the taxpayer or other property of a kind which would properly be included in inventory, or property that is held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, is treated as ordinary income.

Commodities dealers (as defined in section 1402(i)(2)(B)) and options dealers (as defined in section 1256(g)(8)) report their gains and losses from the trading of "section 1256 contracts" (other than certain hedging transactions) under a mark-to-market regime.[421] Under this regime, gains and losses from the trading of section 1256 contracts are treated as arising from the sale or exchange of a capital asset.[422] The resulting gain or loss (as well as any gain or loss from any section 1256 contract that was closed during the taxable year) is treated as if it is 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss (the "60/40 rule").

A commodities dealer means any person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission. An options dealer means any person registered with a national securities exchange as a market maker or specialist in listed options, as well as any person whom the Secretary determines performs similar functions. A "section 1256 contract" is defined as any (1) regulated futures contract, (2) foreign currency contract, (3) nonequity option, and (4) dealer equity option.

A dealer in securities must compute its income pursuant to the mark-to-mark method of accounting. Any security that is inventory in the hands of the dealer must be included in inventory at its fair market value, and any security that is not inventory and that is held at the end of the taxable year is treated as having been sold for its fair market value. The resulting gain or loss generally is treated as ordinary gain or loss. Commodities dealers (as well as traders in commodities and securities) can elect the application of section 475.

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[421] Section 1256.

[422] Section 1256(f)(3)(A).

Description of Proposal

The proposal would require commodities dealers and options dealers to treat the income from their day-to-day dealer activities with respect to section 1256 contracts as ordinary in character, not capital. Thus, under the proposal, the 60/40 rule would no longer apply with respect to gains and losses of commodities dealers and equity options dealers. The proposal would not affect the application of the mark-to-market rules with respect to such gains and losses.

Effective date.--The proposal would be effective for tax years beginning after the date of enactment.

Analysis

The proposal would provide that a commodities dealer's and an option dealer's gains and losses with respect to section 1256 contracts would be treated as ordinary income. The proposal thus would deny such dealers the benefits of the 60/40 rule, but would allow net losses to be taken into account without regard to any capital loss limitations. The proposal would not otherwise affect the present-law requirement that such dealers report their gains and losses under the mark-to-market method. In essence, the proposal would make the rules of section 475 mandatory with respect to these dealers in lieu of the rules under section 1256.

The 60/40 rule provides favorable treatment for certain dealers with respect to income that otherwise would not qualify for preferential capital gains treatment. This special treatment is not currently relevant in the case of corporate dealers, where the alternative capital gains rate is the same as the rate for ordinary income. For individuals, however, the 60/40 rule results in a maximum tax rate of 27.84 percent on their business income. Proponents would argue that eliminating the 60/40 rule for commodities dealers and options dealers is appropriate -- their business income should be taxed in the same manner as dealers of other types of property.

Some will contend that the 60/40 rule, which was enacted in 1981 and expanded in 1984, was intended to provide the benefit of a lower rate for these taxpayers who, by virtue of the enactment of the mark-to-market regime, were being required to pay tax with respect to gains prior to their realization. The mark-to-market method also makes it impossible to establish a long-term holding period with respect to section 1256 contracts. The 60/40 rule could be viewed as ameliorating these aspects of the mark-to-market regime and, therefore, its retention is appropriate. Others would respond by noting that these concerns have become less significant since the 1993 enactment of section 475, which mandates mark-to-market treatment (and ordinary gain or loss) for dealers in securities.[423]

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[423] In 1997, section 475 was expanded to include an elective regime for commodities dealers (and traders in commodities and securities).

Prior Action

No prior action.

7. Prohibit tax deferral on contributions of appreciated property to swap funds

Present Law

In general, a contribution of property to a controlled corporation does not result in the recognition of gain or loss to the contributing shareholder.[424] Similarly, a contribution of property to a partnership generally does not result in the recognition of gain to the contributing partner.[425] One exception to the general nonrecognition rule is when property is contributed to a corporation that is an "investment company;" gain or loss is recognized on such a contribution.[426] Similarly, gain (but not loss) is recognized on a contribution of property to a partnership that would be treated as an investment company if the partnership were incorporated.[427]

Under Treasury regulations, a contribution of property to a corporation (or to a partnership) is treated as a transfer to an investment company if: (1) the transfer results in diversification of the transferor's interests, and (2) the transferee is (a) a regulated investment company ("RIC"), (b) a real estate investment trust ("REIT"), or (c) a corporation more than 80 percent of the value of whose assets (excluding cash and non-convertible debt obligations) are held for investment and are readily marketable stocks or securities, or interests in RICs or REITs.[428]

A transfer ordinarily results in the diversification of the transferors' interests if two or more persons transfer non-identical assets to a corporation in the exchange. The regulations provide an exception for exchanges in which each transferor transfers a diversified portfolio of stock and securities.[429]

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[424] Section 351.

[425] Section 721.

[426] Section 351(e)(1).

[427] Section 721(b).

[428] Treas. Reg. sec. 1.351-1(c)(1).

[429] Treas. Reg. sec. 1.351-1(c)(6). For this purpose, a portfolio of stock and securities is diversified if not more than 25 percent of the value of the portfolio is invested in the stock and securities of any one issuer and not more than 50 percent of the value of the portfolio is invested in the stock and securities of five or fewer issuers.

Description of Proposal

The proposal would add limited or preferred partnership interests to the list of stock and securities that are taken into account in determining whether a corporation (or a partnership) is an investment company. In addition, the proposal would require a taxpayer to recognize gain on the transfer of marketable stock or securities to a corporation (or partnership) that is: (1) registered under the Investment Company Act of 1940 ("1940 Act") as an investment company; (2) not required to be registered under the 1940 Act because the interests in the fund are offered only to qualified purchasers within the meaning of the 1940 Act; or (3) marketed or sold to investors as providing a means of tax-free diversification.

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

Analysis

Under present law, a partnership or corporation is not treated as an investment company as long as at least 20 percent of the assets are not readily marketable stocks or securities. Certain investment funds, commonly known as "exchange funds" or "swap funds," have been structured in ways that circumvent the definition of an investment company and yet achieve the same desired objective -- diversification of a concentrated ownership of highly-appreciated stock or securities into a broader variety of other stocks and securities without paying tax at the time of the exchange.

Congress has been aware of swap funds and has enacted legislation on several occasions to curtail their availability. In 1966, Congress enacted legislation that prevented the tax-free formation of corporate funds where the result is a diversification of the investor's portfolio. Ten years later, Congress expanded the rule to include transfers to partnerships.[430] Most recently, the Taxpayer Relief Act of 1997 included a provision that expanded the types of assets that are taken into account for purposes of applying the investment company rules. Notwithstanding these efforts, funds continue to be organized in ways that circumvent the intent of the legislative efforts. For example, one particular fund was marketed as avoiding the investment company definition by maintaining 21 percent of its assets in passive interests in real estate limited partnerships.[431]

The proposal contains two elements. First, the proposal would add limited or preferred partnership interests to the list of assets that are taken into account in determining whether a

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[430] See section 2131 of the Tax Reform Act of 1976, P.L. 94-455 (94th Cong.), 1976.

[431] See Lee Sheppard, "Ruby Slippers: Combating Tax-Free Formation of Investment Companies," 84 Tax Notes 1699 (Sept. 27, 1999).

corporation (or partnership) is an investment company. This modification is in direct response to the publicized swap fund previously mentioned.

The second element of the proposal would require gain recognition on the transfer of a non-diversified portfolio of marketable securities to any corporation (or partnership) that is either (1) registered as an investment company, (2) falls within the qualified purchasers exception to the registration requirement, or (3) otherwise is marketed or sold to investors as providing a means of tax-free diversification. This element of the proposal is significant in that it would minimize the importance of the definition of an investment company. Instead, the determination of whether a transfer of marketable securities triggers immediate recognition event would depend on whether the portfolio is diversified, as well as on subjective intent. Some may contend that the proposal is overly broad, and that substituting a subjective intent test for the present-law 80 percent test could create new uncertainties and lead to different treatment of taxpayers. Furthermore, since many of the rules in this area (such as the 80 percent test) are found in the regulations, the Treasury Department already has the ability to correct any problems. Others may respond by noting that the legislative and administrative efforts to date in this area, which have relied on targeted and objective standards, have not succeeded in eliminating swap funds. Therefore, a broader response is warranted.

The proposal would not apply to transfers of already diversified portfolios. Thus, the transfer of a diversified portfolio of marketable securities by a feeder fund to a master-feeder fund, as well as the transfer of a diversified portfolio of securities in connection with a securitization, would not be affected by the proposal.

Prior Action

No prior action.[432]

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[432] However, a similar proposal (H.R. 2705) has been introduced in the 106th Congress by Representative Richard Neal.

C. Provisions Affecting Corporations and Pass-Through Entities

1. Conform control test for tax-free incorporations, distributions, and reorganizations

Present Law

The tax consequences of a particular corporate transaction (such as an incorporation, distribution, or a reorganization) often depend on whether the "control" test is satisfied. For these purposes, the term "control" is defined as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation (sec. 368(c)).

For purposes of determining whether two corporations are sufficiently affiliated so that, in essence, they are treated as a single corporation for some tax purposes (such as the filing of a consolidated return, tax-free liquidations, and qualified stock purchases), the ownership test requires 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 (sec. 1504(a)(2)). For this purpose, stock does not include preferred stock that meets the requirements of section 1504(a)(4).

Description of Proposal

The proposal would conform the control test under section 368(c) with the affiliation test under section 1504(a)(2). Thus, "control" would be defined as the ownership, directly or through one or more controlled corporations, of stock possessing at least 80 percent of the total voting power of the stock of the corporation, and at least 80 percent of the total value of the stock of the corporation. For this purpose, stock would not include preferred stock that meets the requirements of section 1504(a)(4).

Effective date.--The proposal would be effective for transactions on or after the date of enactment.

Analysis

Recent corporate transactions have highlighted the use of an equity structure where the voting power and the value have been separated (e.g., one class of common stock is heavy vote-light value stock, and another class is light vote-heavy value). This separation of vote from value permits a party to satisfy the "control" test through voting power, while disposing of much of the value of the common stock and future growth of a subsidiary. Some observers have characterized this as the disposition of a subsidiary in a transaction that has characteristics of a sale but nonetheless is designed to qualify for tax-free treatment.[433]

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[433] See, e.g., Sloan, "Corporations' Last-Minute Lunge For an Obscure Tax Loophole," The Washington Post (July 6, 1999), C-3; Sisk, "Conoco Deal Seen Legitimizing Spinoff Tax

One type of transaction where the disproportionate equity structure has been used is with tax-free spin-offs. A corporation must "control" a subsidiary at the time of the spin-off to qualify for tax-free treatment. However, the disposition of significant stock value can occur prior to the spin-off through the issuance of "light vote" stock. The parent corporation may use the proceeds of such stock issuance as cash it retains tax-free in connection with the disposition.

Light vote-heavy value stock also has been used in connection with reorganizations. Voting preferred stock is combined with voting common stock in a transaction that arguably resembles a disguised sale but is structured to qualify as a tax-free reorganization (so the seller can avoid capital gains). The putative seller transfers appreciated property in exchange for a stock interest that shares in little, if any, of the economic growth potential of the property it formerly owned--the growth potential now belongs to the other party to the transaction (the buyer). Instead, the seller's stock interest reflects the economic value of property (including cash) contributed by the buyer as part of the transaction.[434]

The proposal is intended to curtail the ability to engage in tax-free transactions with "sales-like" characteristics. At the same time, some commentators argue that the proposal is overly broad because it would affect other corporate transactions that lack this element. Some question whether changing this long-standing rule[435] is necessary, and whether it could result in new planning opportunities. Moreover, such a change could have significant collateral (and unintended) consequences that must be analyzed in connection with the proposal.

The development of this proposal is comparable to the history of the affiliation test under section 1504(a). Prior to 1984, the affiliation test required an ownership of 80 percent of the voting power and 80 percent of each class of the nonvoting stock of each includible corporation. In the Deficit Reduction Act of 1984, Congress amended section 1504(a) to include an 80-percent value test, in part because "notwithstanding the intent of the provision, 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

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Technique," Corporate Financing Week, Vol. XXIV, No. 46 (November 16, 1998).

[434] See, e.g., Sheppard, "Corporate Sales: Ignore that LLC behind the Curtain," 82 Tax Notes 32 (January 4, 1999).

[435] Section 202(c)(3) of the Revenue Act of 1921 provided that "for purposes of [the predecessor to section 351], a person is, or two or more persons are, 'in control' of a corporation when owning at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation."

corporation."[436] Congress did not amend the section 368(c) control test.[437] Some commentators, however, question whether the two tests serve similar purposes.[438]

Under present law, if light vote-heavy value stock is issued in an IPO that is related to a tax-free spin-off, and the stock has a value equal to or greater than 50 percent of the issuing corporation, then the IPO would result in a corporate level tax under section 355(e). Thus, in section 355 transactions, the disproportionate equity structure is relevant only when the stock being issued has a value of between 20-50 percent of the issuing corporation. Moreover, a similar result might be achieved by having the issuing corporation borrow funds and distribute the proceeds to the parent prior to the spin-off. It is also arguable that to the extent that the parent's basis in the stock of the subsidiary reflects post-affiliation earnings, the parent corporation should be able to receive these amounts regardless of whether the source of the funds is from leveraging or from an IPO using light vote-heavy value stock.

One aspect of the proposal is that, in determining whether the 80-percent vote and value test is satisfied, so-called "pure" preferred stock would be excluded from the calculations.[439] This raises a question of whether pure preferred stock could be used as a substitute for light vote-

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[436] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, 170-171.

[437] In 1985, the staff of the Senate Finance Committee recommended amending the control test to conform with the new affiliation test. See, Senate Finance Committee Staff Report, *The Subchapter C Revision Act of 1985*, S. Print 99-47, 99th Cong., 1st Sess. (1985), proposed section 366(c).

[438] See, American Bar Association Section of Taxation, Comments on Proposed Change to Section 368(c) Definition of Corporate Control, 1999 TNT 68-24, at 7 (April 7, 1999) ("The analogy [between the 1984 change to the section 1504 control test and the proposal] is not appropriate, however, because the policies underlying the control requirement in a consolidated return context call for a stricter definition of control than do the policies for the control requirement in section 368."). Cf. New York State Bar Association Tax Section, "Report on Proposal to Amend the Control Test in Section 368(c)," 1999 TNT 135-28 (July 9, 1999) (majority supports inclusion of an 80 percent value standard for purposes of the section 368(c) control test; a significant minority believes that less unity should be required to avoid a recognition event in an incorporation or reorganization transaction than should be required to treat two taxpayers as one under section 1504).

[439] The term "pure" preferred stock refers to preferred stock that satisfies the requirements of section 1504(a)(4).

heavy value stock.[440] However, in other instances where ownership is relevant, the value of pure preferred stock is disregarded.[441]

Another aspect of the proposal is that it would permit the control test to be satisfied via the indirect ownership of the stock through one or more controlled corporations. On the one hand, this aspect of the proposal could be viewed as consistent with the principles of the post-acquisition drop-down rules of section 368(a)(2)(C) and recent regulations issued under section 368.[442] It also would provide the parties with greater planning flexibility, particularly with respect to acquisitive reorganizations -- for example, triangular reorganizations using grandparent stock would be permitted. On the other hand, the proposal appears to be a significant liberalization of the control requirement. Therefore, it potentially could have unanticipated collateral consequences in both the corporate area as well as other areas that rely on the section 368 control definition.

Prior Action

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal.

2. Treat receipt of tracking stock as property

Present Law

The term "tracking stock" refers to a special class of stock of an issuing corporation that tracks the performance or value of one or more separate assets of the issuing corporation. The holder of tracking stock has the right to share in the earnings or value of less than all of the corporate issuer's earnings or assets (i.e., 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 IRS has indicated it will not rule on whether tracking stock is treated as stock of the issuer.[443] Whether tracking stock represents stock of the issuer is dependent upon the correlation of the rights of the stock to the underlying assets.

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[440] The pure preferred stock could not be considered "nonqualified preferred stock" as defined in section 351(g).

[441] See, e.g., sections 332(b)(1) and 338(d)(3). Cf. section 382(e)(1), where the value of pure preferred stock is included in determining the value of a corporation.

[442] See, e.g., Treas. Reg. See. 1.368-1(d), -1(e), and -2(k).

[443] Rev. Proc. 2000-3, 2000-1 I.R.B. 103, sec. 3.01(44) states that the IRS will not issue rulings regarding the classification of an instrument that has certain voting and liquidation rights in an issuing corporation but whose dividend rights are determined by reference to the earnings of a segregated portion of the issuing corporation's assets, including assets held by a subsidiary.

Tracking stock is often issued to shareholders in respect of their shares held in a distributing corporation. The receipt of tracking stock in such a manner may be tax-free if the distribution qualifies a stock dividend under section 305. If, in addition to the tracking stock of the issuing corporation the shareholder also receives other assets, such other property is generally treated as a dividend to the shareholder. Similar rules apply to exchanges that qualify as tax-free recapitalizations under section 368(a)(1)(e) or certain other stock-for-stock exchanges under section 1036.

Description of Proposal

The proposal would treat the receipt of tracking stock, in the hands of a shareholder, as a receipt of other property in the case of (1) a distribution of a corporation's tracking stock made by such corporation with respect to its stock or (2) tracking stock received in exchange for other stock in the issuing corporation (either in a recapitalization or section 1036 exchange). The proposal would not apply to a stock split of tracking stock or any similar transaction. Under the proposal, the Treasury 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 for other purposes.

The proposal would not apply to an issuance of tracking stock if the underlying "tracked" assets could be distributed in a transaction that would qualify for tax-free treatment under section 355.

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). In making such determinations, factors taken into account would include whether (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 value of the tracked entity or assets.

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

Effective date.--The proposal would be effective for tracking stock issued on or after the date of enactment.

Analysis

Tracking stock has been utilized in many ways, including raising capital, providing consideration in acquisitions, and representing valuable property in distribution-type transactions. The Administration's concern is that tracking stock is utilized to create a structure that fundamentally changes the shareholder's interest in the issuing corporation.

Some commentators have suggested that tracking stock can be used to obtain some of the benefits, without the related tax burden, of an actual distribution that would not otherwise qualify under section 355. An actual distribution of only a portion of the assets of a corporation or the stock of a subsidiary would generally result in taxable income to the shareholders equal to the value of the property received (and gain to the distributing corporation on any appreciation of such property). However, others contend that the rights associated with tracking stock can reflect significant differences from a stock ownership that is limited directly to the underlying tracked assets. Opponents may also argue that taxpayers should be free to alter a holder's equity interest, for example in recapitalizations or stock-on-stock distributions, to account for features that satisfy the current investor demands.[444]

The proposal would provide an exception where the underlying "tracked" assets could be distributed in a transaction otherwise eligible for section 355 treatment. This responds to criticisms with respect to taxpayers that have the present ability to undertake a tax-free section 355 transaction but, for non-tax business reasons, prefer to issue tracking stock. However, the proposal does not describe how the tracked assets would be measured in determining whether such assets could be distributed pursuant section 355. Presently, section 355 requires the distribution of "control," which is defined as stock possessing at least 80 percent of the voting power and at least 80 percent of the number of shares in each and every class of nonvoting stock. Tracking stock, however, traditionally tracks all or a portion of the earnings or value of a group of assets. This dichotomy may create uncertainty such that taxpayers may be leery of relying on this exception until detailed guidance is issued.

Under present law, the IRS has indicated that it will not rule on the proper classification of tracking stock, although taxpayers have been permitted to represent that tracking stock is stock of the parent corporation issuer (rather than of a subsidiary, for example) in obtaining private letter rulings. Most taxpayers, though, obtain advance rulings with respect to section 355 transactions. Query whether taxpayers would be able to request an advance ruling as to their qualification under the exception to the tracking stock proposal (i.e., whether the "tracked" assets could be distributed pursuant to section 355). The IRS historically is not accustomed to issuing "what if" guidance.

Analytical questions have been raised regarding the proper treatment of tracking stock. Some commentators have suggested that if there is a high correlation between the economic performance of the tracking stock and the tracked assets, the tracking stock could be viewed as if it were an interest in a joint venture between the parent corporation and the holders of tracking stock.[445] If a corporation actually distributed to its shareholders an interest in a joint venture that

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[444] The issuance of tracking stock in exchange for cash would not be subject to tax under the proposal.

[445] New York State Bar Association Tax Section, "Report on Tracking Stock Arrangements", 43 Tax Law Review 51 (Fall 1987).

was not treated as stock of the issuer, then the shareholders generally would be subject to tax on the value of property received (and the corporation generally would pay tax on the excess of the value of the distributed rights over the basis in the hands of the corporation). Alternatively, a primary offering by the joint venture might be nontaxable. A disposition or offering of a sufficiently large interest in the venture would prevent consolidation with the parent.

Issues may arise regarding the value and nature of the interest deemed distributed under the Treasury proposal. For example, tracking stock may be structured in any number of ways that could result in holders having very different types of rights with respect to tracked assets. While it generally is anticipated that the issuing corporation will pay dividends linked to the tracked assets, in many instances holders of tracking stock may not actually be entitled to the dividends, even though the tracked assets are profitable, if the parent corporation does not declare dividends. The tracked assets may be subject to liabilities of the parent corporation that could diminish the tracking stock shareholders' interests in the values of such assets. In such circumstances, it might be questioned whether the issuance of such stock is economically equivalent to a direct ownership of the underlying assets. Critics of the proposal also note that a shareholder receiving tracking stock under the proposal may not have the wherewithal to pay the related tax liability unless, perhaps, he or she sells some of his or her investments and uses the cash proceeds to satisfy the tax obligation.

The proposal authorizes the Secretary of the Treasury to treat tracking stock as an interest other than stock, or as stock of another entity, and to provide for increased basis in the tracked assets as the result of gain recognized. While it would be anticipated that any unfavorable guidance would apply only on a prospective basis, until guidance is issued, taxpayers would face uncertainty regarding the treatment of any particular transaction.

Prior Action

A similar proposal was included in the President’s Fiscal Year 2000 Budget Proposal, except such proposal would have required the corporation that issued the tracking stock to recognize gain, rather than the shareholder who received the tracking stock. Also, last year’s proposal did not provide an exception when the tracked assets could have otherwise qualified for section 355 treatment.

3. Require consistent treatment and provide basis allocation rules for transfers of intangibles in certain nonrecognition transactions

Present Law

Generally, no gain or loss is recognized if one or more persons transfer property to a corporation solely in exchange for stock in the corporation and, immediately after the exchange such person or persons are in control of the corporation. Similarly, no gain or loss is recognized in the case of a contribution of property in exchange for a partnership interest. Neither the Code nor the regulations provide the meaning of the requirement that a person "transfer property" in exchange for stock (or a partnership interest). The IRS interprets the requirement consistent with the "sale or other disposition of property" language in the context of a taxable disposition of property. See, e.g., Rev. Rul. 69-156, 1969-1 C.B. 101. Thus, a transfer of less than "all substantial rights" to use property will not qualify as a tax-free exchange and stock received will be treated as payments for the use of property rather than for the property itself. These amounts are characterized as ordinary income. However, the Claims Court has rejected the IRS'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.[446]

Description of Proposal

Under the proposal, the transfer of an interest in intangible property constituting less than all of the substantial rights of the transferor in the property may be treated as a transfer of property and thus be eligible for nonrecognition treatment, for purposes of the nonrecognition provisions regarding transfers of property to controlled corporations and to partnerships. Consistent reporting by the transferor and transferee would be required. Further, under the proposal, in the case of a transfer of less than all of the substantial rights that is treated as a transfer of property, the transferor would be required to allocate the basis of the intangible between the retained rights and the transferred rights based upon their respective fair market values.

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

Effective date.--The proposal is effective for transfers on or after the date of enactment.

Analysis

The proposal is directed at the potential "whipsaw" that could arise under present law. For example, the transferor and transferee might take inconsistent positions regarding whether the transfer qualified at all as a transfer of property under section 351. The transferor might take the position that the transfer qualified as a transfer of property (resulting in no gain to the transferor) while the transferee might take the position that the transfer failed to qualify, resulting in "sale" treatment and a basis step-up to the transferee. In addition, some taxpayers might treat the transfer as a transfer of property without gain recognition, but might fail to allocate basis between the rights transferred and the rights retained.

The proposal would generally remove much of the uncertainty regarding whether transfers of less than all intangible rights can qualify as a transfer of property. The proposal would also require basis allocation, thus clarifying the appropriate results when tax-free

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[446] See E.I. DuPont de Nemours & Co. v. U.S.,471 F.2d 1211 (Ct. Cl. 1973).

treatment is provided. The requirement of valuation of rights retained and transferred, however, arguably may add complexity.

The proposal might arguably allow some amount of electivity, since taxpayers might still attempt to structure a transfer of less than all rights as a license rather than a contribution or property with basis allocation. However, the proposal would require consistent treatment by transferors and transferee. It is unclear how the proposal would enforce this requirement.

Prior Action

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal and in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President.

4. Modify tax treatment of certain reorganizations in which portfolio interests in stock disappear

Present Law

The combination of a parent and subsidiary corporation may qualify for tax-free treatment as either a liquidation pursuant to section 332 or a reorganization pursuant to section 368. The determination of which rule may apply to a particular transaction generally depends on the legal form (e.g., upstream v. downstream and statutory merger v. asset transfer) of the transaction. In both of these tax-free transactions, any difference between the value and basis of any subsidiary corporation stock held by the parent corporation disappears, without recognition of gain or loss.

A subsidiary corporation that merges upstream (or completely liquidates) into its parent corporation may receive tax-free treatment as either a section 332 liquidation or a section 368 reorganization, depending on the amount of stock ownership. If the parent corporation owns at least 80 percent of the subsidiary corporation's voting power and value (as defined in section 1504) and certain other requirements are satisfied, the transaction generally qualifies as a liquidation pursuant to sections 332 (tax-free to the parent corporation) and 337 (tax-free to the subsidiary corporation).[447] If, however, the parent owns less than either 80 percent of the stock of the subsidiary corporation, by vote or value, sections 332 and 337 are not applicable. In cases where the parent corporation does not satisfy the 80-percent ownership requirement, an upstream merger of a subsidiary corporation into its parent corporation may qualify as a tax-free reorganization pursuant to section 368, if certain other requirements are met.[448]

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[447] Section 332(b) (last sentence) and Treas. Reg. sec. 1.332-2(d).

[448] Treas. Reg. sec. 1.368-1(e)(6), Ex. 7; Rev. Rul. 58-93, 1958-1 C.B. 188; May B. Kass v. Commissioner, 60 T.C. 218 (1973); GCM 39404; PLR 9321025 (Feb. 22, 1993); and

A parent corporation that merges (or transfers its assets) downstream into its subsidiary may qualify for tax-free treatment pursuant to section 368, irrespective of the amount of subsidiary corporation stock held by the parent corporation, assuming that certain other requirements are met.[449]

Description of Proposal

Under the proposal, where a parent corporation holds less than 20 percent of the value of the stock of a subsidiary corporation and the parent corporation combines downstream with the subsidiary corporation in a reorganization in which the subsidiary corporation is the survivor, the parent corporation would recognize gain, but not loss, as if it distributed the subsidiary corporation stock immediately prior to the reorganization. As long as the other requirements for a reorganization are satisfied, nonrecognition treatment would continue to apply to other assets transferred by the parent corporation to the subsidiary and to the stock and securities received by the parent corporation shareholders.

The proposal also would apply where a parent corporation owns less than 20 percent of the value of the stock of a subsidiary corporation and the subsidiary corporation combines upstream with and into the parent corporation or a second subsidiary of the parent corporation. In such cases, the parent corporation would recognize gain, but not loss, as if it sold its subsidiary corporation stock immediately prior to the reorganization. As long as the other requirements for a reorganization are satisfied, nonrecognition treatment would continue to apply to other assets transferred by the subsidiary corporation to the parent corporation (or a second subsidiary of the parent corporation).

Effective date.--The proposal would be effective for transactions on or after the date of enactment.

Analysis

The proposal would require gain, but not loss, to be recognized by a parent corporation with respect to a subsidiary corporation's stock in what would otherwise qualify as tax-free downstream reorganizations, but only if the parent corporation owns less than 20 percent of the value of the subsidiary corporation's stock. The proposal also would require similar gain

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PLR 9011042 (Dec. 20, 1989).

[449] Rev. Rul. 78-47, 1978-1 C.B. 113; Rev. Rul. 70-223, 1970-1 C.B. 79; Rev. Rul. 57-465, 1957-2 C.B. 250; Rev. Rul. 85-107, 1985-2 C.B. 121; Commissioner v. Estate of Gilmore, 130 F.2d 791 (3d Cir. 1942); Edwards Motor Transit Co. v. Commissioner, 23 T.C.M. (CCH) 1968 (1964); George v. Commissioner, 26 T.C. 396 (1956); PLR 9212018 (Dec. 20, 1991); PLR 9506036 (Nov. 15, 1994); and Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 75 (2d Cir. 1959).

recognition by a parent corporation with respect to a less-than-20-percent-owned (determined by value) subsidiary corporation's stock in what would otherwise qualify as a tax-free upstream reorganization (or a reorganization into a second subsidiary of the parent corporation). The proposal would alter long-standing judicial and administrative precedents that generally support nonrecognition treatment for all parties, and with respect to all assets, in otherwise qualifying downstream or upstream reorganizations (as well as other forms of corporate tiering and un-tiering where gain inherent in underlying assets is preserved).

Opponents of the proposal note that a taxpayer's nontax business purposes for engaging in the specified transactions are not take into account under the proposal. Rather, every transaction described by the objective rule would be subject to tax regardless of intent. On the other hand, the proposal's application is limited to transactions involving only portfolio investments in stock, which arguably should not require an analysis of business purpose.[450]

Proposal advocates argue that a downstream reorganization is functionally equivalent to a taxable distribution by parent corporation of the subsidiary corporation stock followed by a tax-free merger, and that tax law neutrality principles suggest that economically similar transactions should receive similar tax treatment. This year's proposal provides consistency by taxing both upstream and downstream combinations where portfolio stock disappears.

The carryover basis rules of tax-free reorganizations arguably contemplate that the basis of the transferred assets will be relevant to an acquiring corporation. In a downstream reorganization, the parent corporation's basis in the subsidiary corporation stock is irrelevant in the hands of the subsidiary corporation. Similarly, in an upstream merger, the parent corporation's basis in the subsidiary corporation's stock will disappear. Since the carryover basis rationale in tax-free reorganizations cannot apply to subsidiary corporation stock in a downstream or upstream merger, proposal advocates argue that the nonrecognition is not warranted, particularly with respect to a portfolio investment.

Opponents of the proposal argue that downstream and upstream mergers at least do not step up the basis of underlying assets, and may even result in an additional corporate level of taxation. However, present law generally does tax a direct sale or distribution of subsidiary stock unless the distribution qualifies under section 355 as tax-free. Furthermore, after the merger, the former parent corporation shareholders may not own separate interests in the former parent corporation and subsidiary corporation. Thus, the transaction may differ from an actual distribution.

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[450] Section 243 denies any dividends received deduction with respect to investments in less than 20-percent (by vote and value) owned subsidiaries without inquiring as to the taxpayer's intent in owning such an investment.

Some commentators have suggested that the Treasury Department already has authority under section 337(d) to issue regulations that would implement the features of this proposal. However, the matter of authority is not entirely clear.

As with any gain recognition provision, increased complexity may be caused by valuation issues. Non-publicly traded stock valuations are difficult because the underlying tangible and intangible business assets must be valued and other factors such as minority discounts and control premiums must be considered.

Prior Action

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal, except that such proposal, among other things, would not have been limited to ownership of less than 20 percent of the value.

5. Clarify definition of nonqualified preferred stock

Present Law

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. For this purpose, preferred stock is defined as stock which is "limited and preferred as to dividends and does not participate in corporate growth to any significant extent." Nonqualified preferred stock is defined as any preferred stock if (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase, (3) the issuer or a related person has the right to redeem or repurchase and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate 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 (1), (2) and (3) 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.

Description of Proposal

The proposal would clarify the definition of preferred stock to ensure that stock for which there is not a real and meaningful likelihood of actually participating in the earnings and growth of the corporation is considered to be preferred.

No inference is intended as to the characterization of stock under present law that has terms providing for unlimited dividends or participation rights but, based on all the facts and circumstances, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

Effective date.--The proposal would apply to transactions that occur after the date of first committee action.

Analysis

The proposal is intended to deal with cases where taxpayers attempt to avoid characterization of an instrument as nonqualified preferred stock by including illusory participation rights or including terms that taxpayers argue create an "unlimited" dividend. As one example, a corporation that does not pay dividends either to its common or preferred shareholders may create instruments that have a preference on liquidation, but that are entitled to the same dividends as may be declared on common stock (of which there are not expected to be any). As another example, a stock might entitle the holder to a dividend of the greater of 7 percent or whatever the common shareholders receive, while in practice the common shareholders are not expected to receive dividends greater than 7 percent.

It is arguable that the Treasury Department has the ability under existing law to challenge the creation of illusory participation or dividend rights. However, the proposal would clarify the issue and conserve IRS resources.

Although the proposal does not so state, consideration could also be given to whether it is desirable to clarify the definition of preferred stock in other areas of the Code where a similar definition appears.

Prior Action

No prior action.

6. Clarify rules for payment of estimated taxes for certain deemed asset sales

Present Law

In certain circumstances, taxpayers can make an election under section 338(h)(10) to treat a qualifying purchase and sale of 80 percent of the stock of a target corporation from another corporation as a purchase and sale of the assets of the target corporation. The election must be made jointly by the buyer and seller and is due by the 15th day of the ninth month beginning after the month in which the acquisition date occurs. Section 338 also permits a unilateral election by a buyer corporation to treat a qualified stock acquisition as a deemed asset acquisition, whether or not the seller is a corporation. Section 338(h)(13) provides that, for purposes of section 6655 (relating to additions to tax for failure by a corporation to pay estimated income tax), tax attributable to a deemed asset sale shall not be taken into account.

Description of Proposal

The proposal would clarify section 338(h)(13) to require that estimated taxes be paid based upon the deemed asset sale where there is an agreement to make the section 338(h)(10) election, or upon the stock sale where there is no such agreement.

No inference is intended as to the applicability of the penalty for nonpayment of estimated taxes for these transactions prior to the effective date.

Effective date.--The proposal would be effective for transactions that occur after the date of first committee action.

Analysis

The proposal reflects a concern that some taxpayers are taking the position that, in the case of a sale of a target corporation that would be eligible for a section 338(h)(10) election, they do not have to pay any estimated taxes (either on the gain from the actual sale of stock in the case no section 338(h)(10) election will be made or on the gain from a deemed asset sale in the case where an election will be made). Typically, because the section 338(h)(10) election is made jointly by the buyer and the seller, the parties know at the time of the transaction whether such election will be made, and thus the seller should pay estimated taxes accordingly.

Furthermore, even if the parties do not know whether the election will be made, an actual stock sale has occurred that should be included in estimated tax liability.

Opponents might contend that a subsequent election could change actual tax liability. However, proponents take the view that the more appropriate result in such a case would be an adjustment to later liability, rather than an exemption of the transaction from estimated tax consequences.

Prior Action

No prior action.

7. Modify treatment of transfers to creditors in divisive reorganizations

Present Law

Section 355 of the Code permits a corporation ("distributing") to separate its businesses by distributing a subsidiary tax-free, if certain conditions are met. In cases where the distributing corporation contributes property to the corporation ("controlled") that is to be distributed, no gain or loss is recognized if the property is contributed solely in exchange for stock or securities of the controlled corporation (which are subsequently distributed to distributing's shareholders).

The contribution of property to a controlled corporation that is followed by a distribution of its stock and securities may qualify as a reorganization described in section 368(a)(1)(D). That section also applies to certain transactions that do not involve a distribution under section 355 and that are considered "acquisitive" rather than "divisive" reorganizations.

The contribution in the course of a divisive section 368(a)(1)(D) reorganization is also subject to the rules of section 357(c). That section provides that the transferor corporation will recognize gain if the amount of liabilities assumed by controlled exceeds the basis of the property transferred to it.

Because the contribution transaction in connection with a section 355 distribution is a reorganization under section 368(a)(1)(D), it is also subject to the certain rules applicable to both divisive and acquisitive reorganizations. One such rule, in section 361(b), states that a transferor corporation will not recognize gain if it receives money or other property and distributes that money or other property to its shareholders or creditors. The amount of property that may be distributed to creditors without gain recognition is unlimited under this provision.

Description of Proposal

The proposal would limit the amount of money or other property that a distributing corporation can distribute to its creditors without gain recognition under section 361(b) to the amount of the basis of the assets contributed to a controlled corporation in a divisive reorganization. In addition, the proposal would provide that acquisitive reorganizations under section 368(a)(1)(D) would no longer be subject to the liabilities assumption rules of section 357(c).

Effective date.--The proposal would be effective for transactions on or after the date of enactment.

Analysis

The proposal reflects a concern that taxpayers engaged in divisive section 355 transactions can effectively avoid the rules that require gain recognition if the controlled corporation assumes liabilities of the transferor that exceed the basis of assets transferred to such corporation.[451] This could occur because of the rules of section 361(b), which state that the transferor can receive money or other property from the transferee without gain recognition, so long as that money or property is distributed to creditors of the transferor. For example, a transferor corporation could receive money from the transferee corporation (e.g., money obtained from a borrowing by the transferee) and use that money to pay the transferor's creditors, without

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[451] Some might contend that the transferor's total stock basis in the controlled corporation, rather than the basis of assets transferred at the time, could be an alternative appropriate benchmark for measuring gain.

gain recognition. The transaction is economically similar to the actual assumption by the transferee of the transferor's liabilities, but is taxed differently because section 361(b) does not contain a limitation on the amount that can be distributed to creditors.

The proposal also would liberalize the treatment of acquisitive reorganizations that are included under section 368(a)(1)(D). In these cases, the transferor would be permitted to assume liabilities of the transferee without application of the rules of section 357(c). Such an exception is proposed because in an acquisitive reorganization under section 368(a)(1)(D) the transferor must generally transfer substantially all its assets to the acquiring corporation, and then go out of existence. Assumption of its liabilities by the acquiring company thus does not enrich the transferor corporation, which ceases to exist and whose liability was limited to its assets in any event, by its corporate form. The proposal would conform the treatment of acquisitive reorganizations under section 368(a)(1)(D) to that of other acquisitive reorganizations.

Prior Action

No prior action.

8. Provide mandatory basis adjustments if partners have significant built-in loss in partnership property

Present Law

Partnership's basis in remaining assets following a distribution

No gain or loss is recognized to a partnership on the distribution of property (sec. 731(b)). Nevertheless, no adjustment is required to a partnership's basis in its remaining undistributed assets, following a distribution of property to a partner, unless the partnership has an election under section 754 of the Code in effect. An electing partnership decreases or increases its basis in remaining partnership property to reflect the effect of the distribution on the distributeee partner.

The amount of the decrease in the basis of remaining partnership property equals (1) the amount of any loss recognized by the distributee partner, plus (2) the excess of the distributee's basis in the distributed property over the partnership's adjusted basis in the distributed property immediately before the distribution.[452]

The amount of the increase in the basis of remaining partnership property equals (1) the amount of gain recognized by the distributee partner on the distribution, plus (2) the excess of

[452] The general rule is that loss is not recognized by a distributee partner on a distribution of partnership property, except that a loss may be recognized in a liquidating distribution consisting of nothing other than money, unrealized receivables and inventory.

the adjusted basis of the distributed property to the partnership immediately before the distribution, over the basis of the distributed property to the distributee partner.[453]

Partnership's basis in assets following a transfer of a partnership interest

As in the case of a distribution, a partnership recognizes no gain or loss upon a transfer by a partner of its partnership interest by sale or exchange or on the death of the partner. Adjustment to the basis of partnership assets (to reflect the basis of the new partner's partnership interest) is made, however, only if the partnership has an election under section 754 of the Code in effect.

The basis of partnership property of an electing partnership is increased by the excess of the basis to the transferee partner of its interest in the partnership over its proportionate share of the adjusted basis of the partnership property.[454] Conversely, if the transferee partner's basis in its interest is less than its proportionate share of the partnership's adjusted basis in partnership assets, then the basis of partnership property is decreased by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of its interest in the partnership. For this purpose, a partner's proportionate share of the adjusted basis of partnership property is determined in accordance with its interest in partnership capital, and, in the case of property contributed to the partnership by a partner, section 704(c) (relating to precontribution gain that is allocated to the contributing partner) applies in determining its share.

These increases or decreases to the basis of partnership property are with respect to the transferee partner only.

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[453] Generally, gain is not recognized to a distributee partner, except to the extent that any money and the fair market value of marketable securities distributed exceeds the adjusted basis of its partnership interest immediately before the distribution.

[454] Under final Treasury regulations effective for transfers of partnership interests on or after December 15, 1999 (Treas. Reg. sec. 1.743-1(d), T.D. 8847), a transferee partner's share of the adjusted basis to the partnership of the partnership's property is determined as follows. A transferee's share of the adjusted basis to the partnership of partnership property is the sum of the transferee's (1) interest as a partner in the partnership's previously taxed capital, and (2) share of partnership liabilities. The transferee's interest in previously taxed capital is (1) the amount of cash the transferee would receive on liquidation following a hypothetical taxable sale of all the partnership's assets for cash at fair market value, increased by (2) the amount of tax loss (including remedial allocations under Treas. Reg. sec. 1.704-3(d)) that would be allocated to the transferee from the hypothetical sale, and decreased by (3) the amount of tax gain (including such remedial allocations) that would be allocated to the transferee from the hypothetical sale.

<u>Non-electing partnerships</u>

In the case of a partnership that has not made an election under section 754, the partnership does not make adjustments to the basis of its property in the event of a distribution to a partner or a transfer of a partnership interest. Generally, in the case of a distribution by a partnership to a partner, the partner does not recognize gain or loss (sec. 731(a)), but certain exceptions are provided to this general rule that can cause a mismatch in treatment of the partner and the non-electing partnership. For example, if a partner contributes loss property to the partnership, and recognizes a loss upon the distribution of cash in liquidation of its partnership interest (or upon the transfer of its interest for cash), the non-electing partnership that still holds the loss property may recognize the loss again when the property is sold.

Description of Proposal

The proposal would make basis adjustments to partnership property mandatory in the case of certain partnership distributions, and transfers of partnership interests. The mandatory partnership basis adjustments would apply with respect to any partner whose share of net built-in loss in partnership property is equal to the greater of (1) $250,000, or (2) 10 percent of the partner's share of partnership assets. No basis adjustment would be made to the partnership property with respect to a partner whose share of net built-in loss of partnership property does not equal or exceed the greater of these thresholds immediately prior to the distribution or transfer.

For this purpose, net built-in loss would mean the net loss that would be allocated to the partner if the partnership sold all its property in a taxable transaction for an amount of cash equal to the fair market value of the property. A partner's share of partnership assets (for purposes of the 10 percent threshold) would be determined as the amount the partner would receive if, following such a sale of all the partnership's property, the partnership liquidated.

Aggregation rules would apply under the proposal. Persons described in sections 267(b) (relating to related persons) and 707(b) (relating to controlled partnerships) would be treated as one person, and "20 percent" would be substituted for "50 percent" in those provisions.

An anti-stuffing rule would apply for purposes of the 10-percent threshold. Property acquired by the partnership with a principal purpose of avoidance of the 10-percent threshold would be disregarded.

<u>Effective date</u>.–The proposal would be effective for distributions and transfers made after the date of enactment.

Analysis

The proposal is directed at opportunities for duplication of tax losses that may arise because of the electivity of partnership basis adjustments under present law. Advocates of the proposal point to abusive transactions in which tax losses may be duplicated: the losses occur first at the partner level and then again at the partnership level. For example, they point to a situation in which a partner contributes loss property to a partnership, then recognizes a loss on a liquidating distribution or on transfer of the partnership interest; the loss on the distribution or transfer is attributable to the loss property that was contributed to the partnership. Advocates argue that requiring a basis reduction to partnership assets when loss property is still in the partnership following a distribution or transfer would minimize opportunities to deduct the same loss twice.

Opponents of the proposal might argue that determining the built-in loss in partnership property requires knowledge of the basis and value of all of the partnership property, and that there might be circumstances in which the partnership might not know this information (for example, in the case of property that is not regularly traded).

On the other hand, it could be argued that a partnership must keep records of the basis of its property to calculate depreciation, amortization, and gain or loss on sale of the property. In addition, following a distribution of partnership property to a partner, or a transfer of a partnership interest, the value of partnership assets must be known in order to set the amount of the distribution or the transfer price for the partnership interest. Therefore, it is argued, the determination of built-in loss under the proposal does not require information that is not already available.

Some opponents might assert that the proposal is unbalanced, in that it applies when the partnership has net built-in loss property, but not when the partnership has net gain property. They might say that this lack of balance could create traps for unwary partnerships, or alternatively, could be the source of future, unanticipated abusive schemes to avoid payment of tax.

Advocates of the proposal might respond that the proposal is a targeted response to a known problem in the tax law. Advocates might further point to the $250,000 and 10-percent thresholds under the proposal, which limit the likelihood that an unwary partnership would inadvertently be subject to the rules in the proposal. The $250,000 threshold serves to limit the impact of the proposal on small partnerships, and the 10-percent threshold prevents the application of the proposal in the case of a partner with only a de minimis share of partnership net built-in loss. At the same time, advocates argue, these thresholds are set low enough that marketers of tax shelter opportunities to businesses would not find it cost-effective to market transactions covered by the proposal.

Others might criticize the proposal because it adopts the present-law method of calculating basis adjustments to partnership property, which some have criticized as not completely accurate in some situations.[455] Making the present-law basis adjustments mandatory without correcting their calculation could result in inaccurate adjustments in cases in which a partner contributes loss property to the partnership, then receives other property as a distribution in liquidation of its partnership interests.

Advocates urge that the present-law calculation is considerably simpler than a previously proposed alternative[456] designed to correct this inaccuracy, which was criticized as complex, difficult to implement, and flawed. It is argued that making the present-law rule mandatory in targeted circumstances addresses the problem of loss duplication without any increase in complexity for most taxpayers.

Prior Action

No prior action. (A related proposal to make partnership basis adjustments following distributions (sec. 734(b)) mandatory was included with other partnership proposals in the President's Fiscal Year 2000 Budget Proposal.)

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[455] It has been argued that, at least in the case of partnership distributions, the computation of partnership basis adjustments should refer directly to the distributee partner's share of the partnership's asset basis, rather than to the distributee's gain or loss on distribution or the difference between the basis of the distributed property and the distributee partner's basis in its partnership interest. See Department of the Treasury, *General Explanations of the Administration's Revenue Proposals,* February 1999, 135-6; Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal* (JCS-1-99), February 22, 1999, 235 and 237-238; Joint Committee on Taxation, *Review of Selected Entity Classification and Partnership Tax Issues* (JCS-6-97), April 8, 1997, 33; William D. Andrews, "Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions," 47 Tax L. Rev. 3, 22 (fall 1991).

[456] The previously proposed alternative would measure the basis adjustment to partnership property 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. A corollary to this approach would be the addition to the partnership rules of a new concept of partial liquidation of partnership interests, to take account of situations in which a reduction in the partner's share of partnership asset basis results from a distribution that is not in complete liquidation of the partner's interest, as well as to provide for accurate allocation of basis between the distributed property and the partner's remaining interest in the partnership.

9. Modify treatment of closely-held REITs

Present Law

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

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

Under the organizational structure test, except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons. Generally, no more than 50 percent of the value of the REIT's stock can be owned by five or fewer individuals during the last half of the taxable year. Certain attribution rules apply in making this determination.

Description of 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 combined voting power of all classes of voting stock or 50 percent or more of the total value of shares of all classes of stock. For purposes of determining a person's stock ownership, rules similar to attribution rules for REIT qualification under present law would apply (sec. 856(d)(5)). The proposal would not apply to ownership by a REIT of 50 percent or more of the stock (vote or value) of another REIT. In addition, a limited look-through rule would be provided for partnerships.

Effective date.--The proposal would be effective for entities electing REIT status for taxable years beginning on or after the date of first committee action. Any 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.

Analysis

REITs allow individual investors to obtain a single level of tax on passive real estate investments, often in publicly-traded entities. Present law requires that ownership interests must be held by at least 100 persons and that 5 or fewer individuals cannot own more than 50 percent of the value of the REIT. These ownership requirements indicate that Congress intended that REIT benefits not be available to closely-held entities. A REIT held largely by a single corporation does not meet this objective of Congress.

It is clear that, under present law, it is unnecessary for a corporation to establish a separate real estate entity as a REIT in order to ensure that there is a single corporate level tax. If the separate entity is a corporation, the dividends-received deduction and the benefits of consolidation can eliminate a second corporate tax. If the separate entity is a non-publicly-traded partnership or limited liability company, only one level of tax is imposed. The REIT rules were enacted earlier than most of the rules for other pass-through regimes and lack some of the more sophisticated rules of such regimes aimed at preventing unwarranted shareholder benefits. For example, the REIT rules contain no provisions to prevent REIT shareholders from structuring their interests in order to divide the income from the REIT's assets among themselves in a tax-motivated manner (cf. secs. 704(b) and (c) and 1361(b)(1)(D)). Consequently, where REIT status is elected by an entity with a substantial corporate shareholder, a principal reason may be to take advantage of deficiencies in the REIT rules that have been the basis for several recently reported tax-motivated transactions.

Congress may have believed that improper use of the REIT rules was limited by the restrictions on REIT ownership. The 100-or-more shareholder requirement, and the rule that no more than 50 percent of the value of the REIT's stock can be owned by five or fewer individuals, generally require that REIT stock be widely held, with the result that it is less likely that shareholders will be able to agree on a structure designed to yield tax benefits for certain shareholders. However, present law does not contain a provision prohibiting ownership of large amounts of a REIT's stock by one or a few corporations.

Several recent transactions have utilized REITs to obtain tax benefits for large corporate shareholders. In such transactions, the requirement that the REIT have 100 or more shareholders often may be met by having related persons (such as employees of the majority holder) acquire small amounts of stock. The most well-known of these was the so-called "step-down preferred" transaction. In such a transaction, the REIT issued a class of preferred stock that paid disproportionately high dividends in the REIT's early years and "stepped down" to disproportionately low dividends in later years. Such stock might be sold to a tax-exempt entity. One or more corporate shareholders held the REIT's common stock and were in effect compensated for the preferred's dividend rights in the early years by the right to higher payments on, or liquidation proceeds with respect to, the common stock after the preferred dividends "step down." These corporate shareholders generally funded the high dividends paid to the preferred shareholders by making deductible rent payments to the REIT for real property it leased to the corporate shareholders.[457]

The 50-percent or more rule of the proposal is also designed to reduce the ability of REITs and related C corporations to continue to engage in "stapled stock" structures that would

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[457] The Treasury Department issued IRS Notice 97-21, 1997-11 I.R.B. 9, which denies the benefits of a step-down preferred transaction based on a conduit analysis. The Treasury Department subsequently issued regulations addressing such transactions. See Treas. Reg. sec. 1.7701(l)-3.

otherwise result in single entity treatment under section 269B. For example, under present law there may be instances in which a C corporation owns more than 50 percent of REIT stock and the remaining 49 percent of the REIT stock is stapled to the C corporation stock. Since no more than 49 percent of the C corporation stock would be stapled, the arrangement may not fall within the scope of section 269B even though no stock of the REIT is unrelated to the C corporation. Under the proposal, at least some portion of REIT stock would have to be unstapled to the C corporation.

By preventing a shareholder from owning a 50-percent or greater interest in the REIT, the proposal would also substantially reduce the ability of a single shareholder or a small group of shareholders to utilize a REIT to achieve tax benefits based on their individual tax situations. One example of such use may be to place various assets in a REIT in order to obtain "dividend" treatment for income from the REIT where desired, even though the assets if held directly might produce a different form of income (e.g. interest income). However, the proposal may not prevent such structures entirely. For example, it still might be possible under the proposal for three corporations to acquire nearly all of the REIT's shares (with additional small shareholders to meet the 100-shareholder test).

Opponents of the proposal would argue that it adds complexity and in some cases could prevent legitimate business transactions. Because the proposal would prevent one shareholder from having a greater-than-50-percent interest by vote or value, it would be possible that a shareholder who initially did not violate this test subsequently may violate it due to a decline in the REIT's value. Under the proposal, the REIT apparently would become disqualified at such time. Similarly, the proposal could prevent a REIT's organizers from having a single large investor for a temporary period, such as in preparation for a public offering of the REIT's shares. Finally, the proposal may be criticized for adding complexity to the already complex REIT rules. For example, individual shareholders apparently would be subject to the proposal even though they also are subject to the present-law rule preventing five or fewer shareholders from owning more than 50 percent of a REIT's shares by value.

Prior Action

Similar proposals were included in the President's Fiscal Year 1999 and 2000 Budget Proposals, and in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by the President.

10. Apply RIC excise tax to undistributed profits of REITs

Present Law

Prior to the Tax Relief Extension Act of 1999 ("1999 Act"), a REIT was required to distribute 95 percent of its REIT taxable income (adjusted for certain amounts) in order to maintain qualification as a REIT. As a result of changes made by the 1999 Act, a REIT, like a regulated investment company (RIC), now is only required to distribute 90 percent of its REIT taxable income (adjusted for certain amounts) in order to maintain REIT status. Both prior to and after the 1999 Act, both RICs and REITs can make a distribution within a specified period of time after the end of the taxable year, which will be treated as if made in the taxable year for purposes of determining whether the RIC or REIT has satisfied the distribution requirement. The 1999 Act more closely conformed the provisions dealing with these procedures for RICs and REITs.

Shareholders of REITs and RICs generally would not include distributions in income until received.[458] Thus, tax on an amount of income that is distributed after the close of the REIT or RIC taxable year may be deferred, because income is not taxed in the year earned by the RIC or REIT, but rather in the later year received by the shareholder.

A RIC is subject to a four-percent excise tax on the excess of the required distribution for a calendar year over the actual distributed amount for such calendar year (determined without regard to the special rules permitting later-paid dividends to be treated as if made in the taxable year). The required distribution is equal to the sum of 98 percent of the RIC's ordinary income for the calendar year and 98 percent of the RIC's capital gain net income for the 1-year period ending on October 31st of such calendar year. REITs are subject to a similar rule, except that the required distribution is equal to the sum of 85 percent of the REIT's ordinary income for the calendar year and 95 percent of the REIT's capital gain income for such calendar year.

Description of Proposal

The proposal would require a REIT to distribute 98 percent of its ordinary income and capital gain net income for a calendar year in order to avoid the four-percent excise tax imposed under section 4981.

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

Analysis

The proposal would more closely conform the excise tax provisions applicable to REITs with those applicable to RICs. Such a result would be similar to the 1999 Act changes that more closely conformed the REIT distribution requirements to those for RIC's by allowing REITs to retain their REIT status with a 90 percent (rather than 95 percent) distribution, and that more closely conformed the rules for RICs and REITs permitting certain dividends paid after the taxable year to be treated as if made during the taxable year for purposes of qualification.

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[458] For estimated tax purposes, certain 10 percent or greater shareholders of a closely-held REIT must annualize income. Section 6655(e)(5).

The purpose of the excise tax is to compensate in part for the limited deferral permitted as a result of the rules allowing dividends paid after year end to be treated as distributions within the year for qualification purposes, as well as to encourage the entity to pay dividends within the taxable year.[459]

Opponents would contend that REITs may have greater capital investment requirements than RICs, and also may have more difficulty computing their income by year end, and therefore should not be subject to the same excise tax regime applicable to RICs. Proponents, however, would contend that the excise tax is an appropriate mechanism to compensate for the deferral that results from taxing income to the shareholder rather than the REIT, in the year received by the shareholder rather than the year earned by the REIT. They would also contend that the excise tax serves this purpose in addition to discouraging inappropriate deferral through the timing of dividends paid to shareholders; and that closer conformity with the RIC excise tax regime is appropriate.

Prior Action

No prior action.

11. Allow RICs a dividends paid deduction for redemptions only if the redemption represents a contraction

Present Law

Taxation of regulated investment companies

A regulated investment company ("RIC") generally is treated as a conduit for Federal income tax purposes. The Code provides conduit treatment by permitting a RIC to deduct dividends paid to its shareholders in computing its taxable income.[460] In order to qualify for conduit treatment, the RIC must be a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that

[459] Congress also intended the excise tax to compensate for possible deferral that might occur if a REIT or RIC utilized a non-calendar taxable year. See, e.g., H.R. Rep. 94-1515, 94th Cong., 2d Sess. (1976) at 515; Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, 449-450; H.R. Rep. 99-841, 99th Cong. 2d Sess., II-217-218 and II-243-244 (1986); Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986,* at 376-77, 392.

[460] Section 852(b)(2)(D).

Act.[461] In addition, a corporation must elect such status and must satisfy certain tests.[462] One of those tests is a requirement that the RIC distribute at least 90 percent of its income as dividends.[463]

Deductible dividends primarily arise from two sources. First, deductible dividends include amounts distributed as dividends out of earnings and profits accumulated after February 28, 1913, to shareholders with respect to their RIC shares.[464] Second, where stock in a RIC is redeemed, a RIC generally may deduct the portion of a redemption distribution that is properly chargeable to accumulated earnings and profits.[465] "To determine the amount properly chargeable to earnings and profits accumulated after February 28, 1913, there must be deducted from the distribution that part allocable to capital account."[466] The portion of redemption proceeds that may be treated as dividends out of earnings and profits is not reduced by new subscriptions of shares.[467]

<u>Taxation of mutual fund shareholder</u>

Section 301 provides that distributions of property by a corporation are treated: first, as a dividend; second, as a reduction in the shareholder's adjusted basis of the stock; and third, as gain from the sale or exchange of property. Section 302(d) provides that a redemption by a corporation of its stock is treated as a distribution of property to which section 301 applies.

If all of a shareholder's mutual fund shares are redeemed, the transaction is treated as a sale.[468] If less than all of the shareholder's shares in a mutual fund are redeemed, the transaction is treated as a sale if the redemption is "substantially disproportionate"[469] or is "not essentially

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[461] Section 851(a).

[462] Section 851(b).

[463] Section 852(a)(1).

[464] Section 561(a)(1).

[465] See Rev. Rul. 55-416, 1955-1 C.B. 416; G.C.M. 34084.

[466] Treas. Reg. sec. 1.562-1(b)(ii).

[467] G.C.M. 33588 (1967).

[468] Section 302(b)(3).

[469] Section 302(b)(2).

equivalent to a dividend."[470] "Such redemptions are generally believed to be sales for tax purposes and in most cases should be so viewed, since they should not be considered essentially equivalent to a dividend."[471]

Description of Proposal

Under the proposal, a RIC would be allowed to claim a dividends paid deduction with respect to a redemption only if the redemption represents a net contraction of the RIC (as measured by the number of shares outstanding).

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

Analysis

In order to avoid the imposition of a corporate level of tax, RICs generally distribute amounts sufficient to ensure that the dividends paid deduction completely eliminates their taxable income. To the extent that a distribution on a redemption is eligible for the dividends paid deduction, a lesser amount of ordinary dividends need be paid out in order for the RIC to distribute 90 percent of its net income as required by the statute to eliminate its tax liability. In situations where a RIC's shares are redeemed and the redemption represents a contraction in the size of the RIC, the RIC is required to distribute to the remaining shareholders amounts that exceed their pro-rata share of the RIC's income absent such a deduction.

In situations where a RIC redeems shares and the redemption is accompanied by nearly simultaneous investments in the RIC by other investors, the RIC is in essentially the same position it would be in had the redeeming shareholder sold its shares in the RIC directly to the new investors. Nonetheless, if the RIC is allowed to deduct a portion of the redeeming distribution in such a case, this dividend allows the RIC to reduce the dividends it otherwise would make to shareholders at the end of the year. This reduction results in smaller dividend distributions to historic shareholders (shareholders that were in the fund for the entire year).

The effect of the proposal may be illustrated with several examples.

Example #1.--In the first example, assume that a RIC initially has two shareholders, A and B, both of whom paid $100 for one share in the RIC. Initially, both of A's and B's shares have a value $100.

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[470] Section 302(b)(1).

[471] Hervey, 740 T.M., *Taxation of Regulated Investment Companies*, 110.

During the RIC's first year, the RIC realizes income of $10. As a result of the earnings, the value of both A's and B's shares increases to $105.[472]

B is entirely redeemed on the last day of the RIC's year for $105. Just prior to B's redemption, the RIC has paid-in capital of $200 and undistributed earnings of $10. Under both present law and the proposal, $5 of the $105 redemption proceeds is treated by the RIC as a deductible dividend.[473] The remaining portion (i.e., $100) of the $105 redemption proceeds is treated as a reduction of paid-in capital. Thus, just after B's redemption, the RIC has paid-in capital of $100 and undistributed earnings of $5.00.

In order for the RIC to avoid incurring any tax liability for that year, the RIC pays a dividend to A before its year-end of the remaining undistributed income of $5. The RIC is entitled to a total dividends paid deduction of $10--$5 from the portion of the redemption proceeds treated as a dividend and an additional $5 from the dividend paid to A. As a result of the $10 dividends paid deduction, the RIC has no taxable income for that year.

This result is consistent with the conduit treatment of the taxation of RICs since the $5 dividend paid to A was his share of the RIC's earnings while he was a shareholder and the value of A's shares after payment of the dividend is $100 which is the amount of A's paid-in capital.[474]

Example #2.--In the second example, assume the same facts as Example #1, except that C, a new shareholder, purchases one share in the RIC for $105 after B's redemption, but before any dividends are paid.

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[472] A RIC share's net asset value consists of the sum of the following items: (1) undistributed interest and dividend (i.e., ordinary) income, (2) undistributed net capital gains, (3) unrealized appreciation or depreciation, and (4) paid-in capital.

[473] B treats the redemption as a sale and, consequently, realizes $5 of short-term capital gain. Note that, while the RIC is allowed to treat $5 of the redemption proceeds as a dividend, B is entitled to treat the entire redemption proceeds as proceeds from the sale of the stock and consequently can reduce the taxable amount of the redemption proceeds by his basis in the redeemed share and is eligible to treat any resulting gain as a capital gain. The proposal would not modify this inconsistency in treatment of the redemption proceeds (i.e., treatment by the RIC of a portion of the redemption proceeds as dividends while the redeemed shareholder treats the entire redemption proceeds as an amount realized in a sale).

[474] On the other hand, if present law did not treat $5 of the redemption proceeds as a dividend, the RIC would have to pay dividends of $10 to A in order to have no taxable income for that year. A would have been taxed on $10 on income which is more than his share of the RIC's earnings. B still would realize $5 of capital gain.

The steps in example #2 and their consequences may be summarized as follows:

Step	Consequence of step
Step 1 (A and B buy shares for $100)	Both A's and B's shares of paid-in capital are $100 (i.e, 1/2 of $200); A's and B's shares are worth $100 each, consisting of their shares of paid-in capital.
Step 2 (RIC earns $10)	Both A and B have equity interest in undistributed earnings of $5; both A's and B's shares are worth $105 consisting of their shares in paid-in capital of $100 and their shares in the undistributed income of $5.
Step 3 (RIC redeems B for $105)	B receives back his paid-in capital of $100 and his share of the undistributed income of $5; A's share of paid-in capital is $100 (i.e., 100 percent of $100); A has the right to undistributed earnings of $5 (i.e., 100 percent of $5); A's shares are worth $105, consisting of paid-in capital of $100 and his share in undistributed earnings of $5.
Step 4 (C buys on RIC share for $105)	Both A's and C's share of paid-in capital is $102.50 (i.e., 1/2 of $205); both A's and C's share of undistributed earnings is $2.50 (i.e., 1/2 of $5.00); both A's and C's shares are worth $105, consisting of paid-in capital of $102.50 and undistributed earnings of $2.50. (Note that A and C have effectively exchanged their rights to $2.50 of undistributed earnings for $2.50 of paid-in capital.)
Step 5 (RIC pays a dividend of $5.00)	Both A and C would equally receive $2.50 of the $5 dividend, because both A and C were shareholders on the dividend record date.

Under present law, the purchase by C has no effect on the taxation of A, B, or the RIC. The $2.50 dividend is paid to A, which is consistent with the conduit treatment of RICs because A was the shareholder when the income from which the dividend was paid was earned.[475]

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[475] Note that, without equalization accounting, the $5.00 dividend is shared $2.50 to both A and C since both A and C were shareholders of record on the dividend declaration date. Note that, without equalization accounting, C is taxable on $2.50 of dividend income even

Under the proposal, none of the $105 redemption proceeds is treated as a dividend. As a result, in order for the RIC to avoid paying tax for that year, it must pay a dividend of $10. Such a $10 dividend would be paid $5.00 to both A and C. Thus, both A and C would have additional $2.50 of dividend income under the proposal.

Effect of the proposal.--As illustrated by the two examples above, adoption of the proposal would have the effect of increasing the amounts of dividends paid by RICs. This result arguably is more consistent with the conduit treatment of the taxation of RICs than present law because, under the proposal, shareholders will receive more of the income earned by the RIC while they were shareholders (e.g., "A" in the example #2). One the other hand, the proposal would cause new purchasers of RIC shares to pay tax on more income earned by the RIC before they became a shareholder in the RIC (e.g., "C" in example #2).

Adoption of the proposal would have the effect of reducing the amount of capital under management of a RIC to the extent that RIC shareholders do not reinvest the dividends in additional shares (possibly through a dividend reinvestment plan). Finally, if the proposal were adopted, trusts which invest in RICs would have more accounting income which they may be required to distribute to income beneficiaries of the trust.

Uncertainties in the proposal.--The proposal does not indicate how to determine whether a redemption represents a net contraction of the RIC. Specifically, the proposal does not indicate which subscriptions for new stock are to be counted in determining whether a redemption resulted in a contraction of the RIC. The proposal could take into account stock subscriptions occurring for some period both before and after the stock redemptions to determine whether there has been a contraction in the RIC. Presumably, the proposal would not take into account stock subscriptions occurring after the end of the current year so that a RIC would know how much of its currents earnings are undistributed which it should pay as dividends in order to minimize its taxes.

Prior Action

No prior action.

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though C was not a shareholder when the income from which the dividend was paid was realized by the RIC. In effect, C "bought" $2.50 of taxable income when he purchased his share for $105 before the RIC had declared dividends distributing all of its income for the year.

12. Require REMICs to be secondarily liable for the tax liability of REMIC residual interest holders

Present Law

A real estate mortgage investment conduit ("REMIC") is a statutory pass-through vehicle designed to facilitate the securitization of mortgages. A REMIC holds mortgages and issues one or more classes of debt instruments, called REMIC regular interests, that are entitled to portions of the cash flows from the underlying mortgages. A REMIC also issues a single equity class of interest, called a REMIC residual interest, that in entitled to any excess income from the underlying mortgages and temporary investments of mortgage payments. Although a REMIC computes its tax income (and files a tax return), a REMIC is not subject to tax itself. [476] Instead, its income effectively is taxed to the holders of the regular and residual interests. Holders of regular interests are taxable on income from their interests computed on the accrual method of accounting (sec. 860B(b)). The holder of the REMIC residual interest is taxable basically on the daily portions of the excess of the income from the underlying mortgages over deductions for amounts allocable to the regular interests that are treated as debt of the REMIC, both income and deductions being computed under the accrual method of accounting (sec. 860C).

There is no requirement that a REMIC residual interest be allocated a portion of the cash flow generated by the underlying mortgages. As a consequence, it is possible that REMIC residual interests may have a negative value since the tax on the residual's income can be more than the value of cash flows remaining in the residual interest. Nonetheless, the REMIC provisions contain five rules designed to ensure that the tax on a REMIC residual interest is paid when due. First, the REMIC provisions require that the taxable income of the holder of the residual interest cannot be less than "excess inclusions" for the year which effectively prevents the residual's income from being offset by net operating losses.[477] Second, the REMIC provisions treat the income of the residual interest as unrelated business taxable income to tax exempt organizations and other entities subject to the tax on unrelated business income.[478] Third, the REMIC provisions impose a tax on the transfer of a REMIC residual interest to a governmental entity[479] or organization that is exempt from tax. Fourth, under Treasury

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[476] Section 860A(a).

[477] Section 860E(a)(1).

[478] Section 860E(b).

[479] The excise tax is imposed on a disqualified organization. Disqualified organizations include the United States, any State or political subdivision thereof, any foreign government, international organization, their agencies or instrumentalities, organizations exempt from the Federal income tax which are not subject to the tax on unrelated trade or business, and certain cooperatives.

regulations, certain transfers of negative value residual interests are ignored if, at the time of the transfer, the transferor knew or should have known that the transferee would be unwilling or unable to pay taxes due on its share of share of the income.[480] Fifth, under Treasury regulations, a transfer of a REMIC residual interest to a foreign person is ignored if the transfer has tax avoidance potential.[481]

Description of Proposal

The proposal would require a REMIC to be secondarily liable for the tax liability of its REMIC residual interest to ensure that the tax on REMIC residuals is paid when due. If the tax on the residual is not paid when due, the REMIC would be liable for the tax plus additions to tax in the following tax year. Similar rules would apply with respect to Financial Asset Securitization Investment Trusts ("FASITs").

Effective date.--The proposal would be effective for REMICs and FASITs created after the date of enactment.

Analysis

Overview of securitization

An individual can own income-producing assets directly, or indirectly through an entity (i.e., corporation, partnership, or trust). Where an individual owns assets through an entity (e.g., a corporation), the nature of the interest in the entity (e.g., stock of a corporation) is different than the nature of the assets held by the entity (e.g., assets of the corporation).

In general, securitization is the process of converting one type of asset into another and generally involves use of an entity separate from the underlying assets. In the case of securitization of debt instruments, the instruments created in the securitization typically have different maturities and characteristics than the underlying debt obligations that are being securitized. The characteristics (e.g., maturities, subordination) of the separate instruments often are more attractive (and, hence, more valuable) than the underlying instrument.

One helpful way of viewing the basic securitization of real estate mortgages is to view a real estate mortgage as a series of separate debt instruments with different maturities. For example, the standard "30-year level amortization mortgage" can be viewed as 360[482] separate

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480 Treas. Reg. sec. 1.860E-2(c).

481 Treas. Reg. sec. 1.860G-3(a).

482 I.e., 12 monthly payments per year for 30 years. Where the mortgage is for a term different than 30-years (e.g., 25 years), such mortgages similarly could be viewed as multiple

debt instruments each having the same amount of due (but with varying amounts of principal and interest) in each of 360 successive months. In the case of securitization of real estate mortgages, one or more of those 360 separate monthly payments typically is effectively segregated into one or more separate instruments (called “regular interests”) whose maturities and terms are more attractive than ownership of all 360 monthly payments of a 30-year mortgage. Because of the increased attractiveness of the individual trenches, the sum of the values of the various regular interests often is greater than the value of the underlying mortgage.

Securitization of mortgages generally involves an entity that owns the mortgages issuing separate interests whose maturities can be paid from one or more of the monthly payments of the underlying mortgage. Generally, in order for the securitization to be economically possible, it is important that the entity that issues the separate interests not incur a separate tax in the securitization process, else the increased value of segregating the various monthly mortgage payments would be reduced or eliminated.

Securitization of real estate mortgages through REMICs

REMICs were specifically created for the securitization of real estate mortgages. If specified requirements are met, the REMIC generally is not subject to Federal income tax. In general, a REMIC is an entity that owns a fixed pool of mortgages and that issues multiple classes of interests in that pool called “regular interests” and one “residual interest.”.

The economic and taxable income of the underlying mortgages held by a REMIC is allocated to, and taken into account by, the holders of the interests therein. Holders of "regular interests" issued by a REMIC generally take into income the portion of the REMIC's income that would be recognized by an accrual method holder of a debt instrument having the same terms as the particular regular interest; typically, regular interests provide for delayed payments whose income is currently taxed as original issue discount. The holder of the "residual interest" is taxed on all of the taxable income of the REMIC not taken into account by the holders of the regular interests or the net loss of the REMIC.

Effect of interest rate on taxable income of residual interest

Often mortgages are securitized when interest rates are higher for longer maturities than shorter maturities. Such interest rates are said to follow a “positive interest curve.” With securitization of a mortgage, debt instruments with maturities different than underlying mortgage typically are issued -- some shorter than the average maturity of payments of the underlying mortgage, some longer than the average maturity of payments of the underlying mortgage. As a result of certain averaging conventions in the taxation of interest income under the present Federal income tax law, the amount of taxable interest income on the underlying mortgage is

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separate mortgages except than none of those separate mortgages would have a maturity in excess of 25 years.

greater than taxable interest income of the regular interests in the early years of the mortgage and less in the mortgage's later years.[483] This difference is greater where the difference between short-term interest rates and long-term interest rates is large (i.e., the more positive the interest curve, the greater the difference). Under the REMIC rules, this difference is taxable to the holder of the residual interest.

Avoidance of tax on residual's income

In cases where the REMIC residual interest is entitled to few, if any, cash flows, the residual interest can have a negative value when issued. This negative value occurs because the reasonably anticipated net tax liability associated with holding the residual interest is greater than the present value of the cash flows passing to the residual. In such a case, the residual is a liability, not as asset. As a result of its potential tax liability, there is a great incentive to transfer the residual interest to a person who will not incur a tax on the residual's taxable income. Such persons may include entities that are not currently subject to U.S. taxing jurisdiction (e.g., governments of some American Indian tribes) or corporations in bankruptcy.

As stated above, the REMIC provisions contain rules designed to insure that the tax on the residual's income is paid. These rules follow two different approaches. The first approach is to impose a tax on the residual's income where the residual has been transferred to persons that are not otherwise subject to U.S. income tax, but nonetheless are subject to the taxing jurisdiction of the U.S. The imposition of the tax on unrelated business income on exempt organizations, and excise tax on States or foreign governments, that acquire a REMIC residual follow this first approach. The second approach is to ignore any attempt to transfer the residual to a person who is not likely to pay the tax on the residual's income and impose the tax on the residual's income on the transferor. This second approach is the one adopted in the Treasury Regulations cited above.

The first approach is deficient where the taxes are not imposed on all of the persons that are not subject to the Federal income tax. Governments of American Indian tribes is an example of such a deficiency. The second approach is deficient where the incident of tax on the residual's income without residual interest being transferred. For example, where a partnership which owns REMIC residual interests whose original partners on all U.S. taxpayers subsequently admitted new partners who were foreigners and to whom the partnership allocates the income from the residual interests, there arguably has been no transfer of the residual interests to foreigners.[484] Moreover, the second approach often is difficult to apply, because it often is difficult for a transferor to "know or should have known that the transferee would be unwilling

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[483] See Bruce Kayle, "Where Has All the Income Gone? The Mysterious Relocation of Interest and Principal in Coupon Stripping and Related Transactions," 7 Va. Tax Rev. 303 (1987).

[484] See Cebern Mortgage Investor v. Commissioner, Tax Analysts par. 200063.

or unable to pay taxes due on its share of share of the income or whether the transfer has "tax avoidance potential." Finally, there are methods by which tax liability on the residual's income can be forgiven. For example, where a corporation acquires REMIC residual interests and then files for bankruptcy under chapter 7, the future tax on the future income from the residual interests is forgiven as part of the bankruptcy liquidation.

The proposal

The proposal would impose a secondary tax liability on a REMIC for the tax liability of its residual interest if the tax on the residual is not paid when due. The REMIC would be liable for the tax plus additions to tax in the year following the year of nonpayment. The stated purpose of the proposal is to ensure that the tax on REMIC residuals is paid when due.

The proposal has the advantages of being comprehensive (since secondary liability would arise whenever tax on the residual interest has not been paid because the transferee was not subject to tax or could not pay the tax) and comparably easy to administer (secondary liability would be imposed upon a showing by the IRS that tax on the residual interest's income had not been paid).

One major disadvantage with the proposal is its probable effect on the securitization process. Securitization of mortgages works best where the trenches created through the securitization process have the greatest probably of being timely paid. Presumably, where the REMIC becomes liable for tax on the residual interest's income under the proposal, the REMIC must obtain the funds to pay the tax from the underlying mortgages held by the REMIC, in which case all or a portion of the regular interests may not be paid. The risk of nonpayment will have the effect of increasing the yields that purchasers of regular interests will demand to buy them. Some increase in yields on regular interests is likely to occur under the proposal, given the uncertainty of whether secondary liability will actually be imposed on the REMIC. The higher the yields on the regular interests, the less profit that the sponsor of the REMIC will make through the securitization of mortgages and the fewer mortgages that will be securitized. Of course, it is possible that the REMIC's sponsor will pay any taxes arising on the REMIC under the secondary liability proposal. Such action, however, would have similar effect -- smaller profits to REMIC sponsors and fewer securitizations. The fewer mortgages that are securitized, the higher mortgage interest rates will likely be. To the extent that taxes are on income of REMIC residuals is not paid, securitization would operate to subsidize mortgage interest rates similar to the lower mortgage interest rate made possible through the issuance of tax-free mortgage subsidy bonds by State and local governments.

Alternatives to the proposal

As indicated above, one possible effect of the President's proposal to impose secondary liability on the REMIC for tax on the residual interest is to reduce profits of REMIC sponsors, decrease the volume of mortgage securitization, and possibly increase mortgage interest rates even where the secondary liability is never exercised as a result of the uncertainty created by such a broad proposal. Proposals that may not have such negative effects might be proposals that are more targeted than the President's proposal toward the deficiencies in present law. A possible alternative is requiring as a condition of becoming a REMIC that securitizations be structured in such a way that there are sufficient cash flows accruing to the residual interest from which taxes on the residual interest's income may be paid.

Prior Action

No prior action.

13. Deny change in method treatment in tax-free transactions

Present Law

Tax-free transactions

Present law provides rules under which assets or entire businesses may be transferred without the immediate recognition of gain or loss. Some of the most common of these tax-free transactions include contributions to a corporation in exchange for stock if the contributors are in control of the recipient corporation immediately after the exchange (sec. 351), contributions to a partnership in exchange for an interest in the partnership (sec. 721), distributions in complete liquidation of a subsidiary corporation (sec. 332), and certain exchanges of property for stock or securities in corporations pursuant to a plan of reorganization (sec. 361). Section 381 provides rules allowing for the carryover of certain tax attributes, including accounting and inventory methods, in the case of the tax-free acquisition of assets of a corporation by another corporation under section 332, and most acquisitions under section 361. However, section 381 does not apply to tax-free contributions under section 351. Further, no equivalent to section 381 exists for the tax-free contributions of assets to a partnership.

Methods of accounting

A taxpayer is allowed to adopt any permissible method of accounting. A permissible method of accounting must (1) be used consistently, (2) clearly reflect the taxpayer's income, (3) not be prohibited to the taxpayer by the Code or regulations, and (4) be used in keeping the taxpayer's books and records.[485] Once adopted, a method of accounting may not be changed without the consent of the Commissioner. While automatic consent is provided for certain

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[485] A method of accounting generally will be considered used in keeping the taxpayer's books and records if the taxpayer can reconcile its books and records to the amounts disclosed on the tax return.

changes, most accounting methods may not be changed without first applying for and obtaining the consent of the Commissioner to the change.

Section 381 provides special rules that are applicable to certain nonrecognition (tax-free) transactions. In a nonrecognition transaction to which section 381 applies, an acquiring corporation must use the method of accounting that was 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 by the parties to the transaction, 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.

If the transaction does not involve the integration of separate trades or businesses, then each trade or business retains its accounting methods. If separate trades or businesses are to be integrated, but both parties to the transaction use the same method of accounting, that method will be the principal method. If, however, separate trades or businesses are to be integrated as part of the transaction, and the separate trades or businesses use different methods of accounting, the regulations provide specific rules for determining which method will be the principal method required to be used by the integrated business.

The principal method of accounting is determined by comparing the adjusted bases of assets and gross receipts of each component trade or business to the transaction. If this comparison shows that component trades or businesses that use a common method of accounting have <u>both</u> (1) the greatest total of the adjusted bases of assets and (2) the greatest total of gross receipts, such method of accounting is the principal method of accounting. However, if one group using a method of accounting has the greatest total of adjusted bases of assets and a group using a different method has the greatest total of gross receipts, there is no principal method of accounting and the taxpayer is required to request that the Commissioner determine the appropriate method of accounting.[486]

Under present law, section 381 generally does not apply to the tax-free contribution of assets to a corporation described in section 351,[487]or the tax-free contribution of assets to a partnership described in section 721. A corporation or partnership that receives assets in a section 351 or section 721 transaction is required to continue to use its previously adopted methods of accounting, unless the consent of the Commissioner is obtained to change methods of accounting. If the recipient corporation or partnership is a new entity, or has not yet adopted a

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[486] Treas. Reg. sec. 1.381(c)(4)-1(c)(2).

[487] Treas. Reg. sec. 1.1502-17 mandates the application of section 381 where the principal purpose of a section 351 transfer between members of a consolidated group is to effect a change in method of accounting.

method of accounting, it is free to adopt any method of accounting provided the method (1) is used consistently, (2) is used in keeping its books and records, (3) clearly reflects its income, and (4) is not prohibited by the Code or regulations.

Inventories

Taxpayers are required to determine inventories whenever the production, purchase or sale of merchandise is a material income producing factor. The method the taxpayer uses in keeping inventories must conform as closely as possible to the best accounting practices in the trade or business and must clearly reflect income. The amount of inventories of fungible items are generally determined using either the first-in, first-out (FIFO) method or the last-in, first-out (LIFO) method. Inventories may be priced under both the FIFO or LIFO methods in terms of units of goods (the specific goods method) or in terms of dollars (the dollar value method).

If a taxpayer using the LIFO method purchases or produces more of a particular type of inventory than it sells in a given year, it creates a layer of inventory attributable to that year. The inventory in the layer will not be considered sold until the taxpayer sells more of that type of inventory than it purchases or produces in a later year. Growing businesses may establish inventory layers every year. If the cost of purchasing or producing an item of inventory consistently increases from year to year, the cost of items in older layers may be a fraction of the cost of purchasing or producing equivalent inventory in the current year. The gross income attributable to the sale of any item of inventory is equal to its selling price less its cost. Thus, higher taxable income will result if the item sold is considered to come from an older, lower cost layer than if the item sold is considered to come from a later, higher cost layer or from current purchases.

Inventory that is received in a section 351 transaction must be accounted for using the inventory methods of the recipient company. If the recipient company is currently using LIFO and receives LIFO inventory of the same type, the layers established at the contributing company are carried over and integrated into the equivalent inventory layers of the recipient company.[488] If, on the other hand, the recipient company is not using LIFO or is a new company that must adopt an inventory method, the inventory will be considered acquired at its average price in the hands of the contributing company.[489]

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[488] See Joseph E. Seagram & Sons v. Commissioner, 394 F. 2d 738 (2d Cir. 1968), reversing 46 T.C. 698 (1966).

[489] If inventory is considered to be acquired at its average price in the hands of the contributing company, the identity of the LIFO layers is lost. Any sales in the year of acquisition will be considered to come from a combination of current purchases and production and the LIFO layers. Assuming that costs have increased, this will result in an overall lower cost of sales and higher taxable income than would have been the case had the original LIFO layers been preserved.

Under present law, it is not clear whether the transfer of LIFO inventory to a partnership in a section 721 transaction can result in the integration of existing layers into the recipient partnership's inventory.

Depreciation

Special rules apply to methods of computing depreciation allowances. Section 168(i)(7) requires that a corporation or partnership that receives assets in a section 351 or section 721 transaction be treated as the transferor for purposes of computing depreciation deductions with respect to so much of the basis of the property as does not exceed the basis of the property in the hands of the transferor. This "step-in-the-shoes" approach has the same effect as requiring the transferee to use the transferor's method of accounting on that portion of the basis that is carried over. Additional basis, as may be the case when gain is recognized by the transferor due to the receipt of boot, is treated as a new asset that is placed in service on the date of acquisition. Depreciation on this portion of the asset may be accomplished by the use of different methods.

Description of Proposal

The proposal would extend the application of the rules of section 381(c)(4) (regarding methods of accounting) to section 351 and section 721 transactions. If the transferee is a new corporation or partnership (one that has not yet adopted its methods of accounting), it would be required to use the methods of accounting that were used by the transferring entity. An existing corporation or partnership could be required to change its methods of accounting to those of the transferring entity if the transferring entity's method of accounting were considered the integrated business' principal method of accounting.

The proposal would also extend the application of the rules of section 381(c)(5) (regarding inventories) to section 351 and section 721 transactions. Similar to the extension of section 381(c)(4), this could require an existing corporation or partnership to change its methods of keeping inventory to those of the transferring entity if the transferring entity's methods of keeping inventory were considered the integrated business' principal method. However, the proposal would also preserve LIFO inventory layers and allow them to be integrated into the inventory of the recipient entity, rather than treating them as acquired at average cost, assuming the recipient entity will be using LIFO. This could reduce the taxable income of the recipient company, compared to present-law treatment.

The proposal would not modify the present-law rules regarding the methods that must be used to determine depreciation on property that is contributed in a section 351 or 721 transaction.

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

Analysis

Methods of accounting

A taxpayer that is otherwise unable to obtain the consent of the Secretary to a change in its method of accounting may seek to circumvent the consent requirement by contributing the assets to a new or inactive corporation or partnership in a tax-free transaction under section 351 or section 721. Many commentators feel that it is not appropriate to allow taxpayers to circumvent the requirement that they obtain the consent of the Commissioner to changes in methods of accounting in this manner. They note that the consent requirement will support sound tax administration by permitting the Commissioner to review the proposed change in method of accounting to make certain that the change will be to a correct method, that no tax abuse will result from the change, and that the change will be made with the appropriate section 481(a) adjustment so that no items of income escape taxation and no items of expense are deducted twice. They also note that the consent requirement enables the Commissioner to insure taxpayer compliance with the clear reflection of income requirement.

On the other hand, other commentators have expressed concern that the Commissioner may sometimes withhold consent to changes from one permissible method of accounting to a different permissible method, particularly where such change is beneficial to the taxpayer. They note that the Commissioner currently can disallow the use of the new method if the method does not clearly reflect the acquiring entity's income. They suggest that an opportunity to restructure in order to adopt new permissible methods of accounting is a necessary check on the Commissioner's authority in the accounting method area.

The proposal may also create additional complexities in more complex section 351 or section 721 transactions. If a single company contributes assets to a new or inactive corporation in a section 351 transaction, it is not difficult to determine which methods of accounting would be required under the proposal. If multiple companies contribute several trades or businesses to a joint venture (whether operated as a partnership or a separate corporation), determining which method of accounting is the principal method of accounting under the section 381 regulations may be very complex. The application of the section 381 regulations may result in determining that there is no principal method of accounting, thus necessitating a determination by the Commissioner of which accounting methods will be used. This would introduce an additional level of uncertainty into the transaction.

It should be noted that the present section 381 regulations are primarily designed to address the treatment of tax attributes in the tax-free combination of two or more active trades or businesses. It is not clear how or if the section 381 regulations would be modified if they were to be expanded to include the transactions under section 351 and 721. In particular, it is not clear how the section 381 regulations would be intended to apply if one party to the transaction contributes assets that do not, in and of themselves, constitute a trade or business. If such assets are considered, their contribution to an active trade or business may force that acquiring company to change its methods of accounting to those of the contributing company. This may be appropriate in certain circumstances, such as when the contributing entity acquires most of the ownership of the receiving entity in the transaction. However, in other circumstances, it may not be appropriate for the receiving entity's accounting methods to be called into question.

Inventories

Proponents of the proposal will argue that it facilitates the transfer of inventory by LIFO taxpayers in section 351 and section 721 transactions. Allowing LIFO inventory layers to be preserved and integrated into the recipient entity's inventory will preserve one of the essential benefits of the use of the LIFO method. Thus, the proposal will contribute to an accurate reflection of income in the same manner as the contributing entity's use of the LIFO method did.

Opponents of the proposal will argue that requiring the acquiring taxpayer to maintain the LIFO layers created by the contributor will create additional record keeping burdens since a record of the layers and the underlying information supporting their valuation must be maintained. This may be particularly troublesome if the contributing company does not fully share its records relating to the inventory or the contributing and recipient entities use different systems of record retention. It may be appropriate to consider allowing a taxpayer to elect to use an averaging convention where the record keeping required would otherwise be considered too burdensome.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

14. Deny deduction for punitive damages

Present Law

A deduction is allowed for all ordinary and necessary expenses pair or incurred by the taxpayer during the taxable year in carrying on any trade or business.[490] A deduction is not allowed, however, for any payment made to an official of any government or governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government that illegal under Federal law.[491] In addition, no deduction is allowed for any fine or similar payment made to a government for violation of any law.[492]

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[490] Section 162(a).

[491] Section 162(c).

[492] Section 162(f).

Finally, no deduction is allowed for two-thirds of the damage payments made by the taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law.[493]

In general, gross income does not include amounts received on account of personal injuries and physical sickness.[494] This exclusion generally does not apply, however, to punitive damages.[495]

Description of Proposal

No deduction would be allowed for punitive damages paid or incurred by the taxpayer as a judgment or in settlement of a claim. Where the liability for punitive damages is covered by insurance, any such damages paid by the insurer would be included in the gross income of the insured person and the insurer would be required to report such amounts to both the insured person and the IRS.

Effective date.--The proposal would apply to damages paid or incurred on or after the date of enactment.

Analysis

Proponents of the proposal argue that allowance of a tax deduction for punitive damages undermines the role of punitive damages in discouraging and penalizing the activities or actions for which the punitive damages were imposed. Further, proponents note that the determination of the amount of punitive damages generally can be determined by reference to pleadings filed with a court and such a determination already is made by plaintiffs in determining the portion of any payment that is taxable.

Opponents of the proposal argue that a deduction should be allowed for all ordinary and necessary expenses paid or incurred by the taxpayer in carrying on a trade or business in order to properly measure the income of the taxpayer. Disallowance of punitive damages would result in the taxpayer paying taxes on amounts in excess of his income. Opponents also note that determining the amount of any punitive damages will be difficult in many cases, especially where the payment arises from a settlement of a claim.

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493 Section 162(g).

494 Section 104(a).

495 (P.L. 104-188; K. M. O'Gilvie v. U.S., 519 U.S. 79 (1996)).

Prior Action

A substantially identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

15. Repeal the lower of cost or market inventory accounting method

Present Law

A taxpayer that sells goods in the active conduct of its trade or business generally must maintain inventory records in order to determine the cost of goods it sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows. Among these conventions are the "first-in-first-out" ("FIFO") method which assumes that the items in ending inventory are those most recently acquired by the taxpayer, and the "last-in-first-out" ("LIFO") method which assumes that the items in ending inventory are those earliest acquired by the taxpayer.

Treasury regulations provide that taxpayers that maintain inventories under the FIFO method may determine the value of ending inventory under a (1) cost method or (2) "lower of cost or market" ("LCM") method.[496] Under the LCM method, the value of ending inventory is written down if its market value is less than its cost. Similarly, under the subnormal goods method, any goods that are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, may be written down to net selling price. The subnormal goods method may be used in conjunction with either the cost method or LCM.

Retail merchants may use the "retail method" in pricing ending inventory. Under the retail method, the total of the retail selling prices of goods on hand at year-end is reduced to approximate cost by deducting an amount that represents the gross profit embedded in the retail prices. The amount of the reduction generally is determined by multiplying the retail price of goods available at year-end by a fraction, the numerator of which is the cost of goods available for sale during the year and the denominator of which is the total retail selling prices of the goods available for sale during the year, with adjustments for mark-ups and mark-downs.[497] Under certain conditions, a taxpayer using the FIFO method may determine the approximate cost or market of inventory by not taking into account retail price mark-downs for the goods available

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[496] Treas. Reg. sec. 1.471-2(c).

[497] Treas. Reg. sec. 1.471-(8)(a).

for sale during the year, even though such mark-downs are reflected in the retail selling prices of the goods on hand at year end.[498] As a result, such taxpayer may write down the value of inventory below its market value.

Description of Proposal

The proposal would repeal the LCM method and the subnormal goods method. Appropriate wash-sale rules would be provided. The proposal would not apply to taxpayers with average annual gross receipts over a three-year period of $5 million or less.

Effective date.--The proposal would be effective for taxable years beginning after the date of enactment. Generally, any section 481(a) adjustment required to be taken into account pursuant to the change of method of accounting under the proposal would be taken into account ratably over a four taxable year period beginning with the first taxable year the taxpayer is required to change its method of accounting.

Analysis

Under present law, income or loss generally is not recognized until it is realized. In the case of a taxpayer that sells goods, income or loss generally is realized and recognized when the goods are sold or exchanged. The LCM and subnormal goods inventory methods of present law represent exceptions to the realization principle by allowing the recognition of losses without a sale or exchange. These methods have been described as one-sided in that they allow the recognition of losses, but do not require the recognition of gains.

In general, the LCM and subnormal goods inventory methods have been long-accepted as generally accepted accounting principles ("GAAP") applicable to the preparation of financial statements and have been allowed by Treasury regulations for tax purposes since 1918. However, the mechanics of the tax rules differ from the mechanics of the financial accounting rules. Moreover, the conservatism principle of GAAP requires the application of the LCM and subnormal goods methods so that the balance sheets of dealers in goods are not overstated relative to realizable values. There is no analog to the conservatism principle of financial accounting under the Federal income tax.

The repeal of the LCM method may cause some taxpayers to change their methods of accounting for inventory to the LIFO method. The LIFO method typically results in a lower measure of taxable income if costs increase over time, but the LCM method may not be used in connection with the LIFO method. This has caused some taxpayers to retain the use of the FIFO method. If the use of the LCM method is denied to both FIFO and LIFO taxpayers, it may be expected that many such taxpayers would convert to the LIFO method, despite the LIFO method

[498] Treas. Reg. sec. 1.471-8(d).

generally being considered to be a more complicated method of accounting than is the FIFO method.

Prior Action

An identical proposal was included in the President's Fiscal Years 1997, 1998, 1999, and 2000 Budget Proposals. The proposal is substantially similar to a proposal reported by the Senate Committee on Finance in conjunction with the passage of the General Agreement on Tariffs and Trade in 1994.

16. Disallow of interest on debt allocable to tax-exempt obligations

Present Law

In general

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is not subject to tax (tax-exempt obligations).[499] This rule applies to tax-exempt obligations held by individual and corporate taxpayers. The rule also applies to certain cases in which a taxpayer incurs or continues indebtedness and a related person acquires or holds tax-exempt obligations.[500]

Application to non-financial corporations

General guidelines.--In Rev. Proc. 72-18,[501] the IRS provided guidelines for application of the disallowance provision to individuals, dealers in tax-exempt obligations, other business enterprises, and banks in certain situations. Under Rev. Proc. 72-18, a deduction is disallowed only when indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt obligations.

This purpose may be established either by direct or circumstantial evidence. Direct evidence of a purpose to purchase tax-exempt obligations exists when the proceeds of indebtedness are directly traceable to the purchase of tax-exempt obligations or when such

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[499] Section 265.

[500] Code section 7701(f) (as enacted in the Deficit Reduction Act of 1984 (sec. 53(c) of P.L. 98-369)) provides that the Treasury Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of any income tax rules which deal with linking of borrowing to investment or diminish risk through the use of related persons, pass-through entities, or other intermediaries.

[501] 1972-1 C.B. 740.

obligations are used as collateral for indebtedness. In the absence of direct evidence, a deduction is disallowed only if the totality of facts and circumstances establishes a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations.

Two-percent de minimis exception.--In the case of an individual, interest on indebtedness generally is not disallowed if during the taxable year the average adjusted basis of the tax-exempt obligations does not exceed 2 percent of the average adjusted basis of the individual's portfolio investments and trade or business assets. In the case of a corporation other than a financial institution or a dealer in tax-exempt obligations, interest on indebtedness generally is not disallowed if during the taxable year the average adjusted basis of the tax-exempt obligations does not exceed 2 percent of the average adjusted basis of all assets held in the active conduct of the trade or business. These safe harbors are inapplicable to financial institutions and dealers in tax-exempt obligations.

Interest on installment sales to State and local governments.--If a taxpayer sells property to a State or local government in exchange for an installment obligation, interest on the obligation may be exempt from tax. Present law has been interpreted to not disallow interest on a taxpayer's indebtedness if the taxpayer acquires nonsalable tax-exempt obligations in the ordinary course of business in payment for services performed for, or goods supplied to, State or local governments.[502]

Application to financial corporations and dealers in tax-exempt obligations

In the case of a financial institution, the allocation of the interest expense of the financial institution (which is not otherwise allocable to tax-exempt obligations) is based on the ratio of the average adjusted basis of the tax-exempt obligations acquired after August 7, 1987, to the average adjusted basis of all assets of the taxpayer.[503] In the case of an obligation of an issuer which reasonably anticipates to issue not more than $10 million of tax-exempt obligations (other than certain private activity bonds) within a calendar year (the "small issuer exception"), only 20 percent of the interest allocable to such tax-exempt obligations is disallowed.[504] A similar pro rata rule applies to security dealers in tax-exempt obligations, but there is no small issuer exception, and the 20-percent disallowance rule does not apply, and the proportional disallowance rule does not apply to interest of debt whose proceeds the dealer can trace to uses other than the acquisition of tax-exempt obligations.[505]

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[502] R.B. George Machinery Co., 26 B.T.A. 594 (1932), acq. C.B. XI-2, 4; Rev. Proc. 72-18, as modified by Rev. Proc. 87-53, 1987-2 C.B. 669.

[503] Section 265.

[504] Section 291(a)(3).

[505] Rev. Proc. 72-18, *supra.*

Treatment of insurance companies

Present law provides that a life insurance company's deduction for additions to reserves is reduced by a portion of the company's income that is not subject to tax (generally, tax-exempt interest and deductible intercorporate dividends).[506] The portion by which the life insurance company's reserve deduction is reduced is related to its earnings rate. Similarly, in the case of property and casualty insurance companies, the deduction for losses incurred is reduced by a percentage (15 percent) of (1) the insurer's tax-exempt interest and (2) the deductible portion of dividends received (with special rules for dividends from affiliates).[507] If the amount of this reduction exceeds the amount otherwise deductible as losses incurred, the excess is includible in the property and casualty insurer's income.

Description of Proposal

The proposal would amend the definition of financial institution to which the proportionate disallowance rule applies 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, the rule that applies to financial institutions that disallows interest deductions of a taxpayer (that are not otherwise disallowed as allocable under present law to tax-exempt obligations) in the same proportion as the average basis of its tax-exempt obligations bears to the average basis of all of the taxpayer's assets would be applied to all financial intermediaries. This proposal would not apply to insurance companies (although a separate proposal included in the President's Fiscal Year 2001 Budget Proposal would increase the proration percentage for property and casualty insurance companies).

Effective date.--The proposal would be effective for taxable years beginning after the date of enactment with respect to obligations acquired after the date of first committee action.

Analysis

In general

The present-law rules which disallow interest deductions on indebtedness whose proceeds are used to finance tax-exempt obligations are intended to limit what is perceived as a double tax benefit of (1) exclusion of interest received on tax-exempt obligations from income and (2) deduction of interest paid on obligations that finance the tax-exempt obligations. Present law provides different rules for different types of taxpayers. The proposal is based on acceptance of the premise that money is fungible for all financial intermediaries that operate similarly and,

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[506] Sections 807 and 812.

[507] Section 832(b)(5)(B).

accordingly, all debt of any financial intermediary finances its proportionate share of all of that intermediary's assets, including tax-exempt obligations.

Limitations to 2-percent de minimis exception

The proposal would extend to all financial intermediaries the pro rata rule that now applies only to banks. Extension of the pro rata rule would repeal the 2-percent de minimis exception for non-bank financial intermediaries. In addition, extension of the statutory pro rata rule to securities dealers would remove their ability to avoid an administrative pro rata rule under which the taxpayer can establish through tracing of funds that borrowings were not used to acquire tax-exempt obligations.

Some proponents of the proposal accept the premise that money of all financial intermediaries is fungible and, accordingly, would disallow interest deductions on a pro rata basis (e.g., in the same proportion as the taxpayer's average basis in its tax-exempt obligations bears to the average basis of its total assets). These proponents argue that permitting the holding of tax-exempt obligations without limiting the deductibility of interest expense under the 2-percent de minimis exception for some financial intermediaries, but not others, may be viewed as a tax subsidy which may create a competitive advantage for some financial intermediaries over other financial intermediaries with whom they compete. These proponents argue that the proposed pro rata allocation of indebtedness among assets (in the manner prescribed for financial institutions) has the additional administrative benefit, for taxpayers that own more tax-exempt obligations than the 2-percent de minimis amount, of avoiding the difficult and often subjective inquiry of when indebtedness is incurred or continued to purchase or carry tax-exempt obligations.

Opponents of the proposal argue that the proposal would have the effect of raising the financing costs for a State or local government. Opponents also argue that the scope of the proposal is uncertain, because it is unclear which taxpayers would be treated as financial intermediaries for this purpose. Finally, opponents note that the 2-percent de minimis exception of present law avoids the complexity of complying with the proposed pro rata rule.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal. The proposal is substantially similar to a proposal made in the President's Fiscal Year 1999 Budget Proposal. In addition, the proposal is narrower than a similar proposal made by the President's Fiscal Year 1998 Budget Proposal. In general, the Fiscal Year 1998 Budget Proposal would have applied the proportional disallowance rule to all corporations and would have applied the proportionate disallowance rule to all assets and borrowings of all related corporations.

17. Capitalization of commissions by mutual fund distributors

Present Law

Taxpayers generally are allowed to deduct all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on a trade or business. However, if the expenditure is incurred to create a significant long term benefit, the expenditure will generally be required to be capitalized, whether or not a separate and distinct asset is created or enhanced.[508] The amount capitalized is then allowed as a deduction over the period of the anticipated benefit or, if provided, a statutory or regulatory life. This allows the deduction to be matched with the revenue it generates. A number of statutory and regulatory exceptions to these rules exist, allowing current deduction of certain expenditures by certain taxpayers without regard to whether the expenditure is incurred to create a significant long term benefit. For example, the regulations allow a dealer in securities to deduct any brokerage commissions currently as an ordinary and necessary business expense.[509]

Mutual funds typically employ an underwriter/distributor to facilitate the distribution of their shares. New shares in a mutual funds are sold to investors in a number of different ways. In some cases, the shares are sold for their net asset value (without load). In other cases, the shares are sold at a premium (usually 1 to 5 percent) to their net asset value (with load). If the shares are purchased through a broker, all or a part of the premium or load is typically retained by the broker as its commission. In there is no premium or load, the broker may charge a separate commission.

Although there are situations where a mutual fund investor may deal directly with the underwriter/distributor in the purchase of mutual fund shares, there are many reasons why an investor may prefer to use a broker. A broker can facilitate the investing process, may offer investment guidance and advice, and can provide the investor with centralized record keeping. The broker may also be serving as trustee if the mutual fund shares are held by a tax advantaged retirement plan, such as an IRA, Roth-IRA, Keogh, 401(k), or a similar plan.

Because many mutual fund investors resist paying a load or commission on the purchase of shares, and because brokers typically insist on the payment of a commission for their services, underwriter/distributors have developed different approaches to the marketing of mutual fund shares. In one such approach, the underwriter/distributor as seller of the mutual fund shares pays the broker the commission it would otherwise collect from the purchaser through the load. The underwriter/distributor recovers this cost through a distribution fee (12b-1 fee) that is charged at regular intervals against each share of the mutual fund. In addition, a redemption fee or "back-end load" may be charged if the shares are sold within a fixed period of time.

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[508] INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992).

[509] Treas. Reg. sec. 1.263(a)-2(e). See also TAM 9345003 (July 15, 1993).

The underwriter/distributor typically takes the position that it is a dealer in the securities of the mutual fund in that it regularly purchases such securities from or sells them to its customers in the ordinary course of business. As a dealer, it is authorized by Treasury Regulations to treat the brokerage fees it pays in connection with the securities it buys and sells as ordinary and necessary business expenses, without regard to the creation of a future benefit through the collection of distribution fees and/or redemption fees.

Description of Proposal

Commissions paid to a broker by an underwriter/distributor would be capitalized and recovered over the period investors would have to hold the shares without incurring a fee on redemption.

Effective date.–The proposal would be effective for commissions paid or incurred in taxable years ending after the date of enactment.

Analysis

An underwriter/distributor expects to recover any commission it pays a broker on the distribution of the shares of a mutual fund. If that recovery is expected to occur over time through the collection of distribution fees and/or redemption fees, a better matching of income and expense will be achieved if the commission is capitalized and amortized over a reasonable approximation of the period the fees are expected to be received.

On the other hand, advertising, selling and distribution expenditures are generally allowed to be deducted, even though they may result in some additional revenue in later periods. The commission paid by an underwriter/distributor on the distribution of the shares of a mutual fund may be comparable to other types of advertising, selling and distribution expenses that will remain deductible. It should also be noted that the capitalization of commissions paid by an underwriter/distributor would increase the public's cost of investing in mutual funds as compared to other investment vehicles.

Prior Action

No prior action.

D. Cost Recovery Provisions

1. Provide consistent amortization period for intangibles

Present Law

At the election of the taxpayer, start-up expenditures[510] and organizational expenditures[511] may be amortized over a period of not less than 60 months, beginning with the month in which the trade or business begins. Start-up expenditures are amounts that would have been deductible as trade or business expenses, had they not been paid or incurred before business began. Organizational expenditures are expenditures that are incident to the creation of a corporation (sec. 248) or the organization of a partnership (sec. 709), are chargeable to capital, and that would be eligible for amortization had they been paid or incurred in connection with the organization of a corporation or partnership with a limited or ascertainable life.

Treasury regulations[512] require that a taxpayer file an election to amortize start-up expenditures no later than the due date for the taxable year in which the trade or business begins. The election must describe the trade or business, indicate the period of amortization (not less than 60 months), describe each start-up expenditure incurred, and indicate the month in which the trade or business began. Similar requirements apply to the election to amortize organizational expenditures. A revised statement may be filed to include start-up and organizational expenditures that were not included on the original statement, but a taxpayer may not include as a start-up expenditure any amount that was previously claimed as a deduction.

Section 197 requires most acquired intangible assets (such as goodwill, trademarks, franchises, and patents) that are 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.

Description of Proposal

The proposal would modify the treatment of start-up and organizational expeditures. A taxpayer would be allowed to elect to deduct up to $5,000 each of start-up and 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

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[510] Section 195.

[511] Sections 248 and 709.

[512] Treas. Reg. sec. 1.195-1.

amortized over a 15-year period consistent with the amortization period for section 197 intangibles.

Effective date.--The proposal would be effective for start-up and organizational expenditures incurred after the date of enactment. Start-up and organizational expenditures that are incurred on or before the date of enactment would continue to be eligible to be amortized over a period not to exceed 60 months. However, all start-up and organizational expenditures related to a particular trade or business, whether incurred before or after the date of enactment, would be considered in determining whether the cumulative cost of start-up or organizational expenditures exceeds $50,000.

Analysis

Allowing a fixed amount of start-up and organizational expenditures to be deductible, rather than requiring their amortization, may help encourage the formation of new businesses that do not require significant start-up or organizational costs to be incurred. However, requiring all start-up or organizational costs to be amortized over 15 years (rather than 5 years as under present law) if such category of costs exceeds $55,000 may discourage the formation of businesses that incur otherwise deductible costs of at least this amount prior to the commencement of business.

Prior Action

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal, except that proposal did not cover the organization expenditures of a partnership under section 709.

2. Establish specific class lives for utility grading costs

Present Law

A taxpayer is allowed a depreciation deduction 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 cost 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. Section 168 provides specific class lives for certain assets. The class life of other assets is determined by reference to the list of class lives provided by the Treasury Department that was in effect on January 1, 1986.[513] If no class life is provided, the asset is allowed a 7-year recovery period under MACRS.

[513] Rev. Proc. 87-56, 1987-2 C.B. 674.

Assets that are used in the transmission and distribution of electricity for sale are included in asset class 49.14, with a class life of 30 years and a MACRS life of 20 years. The cost of initially clearing and grading land improvements are specifically excluded from asset class 49.14. Prior to adoption of the accelerated cost recovery system (ACRS), the IRS ruled that an average useful life of 84 years for the initial clearing and grading relating to electric transmission lines and 46 years for the initial clearing and grading relating to electric distribution lines, would be accepted.[514] However, the result in this ruling was not incorporated in the asset classes included in Rev. Proc. 87-56 or its predecessors. Accordingly such costs are depreciated over a 7-year life under MACRS as assets for which no class life is provided.

A similar situation exists with regard to gas utility trunk pipelines and related storage facilities. Such assets are included in asset class 49.24, with a class life of 22 years and a MACRS life of 15 years. Initial clearing and grade improvements are specifically excluded from the asset class, and no separate asset class is provided for such costs. Accordingly, such costs are depreciated over a 7-year life under MACRS as assets for which no class life is provided.

Description of 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 include these assets in 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).

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

Analysis

The clearing and grading costs in question are incurred for the purpose of installing the transmission lines or pipelines and are properly seen as part of the cost of installing such lines or pipelines and their cost should be recovered in the same manner. The clearing and grading costs are not expected to have a useful life other than the useful life of the transmission line or pipeline to which they relate.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

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[514] Rev. Rul. 72-403, 1972-2 C.B. 102.

3. Extend the present-law intangible amortization provisions to acquisitions of sports franchises

Present Law

In general, the purchase price allocated to intangible assets (including franchise rights) acquired in connection with the acquisition of a trade or business must be capitalized and amortized over a 15-year period under section 197. These rules were enacted in 1997 to minimize disputes regarding the proper treatment of acquired intangible assets. These rules do not apply to acquisitions of professional sports franchises, rather, special rules apply.

Under section 1056, when a franchise to conduct a sports enterprise is sold or exchanged, the basis of a player contract acquired as part of the transaction is generally limited to the adjusted basis of such contract in the hands of the transferor, increased by the amount of gain, if any, recognized by the transferor on the transfer of the contract. Moreover, not more than 50 percent of the consideration from the transaction may be allocated to payer contracts unless the transferee establishes to the satisfaction of the Commissioner that a specific allocation in excess of 50 percent is proper. However, these basis rules may not apply where a sale or exchange of a franchise to conduct a sports enterprise is effected through a partnership.[515] Basis allocated to the franchise or to other valuable intangible assets acquired with the franchise may not be amortizable if these assets lack a determinable useful life.

Description of Proposal

The proposal would extend to acquisitions of sports franchises the same rules for amortization of intangibles that apply to other acquisitions under present law. Thus, all intangibles acquired in connection with the acquisition of a sports franchise would be amortized over a 15 year period.

Effective date.--The proposal would be effective for acquisitions occurring after the date of enactment.

Analysis

The present law rules under section 197 were enacted to minimize disputes regarding the measurement of acquired intangible assets. Prior to the enactment of those rules, there were many disputes regarding the value and useful life of various intangible assets acquired together in a business acquisition. Furthermore, in the absence of a showing of a reasonably determinable useful life, an asset could not be amortized. Taxpayers tended to identify and allocate large amounts of purchase price to assets said to have short useful lives, while the IRS might allocate a

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[515] P.D.B. Sports, Ltd. v. Comm., 109 T.C. 423 (1997).

large amount of value to intangible value for which no determinable useful life could be shown, (e.g., goodwill) thus denying amortization for that amount of purchase price.

The section 197 rules when enacted were not applied to sports franchises. At the time the 197 rules were enacted, it was believed that sports franchise acquisitions already had a set rules under section 1056 that effectively limited the amount that could be allocated to short-lived assets (such as player contracts) and that thus effectively restricted the amounts over which disputes might arise.

Since that time, at least one court has concluded that the rules of section 1056 do not apply where an acquisition is effected through a partnership. Therefore, the premise upon which section 197 was not applied to sports franchises is now questionable.

Furthermore, even if the rules of section 1056 do apply to acquisitions effected through a partnership, those rules do not eliminate the potential for disputes, because they address only player contracts, while a sports franchise acquisition can involve many intangibles other than player contracts. In addition, disputes may arise regarding the appropriate period for amortization of particular player contracts.

Opponents may contend that application of a 15 year rule is too harsh because many acquired assets have a shorter useful life.

Proponents contend that the 15 year rule is a rough justice rule that provides amortization for assets such as goodwill without the necessity of attempting to break that element down into identifiable assets with reasonably determinable useful lives. They would contend that the section 197 rules apply to all types of businesses regardless of the nature of their assets, and that it is not clear why sports franchises should be treated differently.

Prior Action

No prior action.

E. Insurance Provisions

1. Require recapture of policyholder surplus accounts

Prior and Present Law

Under the law in effect from 1959 through 1983, a life insurance company was subject to a three-phase taxable income computation under Federal tax law. Under the three-phase system, a company was taxed on the lesser of its gain from operations or its taxable investment income (Phase I) and, if its gain from operations exceeded its taxable investment income, 50 percent of such excess (Phase II). Federal income tax on the other 50 percent of the gain from operations[516] was deferred, and was accounted for as part of a policyholder's surplus account and, subject to certain limitations, taxed only when distributed to stockholders or upon corporate dissolution (Phase III). To determine whether amounts had been distributed, a company maintained a shareholders surplus account, which generally included the company's previously taxed income that would be available for distribution to shareholders.[517] Distributions to shareholders were

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[516] The legislative history to the Life Insurance Company Tax Act of 1959 states that "[t]his 50 percent reduction in underwriting gains is made because of the claim that it is difficult to establish with certainty the actual annual income of life insurance companies. It has been pointed out that because of the long-term nature of their contracts, amounts, which may appear as income in the current year and as proper additions to surplus, may, as a result of subsequent events, be needed to fulfill life insurance contracts. Because of this difficulty in arriving at true underwriting gains on an annual basis, the bill provides for the taxation of only 50 percent of this gain on a current basis." Report of the Committee on Ways and Means to accompany H.R. 4245, H. Rep. No. 34, 86th Cong., 1st Sess. at 13 (1959). Similarly, the Senate report provides, "Although it is believed desirable to subject this underwriting income to tax, it is stated that because of the long-term nature of insurance contracts it is difficult, if not impossible, to determine the true income of life insurance companies otherwise than by ascertaining over a long period of time the income derived from a contract or block of contracts. Because of this, the bill as amended by your committee, like the bill as passed by the House, does not attempt to tax on an annual basis all of what might appear to be income. In both the House and your committee's bill, half of the underwriting income is taxed as it accrues each year. The other half of the underwriting income is taxed when it is paid out in a distribution to shareholders after the taxed income has been distributed, or when it is voluntarily segregated and held for the benefit of the shareholders. This other half of the underwriting income also is taxed if the cumulative amount exceeds certain prescribed limits or if for a specified period of time the company ceases to be a life insurance company." Report of the Committee on Finance to accompany H.R. 4245, S. Rep. No. 291, 86th Cong., 1st Sess. at 7 (1959).

[517] Other events are treated as a subtraction from the policyholders surplus account. If for any taxable year the taxpayer is not an insurance company, or for any 2 taxable years the company is not a life insurance company, then the balance in the policyholder surplus account at

treated as being first out of the shareholders surplus account, then out of the policyholders surplus account, and finally out of other accounts.

The Deficit Reduction Act of 1984 included provisions that, for 1984 and later years, eliminated further deferral of tax on amounts (described above) that previously would have been deferred under the three-phase system. Although for taxable years after 1983, life insurance companies may not enlarge their policyholders surplus account, the companies are not taxed on previously deferred amounts unless the amounts are treated as distributed to shareholders or subtracted from the policyholders surplus account.

Under present law, any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company is subject to tax at the corporate rate in the taxable year of the distribution.[518] Present law (like prior law) provides that any distribution to shareholders is treated as made (1) first out of the shareholders surplus account, to the extent thereof, (2) then out of the policyholders surplus account, to the extent thereof, and (3) finally, out of other accounts.[519]

Description of Proposal

The proposal would require a stock life insurance company with a policyholders surplus account to include in income the amount in the account as of the beginning of the first taxable year beginning after the date of enactment. The amount included would be 5 percent in the first taxable year beginning after the date of enactment, 10 percent in the next year, 15 percent in the next year, 30 percent in the next year, and 40 percent in the last year. In the event of a direct or indirect distribution to shareholders or other event that requires inclusion in income of any amount in a policyholders surplus account, then the company would include a corresponding portion of the remaining amount in the policyholders surplus account in income over the remainder of the 5-year period.

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the close of the preceding taxable year is taken into income (former sec. 815(d)(2) as in effect prior to the 1984 Act, which is referred to in present-law sec. 815(f)). Further, the policyholder surplus account is reduced by the excess of the account over the greatest of 3 amounts related to reserves: (1) 15 percent of life insurance reserves at the end of the taxable year; (2) 25 percent of the amount by which the life insurance reserves at the end of the taxable year exceed the life insurance reserve at the end of 1958; or (3) 50 percent of the net amount of the premiums and other consideration taken into account for the taxable year (former sec. 815(d)(4)(A)-(C), as in effect prior to the 1984 Act, which is referred to in present-law sec. 815(f)).

[518] Section 815.

[519] Section 815(b).

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

Analysis

Proponents of the proposal argue that continued deferral of income that was tax-deferred in years before 1984 is no longer justified. Proponents argue that the original rationale for permitting the deferral--that ascertaining the underwriting underwriting of a life insurance company on an annual basis is too difficult and could result in an overestimate of the company's income--no longer applies. Present law taxing life insurance companies provides for inclusion of underwriting income without a 50 percent exclusion as under the prior three-phase system. Further, it is argued, virtually all the contracts that generated the deferred income have either terminated (whether through surrender of the contract, non-payment of premiums, or because the insured person has died), or have been reinsured with other companies. Thus, the risks are no longer with the companies that maintain the policyholders surplus accounts and continue to defer pre-1984 income with respect to those contracts.

Opponents might argue that both the 1959-1983 rules that permitted deferral, and the 1984 (present-law) rules that generally continue the deferral of tax on that income, were structured so favorably to taxpayers that events triggering tax on the deferred amounts are extremely unlikely to occur. It is argued that this structure reflects an implicit Congressional intent never to impose tax on the deferred amounts except in the extraordinary circumstances which would arise only if a company were liquidating and going out of business. Therefore, it is argued, it would be inconsistent with Congressional intent, and with taxpayers' understanding of the 1959 and 1984 legislation, to impose tax now on amounts in stock life insurance companies' policyholders surplus accounts.

On the other hand, it could be said that there is no reason to assume that Congress believed no amount would ever be included in a taxpayer's income, but rather, that such amounts were simply deferred and could be taxed later. The rules would not have listed events triggering tax on amounts in the policy holder's surplus account, if Congress had intended permanent deferral, it is argued.[520] Also, it could be argued that other favorable tax rules, some explicitly providing for permanent deferral or exclusion, have been repealed by Congress as it became clear that the rationale for them no longer applied. Thus, it is argued, the fact that Congress enacted a deferral provision in the past is not a sufficient reason to retain the deferral rule permanently.

Opponents might also argue that the policyholders surplus account does not represent any actual funds set aside, bur rather, is merely an accounting entry, and that requiring inclusion of

[520] In addition, the prior law has been interpreted in a recent case as requiring taxpayers to include amounts from the policyholders surplus account in income. See Bankers Life and Casualty Co. v. U.S., 142 F.3rd 973 (7th Cir. 1998), cert. denied (Nov. 2, 1998), 119 S. Ct. 403.

these amounts in income would give rise to tax liability with which no specific pool of funds or assets is associated. On the other hand, it could be said that the companies have had the benefit of deferral of tax on pre-1959 earnings, and that the economic benefit of the reduced taxes is represented in the companies' assets generally. Increased wealth arising from tax savings over the long period of deferral arguably provides a source from which to pay the tax liability on the deferred income.

Generally, the rules relating to amounts in policyholder surplus accounts affect stock but not mutual life insurance companies, because direct and indirect distributions to shareholders trigger tax on amounts in the policyholder surplus account under present law. Some might argue that the proposal would have a disparate impact on stock life insurance companies that is based only on their form of doing business and not related to any real economic distinction among the companies. As a practical matter, it is understood that mutual companies under the prior three-phase system rarely came within Phase II, but rather, were ordinarily taxed under Phase I on their taxable investment income (because their gain from operations generally did not exceed their taxable investment income). Thus, only the companies that had the benefit of deferral would be affected by the proposal.

Prior Action

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal, except that under that proposal, the period of inclusion was ten years, not five years, and the inclusion would have been ratable over the period.

2. Modify rules for capitalizing policy acquisition costs of insurance companies

Present Law

Insurance companies are required to capitalize policy acquisition expenses and amortize them on a straight-line basis, generally over a period of 120 months[521] beginning with the first month in the second half of the taxable year. Policy acquisition expenses required to be capitalized and amortized are determined, for any taxable year, for each category of specified insurance contracts, as a percentage of the net premiums for the taxable year on specified insurance contracts in that category. The percentages for each of the categories are as follows:

Annuities	1.75 percent
Group life	2.05 percent
Other life (including noncancellable or guaranteed renewable accident and health)	7.70 percent

[521] A special rule permits a 60-month amortization period for certain small companies.

Specified insurance contracts that are subject to the capitalization and amortization rule do not include any pension plan contract, any flight insurance or similar contract, contracts of certain noncontiguous foreign branches, or any contract that is a medical savings account ("MSA").

Regulatory authority is provided to the Treasury Department to provide a separate category for a type of insurance contract, with a separate percentage applicable to the category, under certain circumstances. The authority may be exercised if the Treasury Department determines that the deferral of policy acquisition expenses for the type of contract which would otherwise result under the provision 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 of the contract had been used. In making this determination, Congress intended that the amount of a reserve for a contract not be taken into account.[522] If the authority is exercised, the Treasury Department is required to adjust the percentage that would otherwise have applied to the category that included the type of contract, so that the exercise of the authority does not result in a decrease in the amount of revenue received by reason of the amortization provision for any fiscal year.

Description of Proposal

The proposal would modify the categories of specified insurance contracts under the rules requiring capitalization and amortization of policy acquisition expenses. The proposal would provide for the following categories:

Term life insurance (group or individual)	2.05 percent
Non-pension annuity contracts	4.80 percent
Group or individual noncancellable health insurance	7.70 percent
Cash value life insurance, credit life insurance, credit health insurance, and any other specified insurance contracts	10.30 percent

The category of group or individual noncancellable health insurance at 7.70 percent is the same as under present law. In addition, the percentage of net premiums capitalized for group or individual non-cancellable health insurance remains at 7.70 percent, as under present law.

The proposal retains the present-law exceptions from the definition of specified insurance contracts for any pension plan contract, any flight insurance or similar contract, certain contracts of noncontiguous foreign branches, or any contract that is an MSA.

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[522] See H. Rept. 101-964, Conference Report to accompany H.R. 5835, Omnibus Budget Reconciliation Act of 1990 (101st Cong., 2d Sess.), 1066, 1070.

Under the proposal, changes in the percentage of net premiums capitalized would be treated as a change in the taxpayer's method of accounting. The amount of the difference would be includable in the taxpayer's income ratably over a five-year period.

The proposal would also provide that an insurance company would be able to elect to capitalize the amount of its actual policy acquisition expenses, in lieu of applying the above percentages to its net premiums. This election would be made on a one-time basis for all lines of business of all members of the controlled group (within the meaning of sec. 848(b)(3)), and would be treated as a method of accounting.

<u>Effective date</u>.–The proposal would be effective for taxable years beginning after the date of enactment.

<u>Analysis</u>

The provision requiring insurance companies to capitalize and amortize policy acquisition expenses was enacted in 1990 to correct prior-law mismeasurement of the income of insurance companies. Policy acquisition expenses arise in connection with acquiring a stream of premium and investment income that is earned over a period well beyond the year the expenses are incurred. It is a well-established principle of the tax law that costs of acquiring an asset with a useful life beyond the taxable year are amortized over the life of the asset. Congress adopted a "proxy" approach designed to approximate the expenses for each year that are attributable to new and renewed insurance contracts in each of several broad categories of business. While this approach does not measure actual acquisition expenses, Congress believed that the advantage of adopting a theoretically correct approach was outweighed by the administrative simplicity of the proxy approach.

It could be argued that Congress was aware that a proxy approach could not be accurate with respect to the actual percentage of net premiums representing commissions and other policy acquisition costs, and therefore, that all of the percentages were calculated deliberately to err on the low side rather than on the high side. On the other hand, it could be said that there is no evidence that Congress intended the percentages to be low, or it is possible that accurate information was not available at the time the percentages were set, so that the percentages represented the best approximation that could be made at the time. Now that specific, current information about commission rates for particular lines of insurance business is available, it arguably is appropriate to revise the percentages applicable under present law. It could further be argued that, even if Congress did have specific, current information at the time the percentages were set, that commissions and other policy acquisition costs may have changed, and updating the percentages, modifying the amortization periods, and increasing the number of categories would be appropriate to achieve greater accuracy in measuring income.

For some lines of business, it could be argued that even though that line of business has relatively high actual acquisition expenses, the contracts tend to have a relatively short duration and therefore the present value of the amortization deduction (plus any currently deductible amounts) is lower under present law than if the contracts had a shorter amortization period for tax purposes (even if the entire actual amount of such expenses were capitalized). Therefore, it is argued, the percentages for these lines of business should not be increased, so as to take account indirectly of the short duration of such contracts. On the other hand, proponents point to the high ratio of commissions (which do not necessarily include all policy acquisition expenses) to net premiums. These ratios are higher than the percentages under the proposal. Also, they argue that the actual duration of most contracts is longer than ten years, and that the duration is shorter than ten years generally for lines of business with particularly high ratios of policy acquisition expenses to net premiums. Further, they argue, some lines of insurance business may be reinsured with small companies eligible for the more favorable 60-month amortization period, and consequently the present value of the deductions for acquisition expenses in such a case is greater.

Proponents of the proposal argue that the revision of the categories and percentages for capitalization and amortization is similar to the methodology that insurance companies use for financial reporting purposes under generally accepted accounting principles ("GAAP"). While a GAAP approach may have been rejected at the time the present-law rules were enacted, at least in part because some mutual insurance companies did not file GAAP statements, some observers point to a change in financial reporting practices under which insurance companies now generally report on a GAAP basis. They argue that GAAP more accurately measures income than the present-law tax rules do.

Opponents of increasing the percentages may argue that efficient companies with relatively low acquisition costs would be unfairly penalized by the increases under the proposal. Proponents point to the election under the proposal to capitalize and amortize actual acquisition expenses, and argue that efficient companies could make this election. They argue that the election could be based on the amount of policy acquisition expenses the company reports for GAAP purposes, so that the election could be relatively simple to administer.

The Treasury Department has regulatory authority to create an additional category of contract (provided it adjusts the category from which the contract was drawn so that there is no decrease in revenue from the provision), as noted above. Some may argue that this may suggest that legislation might not be required to change the capitalization percentages. On the other hand, it could be said that determining the proper percentage for any new category of contract and making the correct adjustment to its former category might be viewed as a judgment that is best left to Congress. Further, it could be said that the regulatory authority may not encompass changing the amortization period for a particular percentage, nor increasing the percentages in all the categories without offsetting reductions. Some might argue that the requirement that adjustments to the categories be balanced by an offsetting adjustment indicates that Congress viewed unfavorably any administrative change to the categories, making legislation the preferred means for any change to the categories.

Some argue that the proposal would apply with respect to existing contracts, and would change the percentages for them. It is argued that this type of effective date is unfair, and that it would be preferable to apply the proposal to premiums paid on newly issued contracts. On the other hand, it could be argued that if the percentages had been based on the ratio of commissions to first-year premiums, then the percentages would have been considerably higher, to reflect current commission payment practices for the first year of premiums. Proponents argue that because the percentages in the proposal are not based on the ratio of commissions to first-year premiums, it would be theoretically incorrect to apply the percentages in the proposal only to premiums on newly issued contracts.

Prior Action

A similar but narrower proposal was included in the President's Fiscal Year 1999 Budget Proposal, that applied only to credit life insurance (whether or not group credit life insurance). That proposal would have required insurance companies to capitalize and amortize 7.70 percent of net premiums for the taxable year with respect to credit life insurance, not 2.05 percent as under present law.

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal, except that proposal had slightly different percentages and did not treat the percentage changes as a change in method of accounting.

3. Increase the proration percentage for property and casualty insurance companies

Present Law

The taxable income of a property and casualty insurance company is determined as the sum of its underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions. Underwriting income means premiums earned during the taxable year less losses incurred and expenses incurred. In calculating its reserve for losses incurred, a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment or annuity contracts.

This 15-percent proration requirement was enacted in 1986. The reason the provision was adopted was Congress' belief that "it is not appropriate to fund loss reserves on a fully deductible basis out of income which may be, in whole or in part, exempt from tax. The amount of the reserves that is deductible should be reduced by a portion of such tax-exempt income to reflect the fact that reserves are generally funded in part from tax-exempt interest or from wholly or partially deductible dividends."[523] In 1997, the provision was expanded to take into account the increase for a taxable year in the cash value of certain insurance contracts.[524]

Description of Proposal

The proposal would increase the proration percentage applicable to a property and casualty insurance company from 15 percent to 25 percent.

Effective date.–The proposal would be effective for taxable years beginning after the date of enactment with respect to investments acquired on or after the date of first committee action.

Analysis

The proposal relates to the effect of the 15-percent proration percentage of present law on the funding of deductible loss reserves by means of income that may be, in whole or in part, exempt from tax. In 1998, property and casualty insurers held between 13 and 14 percent of all tax-exempt debt outstanding,[525] and about 22 percent of these companies' financial assets were invested in tax-exempt debt.[526] Proponents of the proposal interpret this as evidence that property and casualty insurers continue to find tax-exempt debt more profitable than otherwise comparable taxable debt.

Critics of the proposal note that by reducing the effective yield received by property and casualty insurers on their holdings of tax-exempt debt, the proposal can reduce the demand for tax-exempt bonds by this industry. As noted above, property and casualty insurers are large holders of tax-exempt bonds. A reduction in demand for these securities by the property and casualty insurers may lead to an increase in borrowing costs for State and local governments. Even a small increase in the interest cost to tax-exempt finance could create a substantial increase in the aggregate financial cost of debt-financed public works projects to State and local governments.

On the other hand, it could be said that the proration rate under the proposal is low enough so that there would be no such reduction in demand. Depending on yield spreads between tax-exempt and taxable securities, a modest increase in the proration percentage may

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523 H. Rept. 99-426, Report of the Committee on Ways and Means on H.R. 3838, the Tax Reform Act of 1985 (99th Cong., 1st Sess.), 670.

524 P.L. 105-34, The Taxpayer Relief Act of 1997, section 1084.

525 Federal Reserve Board, *Flow of Funds Accounts, Flows and Outstanding*, fourth quarter 1998.

526 *Id.*

only reduce the profit of the property and casualty insurers without changing the underlying advantage those taxpayers find in holding tax-exempt rather than taxable debt.

A taxpayer generally is likely to buy a tax-exempt security rather than an otherwise equivalent taxable security if the interest rate paid on the tax-exempt security is greater than the after-tax yield from the taxable security.[527] The 15-percent proration requirement of present law has the effect of imposing tax on interest paid by a tax-exempt bond at an effective marginal tax rate equal to 15 percent of the taxpayer's statutory marginal tax rate. Proponents of the proposal argue that the 15-percent rate could be increased to a rate that reduces but does not eliminate the use of tax-preferred income to fund deductible reserves.[528]

It is also argued that banks and life insurance companies (which also maintain reserves, increases in which are deductible for Federal income tax purposes) are subject to more effective proration rules that generally prevent them from funding reserve deductions with tax-preferred income. Present law may promote unequal treatment of competitors in the financial service sectors and the proposal would reduce any such unequal treatment, it is argued.

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[527] Mathematically, it is more profitable to hold a tax-exempt security paying an interest rate, r_{te}, than a taxable security of comparable risk and maturity paying an interest rate, r, if $r_{te} > r(1-t)$, where t is the taxpayer's marginal tax rate.

[528] By reducing the deduction for increases in reserves by 15 percent of the taxpayer's tax-exempt interest earnings, the taxpayer's taxable income is increased by 15 percent of the taxpayer's tax-exempt interest earnings. Thus, the 15-percent proration requirement has the effect of imposing tax on the interest paid by a tax-exempt bond at an effective marginal tax rate equal to $(.15)\cdot t$, where t is the taxpayer's marginal tax rate. One effect of creating an effective tax on the interest earned from a tax-exempt bond is that a property and casualty insurer would only find holding the tax-exempt bond more profitable than holding an otherwise comparable taxable bond when $r_{te} \cdot(1-(.15)t) > r\cdot(1-t)$. This is equivalent to: $r_{te} > r\cdot\{(1-t)/(1-(.15)t)\}$.

If the statutory marginal tax rate of the property and casualty insurer were 35 percent, then it would be profitable to purchase tax-exempt debt in lieu of taxable debt when $r_{te} >(.686)r$. Under the proposal, it would be profitable to purchase tax-exempt debt in lieu of taxable debt when $r_{te}>(.7123)r$.

Because the tax-exempt debt offers yields less than that of otherwise comparable taxable debt, some analysts maintain that a holder of tax-exempt debt already pays an "implicit tax" by accepting a lower, albeit tax free, yield. This implicit tax can be measured as the yield spread between the tax-exempt debt and the otherwise comparable taxable security. In this sense the taxpayer's true effective marginal tax rate to holding tax-exempt debt would be the implicit tax rate plus $(.15)\cdot t$. However, in considering the "implicit" tax one must recognize that this implicit tax is not paid to the Federal Government, but rather is received by the issuer of the tax-exempt debt in the form of a lower borrowing cost.

Critics of the proposal could respond that property and casualty insurance may be a sufficiently different business from that of other financial service providers that the disparate treatment of tax-exempt securities across the financial services industry does not create any unfair competitive advantage for one sector over another. Some observers point out that health, disability and long-term care insurance are sold by both life insurance companies and property and casualty companies, so in some respects property and casualty insurers cannot be distinguished from life companies, even though life insurers have more rigorous proration rules. The proposal alternatively could be criticized because it would still provide property and casualty insurers with more favorable proration rules than currently apply to banks and life insurance companies.

More broadly, it is said that the present tax rules provide an inefficient subsidy for borrowing by State and local governments. The interest rate subsidy provided to State and local governments by the ability to issue tax-exempt bonds cannot efficiently pass the full value of the revenue lost to the Federal Government to the issuer. The Federal income tax has graduated marginal tax rates. Thus, $100 of interest income forgone by a taxpayer in the 31-percent bracket costs the Federal Government $31, while the same amount of interest income forgone by a taxpayer in the 28-percent bracket costs the Federal Government $28. Consequently, if a taxpayer in the 28-percent bracket finds it profitable to hold a tax-exempt security, a taxpayer in the 31-percent bracket will find it even more profitable.[529] This conclusion implies that the Federal Government loses more in revenue than an issuer of tax-exempt debt gains in reduced interest payments, illustrating the inefficiency of this subsidy.

Prior Action

A similar proposal was included in the President's Fiscal Year 1999 Budget Proposal, except that in the prior proposal the percentage was 30 percent, not 25 percent. An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

4. Modify treatment of sales of life insurance contracts

Present Law

An exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[530]

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[529] As explained above, a taxpayer generally finds it more profitable to buy a tax-exempt security rather than an otherwise equivalent taxable security if the interest rate paid by the tax-exempt security, r_{te}, is greater than the after-tax yield from the taxable security, $r(1-t)$, where t is the taxpayer's marginal tax rate and r is the yield on the taxable security.

[530] Section 101(a)(1).

If a life insurance contract is sold or otherwise transferred for valuable consideration, the amount paid by reason of the death of the insured that is excludable generally is limited. Under the limitation, the excludable amount may not exceed the sum of: (1) the actual value of the consideration; and (2) the premiums or other amounts subsequently paid by the transferee of the contract. Thus, for example, if a person buys a life insurance contract, and the consideration he pays combined with his subsequent premium payments on the contract are less than the amount of the death benefit he later receives under the contract, then the difference is includable in the buyer's income.

Exceptions are provided to the limitation on the excludable amount. The limitation on the excludable amount does not apply if: (1) the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract;[531] or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.[532]

In the case of certain accelerated death benefits and viatical settlements,[533] special rules treat certain amounts as amounts paid by reason of the death of an insured (that is, generally, excludable from income). The rules relating to accelerated death benefits provide that amounts treated as paid by reason of the death of the insured include any amount received under a life insurance contract on the life of an insured who is a terminally ill individual, or who is a chronically ill individual (provided certain requirements are met). For this purpose, a terminally ill individual is one who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification. A chronically ill individual is one who has been certified by a licensed health care practitioner within the preceding 12-month period as meeting certain ability-related requirements. In the case of a viatical settlement, if any portion of the death benefit under a life insurance contract on the life of an insured who is terminally ill or chronically ill is sold to a viatical settlement provider, the amount paid for the sale or assignment of that portion is treated as an amount paid under the life insurance contract by reason of the death of the insured (that is, generally, excludable from income). For this purpose, a viatical settlement provider is a person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts on the lives of terminally ill or chronically ill individuals (provided certain requirements are met).

Description of Proposal

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[531] Section 101(a)(2)(A).

[532] Section 101(a)(2)(B).

[533] Section 101(g).

The proposal would impose a reporting requirement in the case of the purchase of an existing life insurance contract with a death benefit equal to or exceeding $1 million, and in the case of the payment of benefits under such a contract. Under this reporting requirement, the buyer would report information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. It would be intended that the reporting to the IRS would be directly to that portion of of the industry specialization program ("ISP") relating to the insurance industry. The information reported by the buyer about the purchase would be: (1) the purchase price; (2) the buyer's and seller's taxpayer identification numbers; and (3) the name of the issuer of the contract and the policy number. In addition, under the reporting requirement, the seller would be required to report the taxable portion of the consideration for the purchase on a separate schedule filed with the seller's tax return.

When a death benefit is paid under the contract, the payor insurance company would be required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor would report: (1) the gross amount of the payment; (2) the taxpayer identification number of the payee; and (3) the payor's estimate of the buyer's basis in the contract. The payee would be required to report the computation of the taxable portion of the payment on a separate schedule filed with the taxpayer's return for the year of inclusion of the payment. For purposes of this reporting requirement, the death benefit would be determined based on the highest death benefit payable under the contract (or any contract exchanged for the contract) within the three years preceding the year of the payment.

In addition, the proposal would modify the present-law rules providing an exception to the limitation on the excludable amount of a death benefit, in the case of certain transfers. In particular, the proposal would modify the rule providing an exception if the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.[534] It would be intended that the modification would narrow this rule so its application would be limited to persons who had been related to each other in this way for a significant period of time.

Effective date.–The proposal would be effective for sales or assignments of interest in life insurance contracts and payments of death benefits after the date of enactment.

Analysis

The proposal is directed to the issue of collection of tax on amounts that are includable in income with respect to a life insurance contract that has been transferred for value. Advocates of the reporting rules of the proposal argue that, because information about the identity of parties to transfers of contracts, amounts paid for transferred contracts, and payments under transferred contracts is not now reported, it may be more difficult to enforce the requirement that amounts be included in income. Advocates might further argue that taxpayers who are parties to transfers

[534] Section 101(a)(2)(B).

of life insurance contracts may have a reduced incentive accurately to measure gain on transfers and on payments under transferred contracts, or even to include any amount in income, because they believe enforcement of the requirement of inclusion may be difficult. Thus, it is argued, the reporting provisions are needed to improve voluntary compliance with present law.

Opponents of the reporting requirement may argue that the reporting requirements are burdensome. They may argue that reporting all the information that would be required by the proposal is an inefficient use of IRS resources, which might be better employed addressing other, more pressing tax issues. They may further argue that the level of detail of the reporting under the proposal is excessive, and that if any reporting of transfers of life insurance contracts is proposed, it should be more limited than that proposed. On the other hand, some might point to present-law reporting requirements applicable to banks and mutual funds.

The mechanics of the reporting requirement could be criticized as not fully developed. The proposal does not address the mechanism for reporting in the case of periodic payments for the purchase of an insurance contract. It is unclear whether the full amount that ultimately would be included in the seller's income would have to be reported by the seller in the year of the transfer, or whether the amount taxable to the seller would be reported in the taxable year in which each such amount is includable in income.

The reporting requirement on payment of a death benefit under a contract could also be criticized as somewhat complex. To trigger this reporting requirement, a determination must be made as to whether a death benefit has been paid, a determination that is based on the highest death benefit payable under the contract within the three years preceding the year of the payment. If, by contrast, the reporting requirement applied to any payment under a contract, regardless of the size of the death benefit, then this determination would be eliminated, and the payee would still report the taxable portion (if any) of the payment. On the other hand, those opposed to the proposal's reporting requirements generally on the grounds that they are unduly burdensome might argue that expanding the circumstances in which reporting applies would exacerbate the problem.

With respect to the modification of the present-law rule permitting exceptions to the limitation on the exclusion for death benefits in the case of life insurance contracts transferred for value, advocates of the proposal would argue that purchasers of life insurance contracts (such as viatical settlement companies) should not appear to be more easily able to escape tax on their business income than other taxpayers because enforcement may be difficult due to lack of reporting. The perception that taxpayers might not include income because enforcement of the inclusion requirement may be difficult can be corrected, advocates argue, by making it very clear that enforcement of the inclusion requirement is easy using the reported information.

Opponents of the modification to the present-law exceptions may argue that the proposal is not sufficiently detailed or specific, and that a vague proposal to modify the exceptions could have a chilling effect on legitimate business transactions that are not intended to be covered by the proposal. On the other hand, it could be noted that the proposal would become specific during the legislative process, before any provision would be enacted.

Opponents of the proposals might also argue that it is inconsistent to modify the reporting requirements only for purchases of an existing life insurance contract with a death benefit equal to or exceeding $1 million, while modifying the exclusion rules regardless of the amount of the death benefit under the contract. If reporting is inadequate under present law, it could be argued, it should be applied to all cases in which income should be reported, not just some; or alternatively, the modifications of the exclusion rules should parallel the reporting rules, if the underreporting is principally a problem at that level of death benefits under purchased contracts. Proponents might argue, however, that most reporting requirements under present law require reporting only for amounts over a dollar threshold, and this proposal is consistent with that approach.

Prior Action

No prior action.

5. Modify qualification rules for tax-exempt property and casualty insurance companies

Present Law

A property and casualty insurance company is eligible to be exempt from Federal income tax if its net written premiums or direct written premiums (whichever is greater) for the taxable year do not exceed $350,000.[535]

A property and casualty company may elect to be taxed only on taxable investment income, if its net written premiums or direct written premiums (whichever is greater) for the taxable year exceed $350,000 but do not exceed $1.2 million.[536]

For purposes of determining the amount of a company's net written premiums or direct written premiums under these rules, premiums received by all members of a controlled group of corporations of which the company is a part are taken into account.

Present law provides an election under which a foreign corporation may be taxed as a domestic corporation, if it meets certain requirements.[537] Among the requirements for the election are that the foreign corporation (1) must meet an ownership test generally requiring 25

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535 Section 501(c)(15).

536 Section 831(b).

537 Section 953(d).

percent or more of the vote and value of the corporation's stock to be owned by U.S. shareholders, and (2) would qualify under part I or part II of subchapter L (generally relating to the taxation of life insurance companies and property and casualty insurance companies) for the taxable year if it were a domestic corporation.

Present law imposes an excise tax on certain insurance or reinsurance contracts issued by any foreign insurer or reinsurer, at the rate of either one or four percent of premiums.[538]

Description of Proposal

The proposal would modify the eligibility requirement for tax-exempt status for property and casualty insurance companies. First, only U.S. property and casualty companies would be eligible. Second, to be eligible, a company could have no more than $350,000 of gross receipts (rather than net or direct written premiums). For this purpose, gross receipts would include investment and other types of income, as well as premiums. In addition, the controlled group rule for determining eligibility for tax-exempt status would be modified: gross receipts would include all income of insurance company members of a controlled group of corporations of which the company is a part, and also premium income of any non-insurance-company member of the controlled group.

The proposal would modify the election to be taxed only on taxable investment income. First, the eligibility rules would be broadened, to permit the election by property and casualty companies with net written premiums or direct written premiums of $350,000 or less, as well as the higher amounts under present law. The proposal would modify the controlled group rules applicable under this test to include premiums of foreign as well as U.S. companies, and to include the premiums of tax-exempt companies that would be otherwise be treated as members of the controlled group.

The proposal would limit the election of a foreign corporation to be taxed as a domestic corporation. Under the proposal, the election would not be available if the corporation would be eligible for tax-exempt status when treated as a domestic corporation.

Effective date.–The proposal relating to tax-exempt status and the proposal relating to the election to be taxed only on taxable investment income would be effective for taxable years beginning after the date of enactment. The proposal limiting the election of a foreign corporation to be taxed as a domestic corporation would be effective for the first taxable year after the date of enactment, in the case of a corporation formed after the date of first committee action, and would be effective for the second taxable year beginning after the date of enactment, in the case of a corporation formed before the date of first committee action.

Analysis

[538] Section 4371.

The proposal responds to concerns that the provisions permitting tax-exempt status and taxation only on taxable investment income for some property and casualty companies and the election to be taxed as a domestic company are being applied in circumstances that were not anticipated and that are not consistent with the purposes of the provisions.

Because the provision permitting tax-exempt status for some property and casualty insurance companies is based on premium income only, instead of on all income of the company, some companies that are not small may take the position that they are eligible for tax-exempt status. For example, a property and casualty company that is winding up its business may have little or no premium income, because it is not writing any significant new business, but may have a large amount of investment income with respect to policies already in force that it may argue is exempt from tax under the present-law provision. Thus, advocates of the proposal argue, it is appropriate to target the provision permitting tax-exempt status to property and casualty insurance companies that truly have very little income on a gross receipts basis. In such a case, the loss of revenue from permitting tax-exempt status is arguably outweighed by the greater simplicity for the company and the ease of administration in not requiring the calculation of income under the insurance tax rules of the Code (subchapter L), which are complex. Similarly, they argue, it is appropriate to limit the availability of tax-exempt status to domestic taxpayers, and eliminate the possible use of the provision by foreign companies to eliminate tax on investment income.

Opponents of the proposals might argue that they increase the complexity of the tax laws by imposing additional limitations, to address situations that are remote or uncommon. They argue that companies that are winding up their businesses due to insolvency generally have net operating loss carryforwards that serve to eliminate tax liability during the period of liquidation, so it is not necessary to prevent them from achieving tax-exempt status to avoid tax on investment income.

Some might argue that property and casualty insurance companies organize offshore, as foreign corporations, and then elect to be treated as domestic corporations for Federal income tax purposes, because of State limitations on commissions for credit insurance. They argue that the proposals adversely affect legitimate business arrangements that arise in response to State law. Others might respond that the Federal tax law should not be shaped by taxpayers' attempts to avoid State regulation of their businesses, and that this criticism of the proposal is itself flawed.

Prior Action

No prior action.

F. Tax-Exempt Organization Provisions

1. Subject investment income of trade associations to tax

Present Law

Under present 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 on their investment income. However, section 501(c)(6) organizations are subject to tax on their unrelated business taxable income. The unrelated business income tax ("UBIT") applies with respect to income derived from a trade or business regularly carried on by the organization unless the conduct of the trade or business is related substantially (aside from the organization's need for or use of the revenues) to performance of its tax-exempt functions. Under special rules, dividends, interest, royalties, certain rental income, certain gains or losses from dispositions of property, and certain other specified types of income (and directly connected deductions) of a tax-exempt organization generally are excluded from unrelated business taxable income subject to UBIT, except where derived from debt-financed property or certain controlled entities.[539]

In the case of tax-exempt social clubs, voluntary employees' beneficiary associations ("VEBAs"), and certain other mutual benefit organizations, the UBIT generally applies under present law to all gross income--including investment income--other than certain Aexempt function income. Exempt function income includes items 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.[540]

Dues paid by members of a section 501(c)(6) organization generally are deductible as ordinary and necessary business expenses under section 162(a). However, no deduction is allowed under present law for any amount paid or incurred in connection with certain lobbying and political activities. For section 501(c)(6) organizations, the primary consequence of this provision is to deny members a deduction for dues or similar amounts allocable to lobbying and political activities. An organization must notify its members of a reasonably estimated disallowance percentage for the year at the time of assessment or payment of the dues for that year. Any lobbying and political expenditures made by an organization described in section 501(c)(6) are deemed to be made first out of the dues payments made by the members during the

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[539] Section 512(b).

[540] Section 512(a)(3).

year.[541] As an alternative to the notice requirement and the disallowance of otherwise deductible dues, an organization may choose to pay a proxy tax on the actual amount of its expenditures for lobbying and political expenditures for the year.[542]

Under section 527(f), a tax-exempt organization, including an organization described in section 501(c)(6), that makes expenditures in an attempt to influence the selection of an individual to any Federal, State, or local public office (which generally are referred to as Aelectioneering@ expenditures) is subject to a tax at the highest corporate rates.[543] This tax is determined by computing an amount equal to the lesser of the organization's net investment income for the year involved or the amount expended on electioneering activities.[544] In computing net investment income for purposes of this tax, items of the organization's income already subject to UBIT are excluded from the computation.[545]

Description of Proposal

Under the proposal, trade associations and other organizations described in section 501(c)(6) generally would be subject to tax (at applicable corporate income tax rates) on their net investment income in excess of $10,000. For this purpose, Anet investment income@ would include dividends, interest, royalties, rent, and certain gains and losses from dispositions of property, minus all expenses directly connected with such items of income.

As under present-law, tax would not be imposed 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 501(c)(6) sells property that is used directly in the performance of its exempt function activities, 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.

Effective date.--The proposal would be effective for taxable years beginning on or after the date of enactment.

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541 Section 6033(e)(1)(C).

542 Section 6033(e)(2).

543 The electioneering activities covered by section 527 are somewhat different than the lobbying and political activities covered by section 162(e).

544 Section 527(f)(1).

545 Section 527(f)(2).

Analysis

In general

Under present law, dues payments by members of an organization described in section 501(c)(6) generally are deductible. In addition, the organization generally is not subject to tax on its investment income. Thus, members of such an organization are able to fund future operations of the organization through deductible dues payments, even though the members would have been subject to tax on the earnings attributable to such dues payments if they had been retained and invested by the members and paid at the time the organization had expenses. Supporters of the proposal argue that the tax-exempt treatment accorded to organizations described in section 501(c)(6) should not extend to the accumulation of assets on a tax-free basis. Thus, it can be argued that such organizations should be subject to tax on earnings attributable to amounts collected in excess of the amounts needed to fund current operations of the organization.

Opponents of the proposal will argue that the proposal does not permit organizations described in section 501(c)(6) to plan for anticipated expenditures, such as the purchase of a headquarters building. Thus, it could be argued that the proposal has the effect of forcing such an organization to collect substantial dues from members in the year in which an extraordinary expense arises and that this will have the effect of penalizing those individuals who are members at the time of an extraordinary expense. On the other hand, the proposal does not subject the first $10,000 of investment earnings to tax, and thus allows an organization described in 501(c)(6) to accumulate some assets to meet future expenses.

Opponents of the proposal also may contend that it is not appropriate to extend the tax treatment of social clubs (and other mutual benefit organizations) to organizations described in section 501(c)(6), because the purposes and activities of these types of entities are not analogous. The purpose of a social club is to provide to its members benefits of a recreational or social nature, which generally would not be deductible if directly paid for by the members. Accordingly, it is considered appropriate to prevent such benefits from being provided through tax-free investment income. In contrast, expenditures for many of the activities of a trade association (other than expenditures for lobbying or political activities) would be deductible by the association's members if carried on by the members directly because the expenditures would constitute ordinary and necessary business expenses under section 162(a).

The proposal does not address the interaction of the proposal and the section 527(f) tax imposed on an organization because of its involvement in political activities. Because the proposal would subject the net investment income (above the $10,000 threshold) of section 501(c)(6) organizations to UBIT under all circumstances, section 527(f)(2) would prevent that investment income from being taken into account for purposes of computing the tax under section 527(f)(1). Consequently, it is unclear whether the tax imposed under section 527(f) would have continuing applicability to section 501(c)(6) organizations.

Economic analysis of proposal

In general, the dues collected by a trade association are established at levels that are intended to provide sufficient funds to carry out the exempt purposes of the trade association. That is, the trade association ultimately spends all dues collected on the exempt purposes of the trade association. The effect of the present-law exclusion from UBIT for certain investment income of trade associations is that if the trade association collects $1.00 in dues today, but does not incur expenses until some point in the future, the association will have an amount with a present value of $1.00 available to meet those expenses. For example, if interest rates are 10 percent and the trade association collects $1.00 in January 2000, but incurs no expenses until January 2001, at that time it will have $1.10 available to meet expenses.

The deductibility of dues paid by the trade association member to the trade association effectively reduces the cost of paying the dues to the trade association member.[546] Depending upon whether investment earnings of trade associations predominately are earned and used to fund current year operations or whether substantial balances of assets are carried forward for a number of years, the present-law exclusion from UBIT for investment income of trade associations may permit the trade association and its members to effectively lower the cost of the trade association's dues below the cost reduction created solely by deductibility of dues.

Assume that a trade association does not anticipate any expenses during the first half of 2000, but anticipates $1.05 in expenses in the second half of 2000. The trade association could collect $1.00 in dues in January 2000 and by investing the $1.00 at 10-percent (as in the example above) for half of the year have sufficient funds to meet the future expense. Alternatively, the trade association could collect $1.05 in dues from its members in July 2000. In that case, the association member could invest the $1.00 in dues that was not collected in January and, at a 10-percent rate of return, could realize a gross return of $1.05 in July 2000. The association member could use the $1.05 to pay the association dues at that time. By investing, the association member would have earned an additional $0.05 in income, but by paying dues of $1.05 which are deductible against income, the association member's after-tax (and after dues) income is the same as when he or she paid $1.00 in dues in January 2000. Because the trade association receives $1.05 in July 2000, the trade association is in the same position as if it had received $1.00 in January 2000. Thus, within a single tax year, present law leaves a trade association member indifferent between paying deductible dues now and letting the trade

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[546] In general, permitting a taxpayer to deduct certain expenses from gross income for the purpose of computing taxable income means that the taxpayer makes those expenditures out of pre-tax income. The taxpayer must make most other purchases out of after-tax income. As a result, the "cost," in terms of the forgone other (non-deductible) spending, of the deductible expenditures is $1.00(1 - t), where t is the taxpayer's marginal tax rate. Thus, to give $1.00 to the trade association, the trade association member must sacrifice less than $1.00 of other spending.

association earn pre-tax rates of return to meet exempt purpose expenses or earning the income itself and paying the income over to the trade association as part of its deductible dues.

If the trade association carries over assets on which it earns income from the current year to future years, the trade association member may not be indifferent between paying $1.00 in dues in 2000 or $1.21 in dues in 2002. Under present law, the trade association could invest $1.00 in 2000 at 10 percent and have $1.21 available in 2002. However, the trade association member that invests $1.00 in 2000 may not have $1.21 to contribute as dues to the trade association in 2002, because the member would have to pay taxes on the annual interest earnings if the $1.00 were invested in a bank account. As a result, the trade association member would have somewhat less than $1.21 available in its bank account in 2002 and would have to sacrifice some other consumption to pay $1.21 in dues in 2002. By transferring $1.00 in dues in 2000, the trade association member can both obtain a current deduction and avoid income tax liability on the investment earnings attributable to the dues payment because the trade association's investment earnings are not taxed. Thus, the trade association member would prefer to pay $1.00 in dues in 2000 and let the trade association earn pre-tax rates of return to meet exempt purpose expenses. In this way, the present-law exclusion from UBIT for investment income of trade associations effectively lowers the amount of spending on other goods that the trade association members must give up to fund the activities of the trade association.

The proposal would subject the investment income of the trade association to income tax. In the example above, if the trade association collected $1.00 in dues in 2000 and invested the proceeds, it would have something less than $1.21 in funds available in 2002 to meet expenses, the same result as if the trade association member had retained the $1.00 and invested it itself. Compared to present law, the proposal would have the effect of raising the amount of spending on other goods that the trade association members must give up to fund the exempt purposes of the trade association. If the rate of tax applicable to the trade association and the rate of tax applicable to the trade association member were equal, the trade association member will be indifferent between paying deductible dues now and letting the trade association earn after-tax rates of return to meet exempt purpose expenses or earning the income itself, paying tax on the annual income, and paying the after-tax proceeds over to the trade association as part of its deductible dues.[547]

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal. A similar proposal was included in the Omnibus Budget Reconciliation Act of 1987, as passed by the House; however, that proposal did not include the exemption for the first $10,000 of investment income.

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[547] In general, if the trade association were subject to a higher marginal tax rate than the trade association member, the trade association member would prefer not to pre-fund future expenses of the trade association.

2. Penalty for failure to file Form 5227

Present Law

Tax-exempt organizations (other than churches and certain small organizations) are required to file an annual information return, Form 990 (Form 990-PF for private foundations), with the IRS, and are subject to a penalty for failure to file such returns equal to $20 for each day the failure to file continues, not to exceed the lesser of $10,000 or 5 percent of the organization's gross receipts.[548] In the case of tax-exempt organizations with gross receipts in excess of $1 million for any year, the penalty is increased to $100 per day, not to exceed $50,000. Split-interest trusts (described in sec. 4947(a)(2)) and certain trusts claiming charitable deductions under section 642(c) also are required to file an annual information return, Form 1041-A.[549] The penalty for failure to file Form 1041-A is $10 for each day the failure continues, up to a maximum of $5,000 with respect to any one return.[550] Split-interest trusts, including charitable remainder trusts described in section 664, generally are required to file an additional annual information return, Form 5227, which provides more information than reported on Form 1041-A regarding the trust's financial activities and whether the trust is subject to certain excise taxes imposed under chapter 42.[551]

The penalty imposed under section 6652(c)(2)(A) for failure to file annual trust information returns refers only to "a return required under section 6034." Section 6034 grants the Secretary of the Treasury authority to require the filing of information returns by split-interest trusts and certain other trusts; however, because Form 5227 is required by regulation under section 6011 rather than section 6034, the penalties imposed under section 6652(c)(2) arguably do not apply to a trust's failure to file Form 5227.

In 1996, Congress increased the penalties applicable to tax-exempt organizations for failure to file annual returns in order to provide a greater incentive to organizations to comply with the filing requirements imposed by section 6033. The penalty imposed by section 6652(c)(2)(A) on trusts that fail to file a return required by section 6034 was not increased.

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548 Sections 6033 and 6652(c)(1)(A).

549 Section 6034.

550 Section 6652(c)(2)(A).

551 Split-interest trusts are trusts where some but not all of the interest is held for charitable purposes. Although these trusts are not private foundations, they are subject to some of the private foundation rules. Treas. Reg. sec. 53.6011-1(d).

Description of Proposal

The proposal would impose a penalty for failure to file Form 5227 of $20 for each day the failure to file continues (up to a maximum of $10,000 per return). In the case of a trust with income in excess of $250,000, the penalty would be $100 for each day the failure continues (up to a maximum of $50,000 per return). Any trustee who knowingly fails to file From 5227 would be jointly and severally liable for the amount of the penalty, unless such failure is not willful and is due to reasonable cause.

Effective date.--The proposal would be effective for any return the due date for which is after the date of enactment.

Analysis

Form 5227 is critical to the enforcement efforts of the IRS as it provides detailed information regarding the financial activities of split-interest trusts and possible liability for the private foundation excise taxes to which these trusts are subject. The proposal to impose a penalty for failure to file Form 5227 would encourage voluntary compliance by delinquent filers and would assist the IRS in obtaining information about the activities of such trusts.[552] The proposed penalty amounts generally are comparable to penalties imposed on private foundations for failure to file Form 990-PF, which, like Form 5227, requires reporting of chapter 42 excise taxes.

Prior Action

No prior action.

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[552] The need for improved reporting by split-interest trusts has been illustrated by recent reports of attempts by taxpayers to avoid recognition of gain from appreciated assets through the use of charitable remainder trusts. See Janet Novack, "The New Giving Game," Forbes, Sept. 20, 1999, 180; Frederick P. Gabriel Jr., "Who Knew 'Chutzpah' Trusts Would Raise IRS Ire?," Investment News, Oct. 4, 1999, 1. See also Prop. Treas. reg. sec. 1.643(a)-8, 64 Fed. Reg. 56718 (1999).

G. Estate and Gift Tax Provisions

1. Restore phaseout of unified credit for large estates

Present Law

Under present law, the estate and gift tax rates range from 18 percent on taxable estates not over $10,000, to 55 percent on the excess over $3,000,000. However, in 2000, for example, after application of the unified credit on the first $675,000 of taxable estate, rates effectively range from 37 percent to 55 percent. For taxable estates above $10,000,000, a 5-percent surtax applies, which phases out the benefit of the graduated rates. Thus, estates between $10,000,000 and $17,184,000 are subject to an effective top marginal rate of 60 percent. Estates over $17,184,000 are subject to a top marginal rate of 55 percent, as the benefit of the graduated rates has been phased out.

Description of Proposal

The proposal would expand the 5-percent surtax in order to phase out the benefit of the unified credit as well as the benefit of the graduated rates. The phase-out range would increase as the unified credit continues to rise until 2006. In order to phase out the benefit of both the graduated rates and unified credit, the 5-percent surtax would apply to taxable estates between $10 million and $21,595,000 for 2000 and 2001; between $10 million and $21,780,000 for 2002 and 2003; between $10 million and $22,930,000 for 2004; between $10 million and $23,710,000 for 2005; and between $10 million and $24,100,000 for 2006 and thereafter.

Effective date.--The proposal would be effective for estates of decedents dying after the date of enactment.

Analysis

Prior to enactment of the Taxpayer Relief Act of 1997, a 5-percent surtax was imposed upon cumulative taxable transfers between $10 million and $21,040,000 in order to phase out the benefits of the unified credit and graduated rates. The phaseout of the benefits of the unified credit and the graduated rates was originally adopted in the Omnibus Budget Reconciliation Act of 1987 to restrict these benefits to small estates, which the Congress had determined had the greatest need for tax relief. The Taxpayer Relief Act of 1997 increased the unified credit, beginning in 1998, from an effective exemption of $600,000 to an effective exemption of $1 million in 2006. A conforming amendment that was made to the 5-percent surtax continues to phase out the benefits of the graduated rates but not the benefits of the unified credit, such that the 5-percent surtax applies to taxable estates between $10 million and $17,184,000.

Under present law, the average tax rate, in 2006, on an estate of $24,100,000 would be 50.9 percent, and the average tax rate would increase for estates above $24,100,000, although the average tax rate never would reach 55 percent. Under the proposal, in 2006 for example, the phase out would have the effect of increasing the marginal tax rate to 60 percent with respect to taxable estates between $17,184,000 and $24,100,000, after which the top marginal rate would revert to a flat 55 percent, with no benefit of the unified credit or graduated rates. This would have the effect of creating a tax liability equal to a flat 55 percent of the taxable estate on all estates valued at $24,100,000 or greater.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal. A similar provision was included as a technical correction in the Internal Revenue Service Restructuring and Reform Act of 1998 as passed by the Senate.

2. Require consistent valuation for estate and income tax purposes

Present Law

Under present law, property included in the gross estate of a decedent generally is valued at its fair market value on the date of death (or on an alternate valuation date). Likewise, the basis of property acquired from a decedent is its fair market value on the date of death. However, there is no statutory 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 statutory 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.[553] The Form 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.) The donor has no duty to notify the donee of the donor's basis in the transferred property.

Description of Proposal

The proposal would require that a person receiving property from a decedent use, as basis, the fair market value of the property as reported on the decedent's estate tax return (if one is filed).

The proposal also would require that an estate, by its representative, notify each heir, as well as the IRS, of the fair market value on the date of the decedent's death of any property distributed to such heir. Moreover, donors of lifetime gifts (other than annual exclusion gifts) would be required to notify donees, as well as the IRS, of the donor's basis in the property at the

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[553] Section 6034A.

time of the transfer as well as any payment of gift tax that would increase the basis of the property.

Effective date.--The proposal would be effective for estates of decedents dying and gifts made after the date of enactment.

Analysis

The proposal would impose both a duty of consistency and a reporting requirement. To ensure consistency, the proposal would require that an individual taking a basis under section 1014 (property acquired from a decedent) use the fair market value as reported on the decedent's estate tax return, provided one was filed, as the basis of the property for income tax purposes.

Courts have recognized that taxpayers have a duty to maintain consistent positions with the IRS.[554] In fact, a duty of consistency has been held to apply when an estate determines the fair market value of property at the date of death, and a recipient/heir (who was the estate's executor) later argues, after the period of limitations on the estate tax assessment had expired, that the property had a basis different from that reported (or stipulated to) by the estate.[555] The proposal would codify a duty of consistency with respect to the reporting of the basis of property received from a decedent's estate.

It may be appropriate to codify a duty of consistency for those heirs who participated in valuing property for estate tax purposes initially or by agreement with the IRS. In such a case, an heir would be estopped from claiming a value different than the one claimed on the estate tax return or agreed to with the IRS.

Estoppel, however, may not be appropriate for those transferees who had not participated in the valuation process for an estate. In this instance, the proposal would require these individuals to report, for income tax purposes, the value as reported on the estate tax return or agreed to with the IRS, without an opportunity to challenge such value. The proposal may preclude an heir, who had no role in determining the value of property for estate tax purposes, from challenging the property's value for personal income tax purposes.

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[554] See, e.g., LeFever v. Commissioner, 103 T.C. 525 (1994) (applying a duty of consistency where taxpayers agreed to special-use valuation, then, after the period of limitations on the estate tax return expired, tried to argue that the special-use valuation election was invalid).

[555] See Cluck v. Commissioner, 105 T.C. 324 (1995) (estopping the taxpayer from arguing, after the period of limitations on the estate tax expired, that the basis in land inherited by her spouse should be higher because it was undervalued for estate tax purposes; the taxpayer's spouse in this case was the executor of the decedent's estate, and he was one of the individuals who entered into a prior agreement with the IRS as to the value of the property for estate tax purposes).

It is unclear, under the proposal, what would result when an estate tax return need not be filed, or when the IRS later asserts that an estate tax return should have been filed. It may be that, when an estate is not required to file a return, there would be no duty of consistency under the proposal. In such case, an heir would not be bound to use any value determined by the estate. If an adjustment has been made to an estate, then the estate may have a duty under the proposal to notify heirs of such changes to the valuation of property. When an estate tax return is filed but an item of property is omitted, the proposal may require that the heir takes such property at a zero basis if the period of limitations on assessment of the estate tax has lapsed. In such case, another possible result would be that the heir would take the property at a carryover basis.

The proposal also would impose reporting requirements on estates and donors of lifetime gifts. The representative of an estate would be required to notify heirs and the IRS of the fair market value on the date of death of property distributed to such heir. This requirement extends to both property passing under a will and property not passing under a will, so long as the property is included in the decedent's gross estate. Donor's of lifetime gifts (other than annual exclusion gifts) also would be required to notify donees and the IRS of the donor's basis in the property at the time of transfer as well as any payment of gift tax which would increase the basis.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

3. Require basis allocation for part-sale, part-gift transactions

Present Law

Under present law, when there is a transaction that is a part-sale, part-gift, 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 transfer, plus any gift tax paid by the donor. If the property is later sold by the donee at a loss, then the basis is limited to the fair market value at the time of the gift. The donor in a part-sale, part-gift transaction generally determines gain or loss on the transaction subtracting the entire basis in the property from the amount realized. Thus, donors often realize no gain in a part-sale, part-gift transaction.

Under the rules for bargain sales to charities, the basis of property sold must be allocated between the portion of the property which is "sold" to the charity and the portion of the property which is "donated" to the charity. Thus, the adjusted basis for determining the gain from a bargain sale is that portion of the adjusted basis that bears the same ratio to the property's adjusted basis as the amount realized on the sale bears to the property's fair market value.

The dual basis rule that applies both to gifts and charitable bargain sales requires that, if property is later sold by a donee at a loss, the basis is limited to its fair market value. There is neither gain nor loss on the property's disposition when the amount realized is less than the basis for gain and greater than the basis for loss.

Description of Proposal

The proposal would require that the basis of property transferred in a part-gift, part-sale transaction be allocated ratably between the gift portion and the sale portion based on the fair market value of the property and the consideration paid.

Effective date.--The proposal would be effective for transactions entered into after the date of enactment.

Analysis

Under the proposal, the charitable bargain sale rule would be adopted for all part-sale, part-gift transactions, including those in which a charity is not involved. Under section 1011, the adjusted basis for determining the gain from a charitable bargain sale is that portion of the adjusted basis which bears the same ratio to the property's adjusted basis as the amount realized on the sale bears to the property's fair market value. The proposal would allocate the basis of part-sale, part-gift property ratably between the gift portion and the sale portion based on the fair market value of the property on the date of transfer and the consideration paid. For example, a donor sells to a child for $50,000 property with a basis to the donor of $40,000 and a fair market value of $100,000. Thus, the donor makes a gift to the child of $50,000 ($100,000 fair market value less $50,000 amount realized), which is 50 percent of the value of the property. The amount realized on the part-sale, part gift is 50 percent ($50,000/$100,000) of the value of the property. Under the proposal, the adjusted basis of the nongift (i.e., sold) portion of the property is $20,000 ($40,000 adjusted basis times 50 percent), and the donor/seller recognizes $30,000 of gain ($50,000 amount realized -$20,000 adjusted basis of portion sold). The child would take a basis of $70,000 ($50,000 paid plus $20,000 which is the gift portion of donor's basis).

The dual basis rule would continue to apply if there is a loss transaction and the fair market value of the gift on the date of transfer was less than the donor's basis. For example, if the donor's basis in the above example just prior to the transfer was $140,000, then the donor would have a loss of $20,000 ($50,000 consideration less allocated basis of $70,000 (50 percent of $140,000)). The child's unadjusted basis would be $120,000 ($50,000 paid plus $70,000 which is the gift portion of the donor's basis); however, if the child sold the property at a loss, then the basis would be limited to $100,000 (i.e., fair market value). As under current law, there would be neither gain nor loss on the sale of the property by the child if the amount realized is less than the basis for gain and greater than the basis for loss.

Proponents of the proposal assert that the proposal would establish consistency among the rules for calculating basis in a charitable bargain sale and a part-sale, part-gift transaction. Moreover, under the proposed rule, the basis of property received in a part-sale, part-gift would accurately reflect the portion of the basis which is deemed sold and the portion of the basis which is deemed transferred by gift.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

4. Eliminate the stepped-up basis in community property owned by surviving spouse

Present Law

Property acquired from a decedent generally is assigned a new basis equal to the property's fair market value on the date of the decedent's death. In common-law (non-community-property) States, property jointly owned by both husband and wife at the time one spouse dies is treated as owned one-half by the deceased spouse and one-half by the surviving spouse. Therefore, the surviving spouse receives a step up in basis only as to the deceased spouse's half of property which passes to the surviving spouse. The half treated as owned by the surviving spouse is not eligible for a step up in basis at the death of the first spouse to die.

In community property States, each spouse is treated as owning one-half of the community property. However, under section 1014(b)(6), the surviving spouse is entitled to a step up in basis of property for the portion treated as owned by the surviving spouse as well as the portion owned by the decedent spouse. There are nine community property States and one State with an elective community property regime.[556]

Description of Proposal

The proposal would eliminate the step up in basis in the portion of community property which is owned by the surviving spouse prior to the deceased spouse's death. The portion of community property which passes from the deceased spouse, however, would continue to receive a stepped-up basis.

Effective date.--The proposal would be effective for decedent dying after the date of enactment.

Analysis

The proposal identifies that, under the Federal estate tax law, surviving spouse's property which did not pass from a decedent spouse is treated differently in community-property States

[556] Community-property States include Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Alaska has an elective regime.

than in common-law States. Under present law, assets passing from a decedent spouse to a surviving spouse qualify for a step up in basis. Moreover, under section 1014(b)(6), the step up in basis also applies to a surviving spouse's one-half interest in community property if the other half interest was includible in the decedent spouse's gross estate. This provision grants a step up in basis in a surviving spouse's property which did not pass from a decedent spouse. In common-law (non-community-property) jurisdictions, a surviving spouse's property which did not pass from a decedent spouse is not eligible for a step up in basis.

The step up in basis for community property provision was enacted in 1948. As stated in[557] “the usual case was that practically all the wealth of the married couple was the property of the husband.” For example, if a husband died first, having owned “practically all the wealth,” the surviving spouse would have had a stepped-up basis in most of the property because most of it would have, in fact, passed from the decedent spouse to the surviving spouse by bequest or inheritance. In a community-property State, however, a surviving spouse is deemed to own one-half of the community property, and, consequently, the surviving spouse's one-half interest in community property could not pass to the surviving spouse by bequest or inheritance. Only the decedent spouse's one-half interest would have passed to the surviving spouse from the decedent spouse; therefore, only one-half of the property was eligible for a step up in basis. Section 1014(b)(6), which provides a step up in basis for the surviving spouse's one-half of property, was intended to equalize the two State regimes and “give persons receiving community property the same basis for determining gain or loss on a sale of property after death as is given recipients of property passing under the common law” in that “the surviving spouse's interest in community property shall be deemed to have been acquired by bequest, devise, or inheritance' from the decedent.”[558]

The Administration's position is that changes to the Federal estate tax treatment of jointly-held property in 1981 have undermined the premises upon which section 1014(b)(6) is based. For example, under section 2040(b), one-half of the value of any property held by the decedent and the decedent's spouse as tenants by the entirety or as joint tenants with right of survivorship (when the decedent and decedent's spouse are the only joint tenants) is included in the gross estate of the first spouse to die, regardless of the source of the consideration for the property. As a result, the basis in the part of the jointly held property included in the decedent spouse's estate will be stepped up to fair market value. The one-half interest which is not included in the decedent spouse's estate, however, is not eligible for a step up in basis. In community property States, however, the one-half interest in community property which is not included in a decedent spouse's estate may be eligible for a step up in basis. To the extent that surviving spouses in community-property States may receive a step up in basis for property which, in a common-law State, would not be eligible for a step up in basis, there is inconsistent treatment under present law.

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[557] S. Rept. No. 1013, 80th Cong., 2d Sess., 26 (1948).

[558] S. Rept. No. 1013, 80th Cong., 2d Sess., p. 29 (1948).

The proposal would eliminate the inconsistent treatment among decedents in community-property and common-law States by eliminating the step up in basis for property which never passed from a decedent spouse to a surviving spouse. Surviving spouses' interests in property which would not have been eligible for a step up in basis in a common-law State would also not be eligible for a step up in basis in a community-property State. In this regard, the proposal establishes consistency in the application of the basis rules by ensuring that a step up in basis applies only to property which passes from the decedent spouse to a surviving spouse. Thus, in a community-property State, only the one-half share of the property which is deemed to have passed from a decedent spouse to a surviving spouse would be eligible for a step up in basis.

Under present law, separate property of one spouse receives similar treatment whether in a common-law State or community-property State (although it may be difficult in some States to convert community-property to separate property). For example, property which was owned 100 percent by a decedent spouse which passes to a surviving spouse would be eligible for a step up in basis as to the entire property because it was included in the decedent spouse's estate, even if no tax is due. Similarly, if property was owned 100 percent by the surviving spouse, there would be no step up in basis because the property would not have passed from the decedent spouse. However, to the extent that property would be community property in one State and separate property in another, the community property could be treated less favorably under the proposal. For example, under the proposal, property that would be community property in one state would receive a step up only as to the one-half interest that passes from a decedent spouse. However, in a common law state, if such property was owned solely by the decedent spouse, then the surviving spouse would get a step up in basis as to the entire property.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

5. Require that qualified terminable interest property for which a marital deduction is allowed be included in the surviving spouse's estate

Present Law

For estate and gift tax purposes, a marital deduction is allowed for qualified terminable interest property ("QTIP"). Such property generally is included in the surviving spouse's gross estate. The surviving spouse's estate is entitled to recover the portion of the estate tax attributable to such inclusion from the person receiving the property, unless the spouse directs otherwise by will.[559] A marital deduction is allowed for 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 property in which the decedent had a qualifying income interest for life and for which a

[559] Section 2207A.

marital deduction was allowed under the gift or estate tax. Similarly, section 2519 provides that any disposition of all or a part of the surviving spouse’s qualifying income interest for which a gift or estate tax marital deduction was allowed is treated as a transfer of all interests in the property. Property subject to gift tax under section 2519 is not included in the second spouse’s estate under section 2044.

Description of Proposal

The proposal would provide that if a marital deduction is allowed with respect to qualified terminable interest property (QTIP), inclusion is required in the beneficiary spouse's estate or the property would be subject to gift tax if disposed of during the surviving spouse’s lifetime.

Effective date.–The proposal would be effective for decedents (i.e., surviving spouses) dying and dispositions of property made after the date of enactment.

Analysis

Both the gift tax and the estate tax allow an unlimited deduction for certain amounts transferred from one spouse to another spouse who is a citizen of the United States.[560] Under both the gift and estate marital deduction, deductions are not allowed for so-called “terminable interests.” Terminable interests generally are created where an interest in property passes to the spouse and another interest in the same property passes from the donor or decedent to some other person for less than full and adequate consideration. For example, an income interest to the spouse generally would not qualify for the marital deduction where the remainder interest is transferred to a third party. Special rules permit a marital deduction where the surviving spouse has an income interest if that spouse has a testamentary power of appointment or the remainder passes to the estate of the surviving spouse.

An exception to the terminable interest rule was added when the unlimited marital deduction was provided in 1981. Under this exception, a marital deduction is allowed for a transfer to a trust of “qualified terminable interest property,” called “QTIP,” in which the spouse has a qualifying income interest, so long as the transferor spouse's executor elects to include the trust in the spouse's gross estate for Federal estate tax purposes and subjects the QTIP to gift tax if the spouse disposes of the income interest.

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[560] In addition, a marital deduction is allowed for both gift and estate tax purposes for transfers to spouses who are not citizens of the United States if the transfer is to a qualified domestic trust (“QDOT”). A QDOT is a trust which has at least one trustee that is a United States citizen or a domestic corporation and no distributions from corpus can be made without withholding from those distributions.

The purpose and effect of the terminable interest and qualified terminable interest rules is to permit deferral of taxation on amounts transferred to spouses that are not consumed before the death of the second spouse, not to provide an exemption from estate and gift tax. In some cases, the estate of the first spouse to die has claimed a marital deduction as a QTIP and then, after the period of limitations for assessing tax on the first estate has lapsed, the estate of the second spouse to die argues against inclusion in the second estate due to a technical flaw in the QTIP eligibility or election in the first estate. If it is determined, after the limitations period on the first spouse's estate lapsed, that a prior QTIP election was in fact defective, the estate of the second spouse would assert that it is not required to include the QTIP in the second spouse's estate, thus excluding the QTIP from both spouses' estates.

Under the proposal, the estate of the second spouse to die would be required to include property with respect to which the estate of the first spouse to die claimed a marital deduction even if there was a technical flaw in the QTIP eligibility or election in the first estate. This would effectively estop a second spouse from claiming, after the limitations period on the first spouse's estate lapsed, that the QTIP election on behalf of the first spouse's estate was defective. In addition, if the surviving spouse released or assigned the income interest during life, the proposal would require that the disposition be subject to gift tax.

Opponents to the proposal would assert that the present rules, which require inclusion in the surviving spouse’s gross estate and gift tax liability if an income interest is disposed of during the surviving spouse’s lifetime, adequately address the proper treatment of property for which a QTIP election and deduction have been made. Proponents of this proposal, however, would assert that it is possible to avoid QTIP property’s inclusion in the surviving spouse’s estate or to avoid gift tax by proving that the surviving spouse did not receive a qualifying income interest for life, even if the QTIP deduction was improperly allowed and the limitations period on the decedent spouse’s estate had passed.

Prior Action

A similar proposal also was included in the President's Fiscal Year 2000 Budget Proposal.

6. Eliminate non-business valuation discounts

Present Law

Generally, for Federal transfer tax purposes, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. In valuing a fractional interest in an non-publicly traded entity, taxpayers routinely claim discounts for factors such as minority ownership or lack of marketability. The concept of such valuation discounts is based upon the principle 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, because the buyer may not have the power to manage or control the operations of the business, and may not be able to readily sell his or her interest.

In the family estate planning area, a common planning technique is for an individual 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. In valuing such gifts for transfer tax purposes, taxpayers often claim large discounts on the valuation of these gifts.

Description of 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 (including 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 the propriety of these discounts under present law.

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

Analysis

It is well established that discounts may be appropriate in valuing minority interests in business entities.[561] Generally, these discounts take the form of minority discounts and lack of marketability discounts. A minority discount reflects a decreased value due to the fact that a minority shareholder (or partner) may have little ability to control or participate in the management of the business, or to compel liquidation of the business or payment of distributions. The IRS has stated that minority discounts even may be appropriate in cases where the transferred interest, when aggregated with interests held by family members, is part of a controlling interest.[562] In addition to minority discounts, an additional valuation discount due to lack of marketability also may be available to reflect the fact that there is no ready market for interests in a closely-held entity. It is not unusual for taxpayers to claim combined discounts of 30 to 50 percent, although taxpayers have claimed discounts of as much as 60 to 70 percent in

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[561] See, e.g., Estate of Andrews v. Commissioner, 79 T.C. 938 (1982).

[562] See Rev. Rul. 93-12, 1993-1 C.B. 202.

some cases.[563] (taxpayer claimed a combined discount of 67.5 percent; the Tax Court allowed 45 percent). The appropriate level of discount for any particular business interest often is the subject of litigation.

The proposal raises two separate issues relevant to the valuation of assets and the administration of the estate tax: the appropriateness of minority discounts and the liquidity of assets. The issue of minority discounts relates to circumstances where the value of a fractional holding of an asset may not equal the proportionate market value of the entire holding. Analysts generally believe that minority discounts result from the ability of the controlling owner to dictate the course of future investment, business strategy, or timing of liquidation of the asset. Not being able to make such decisions generally makes a minority claim on the asset less valuable.[564] The extent of any minority discount depends upon the facts and circumstances related to the asset.

An asset's liquidity is its ability to be readily converted to cash. The issue of liquidity of assets relates to identifying those assets which are readily tradeable and, therefore, for which market values are readily ascertainable without great expense to the assets's owner. While people generally view passive assets such as stocks and bonds as liquid assets, not all passive assets are equally liquid, and some passive assets may be less liquid than active assets. For example, specialty brokers may be able to more readily generate offers to purchase a radio station in a major metropolitan area, than would a financial broker who attempts to generate offers for the purchase of a bond issued by a small rural school district.

Although the practice of claiming valuation discounts has been accepted in valuing active businesses, proponents of the proposal maintain that it is less clear whether such discounts are appropriate for entities holding non-business assets. For example, if an individual contributes his or her stock portfolio to an entity and transfers interests in the entity to his or her children, it has been questioned whether the stock portfolio is somehow worth less to the family, simply because its ownership is dispersed among several individuals. In such circumstances, where the underlying assets remain non-business assets, proponents may argue that issues of control are much less important than in the context of making decisions to manage the operations of an ongoing active business. That is, the proposal would deem there to be no minority or other discount in the case of a family enterprise that holds non-business assets.

Opponents of this approach note that it is inconsistent with observed market outcomes to claim that a minority discount cannot exist when the non-business assets in question are liquid. For example, assume that a taxpayer holds a one-third share in a portfolio of New York Stock

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[563] See, e.g., Estate of Barudin v. Commissioner, T.C. Memo. 1996-395.

[564] Using the same reasoning, it can be argued that individuals may be willing to pay more than the proportionate market value of the entire holding in order to have control (i.e., "control premiums").

Exchange stocks and that her brother holds the two-thirds share. In this circumstance, the brother might be able to dictate the course of future investment, investment strategy, and timing of liquidation of the portfolio. Some may argue that such a circumstance could reasonably give rise to a minority discount on the value of the taxpayer's one-third holding even though the underlying assets are liquid.

In determining how much of a minority discount might be appropriate with respect to entities holding liquid assets, it may be helpful to consider the value placed on closed-end mutual funds. Closed-end mutual funds are traded regularly on the open market and, among funds that invest in domestic assets, are almost always traded at a discount from the net asset value of the underlying assets, although the discounts observed in the marketplace generally are smaller than those claimed as minority discounts in valuing transfers of business interests for estate and gift tax purposes. For example, during the last half of 1999, the discount from net asset value of the Herzfeld Closed-End Average has ranged from between approximately 11.25 percent and approximately 7.75 percent of net asset value.[565] On the other hand, closed-end mutual funds also may be valued at a premium. While this is observed infrequently with closed-end mutual funds that invest in domestic equities, it may make it difficult to arrive at any generalized conclusions as to the proper valuation of interests in such entities.

To the extent that the proposal would cover assets such as real estate and art, the arguments that valuation discounts are inappropriate may not be as applicable.[566] For example, if individuals are transferred a portion of art collectibles, it may be appropriate for the value transferred to each individual to reflect a discount under certain circumstances.

Prior Action

A similar proposal was included in the President's Fiscal Year 1999 Budget Proposal, and an identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

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[565] The Herzfeld Closed-End Average is calculated weekly by Thomas J. Herzfeld Advisors, Inc. The Herzfeld Closed-End Average measures 15 equally-weighted closed-end funds that invest principally in equities of U.S. corporations. Barron's Market Week, February 14, 2000, p. MW59. As an average, the Thomas J. Herzfeld Closed-End Average does not reflect the range of discounts or premiums that may be observed on individual funds.

[566] For example, the Tax Court recently accepted a taxpayer's expert's valuation allowing a 44-percent combined discount with respect to the transfer of an undivided one-half interest in timberland, based on the taxpayer's lack of control and the marketing time and real estate commission cost involved in selling real property in that particular market, where the Commissioner's expert admitted that an undivided one-half interest in real property has a limited market and that a fractional interest may be discounted, but introduced no testimony or other evidence to rebut the taxpayer's expert's testimony as to the appropriate level of discount. Estate of Williams v. Commissioner, T.C. Memo. 1998-59.

7. Eliminate gift tax valuation exception for transfers of personal residences to a trust

Present Law

Section 2702 sets forth special valuation rules for circumstances in which an individual sets up a trust, retaining a partial interest in the trust and transferring other interests in the trust to family members. In general, if an interest in a trust is retained by a grantor when other interests are transferred to family members, the retained interest is valued at zero for gift tax purposes unless it is a qualified annuity interest (a "GRAT"), unitrust interest (a "GRUT"), or a remainder interest after a GRAT or a GRUT. A special exception under section 2702(a)(3)(A)(ii) provides that the special valuation rules do not apply in the case of personal residence trusts. In general, a personal residence trust is a trust "all of the property of which consists of a residence to be used as a personal residence by persons holding term interests in such trust."

Description of 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, then 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.

Effective date.--The proposal would be effective for transfers in trust after the date of enactment.

Analysis

The present-law rules pertaining to personal residence trusts were enacted by Congress in 1990 as a specific statutory exception to the general rules of section 2702. Personal residence trusts are commonly used as a tax planning device to reduce transfer taxes by allowing an individual's home (or vacation home) to be transferred to his or her heirs at significant tax savings. For example, an individual may transfer his primary residence to a trust which provides that the grantor may continue to live in the house for fifteen years, at which time the trust assets (i.e., the home) will be transferred to his children. The grantor may retain a reversionary interest in the property (i.e., provide that, if the grantor does not survive the trust term, then the property would revert to his estate).[567] The trust agreement may further provide that the grantor may continue to live in the home after the fifteen-year period as long as he makes rental payments to his children at fair market value. If the requirements for a personal residence trust are satisfied,

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[567] Reversionary interests commonly are retained so that, if the grantor dies before the end of the trust term, then the property may be left to the grantor's spouse, thus qualifying for the marital deduction. Retention of a reversionary interest also has the effect of reducing the amount of the taxable gift.

then the transfer is treated as a gift of the contingent remainder interest, which generally has a relatively small value as compared to the full fair market value of the residence.

The gift tax is imposed on the fair market value of the property transferred. In the case of a transfer such as the one described above, the value of the gift would be determined by taking the fair market value of the entire property, and subtracting from it the actuarially determined value of the grantor's retained income interest and the actuarially determined value of any contingent reversionary interest retained by the grantor. The actuarially determined value of any annuity, interest for life or a term of years, or any remainder or reversionary interest is based upon tables set forth by the IRS under section 7520. These tables set forth valuation rates for each type of interest (e.g., annuity, life interest, remainder interest) based upon applicable interest rates and the length of the term.

There are several advantages and disadvantages to the use of personal residence trusts. First, such trusts allow an individual to transfer his home to his heirs at a significantly reduced value for gift tax purposes. In addition, any future appreciation in the house is not subject to transfer taxes if the grantor survives the trust's term.[568] Lastly, if the grantor continues to live in the home after the trust term has expired, then the required rental payments to his heirs will reduce the size of his estate (and thus his estate taxes) even further. On the other hand, when a personal residence trust is utilized, the heirs receive a carryover basis in the residence rather than having the basis stepped up to its full fair market value on the date of death, as would be the case if the grantor held the property until death and transferred it outright to the heirs at that time. This disadvantage may be alleviated somewhat, however, by the provision in the Taxpayer Relief Act of 1997 that potentially exempts up to $500,000 of capital gain from tax when the home is sold, if the heirs meet the ownership and residence requirements of that provision.

The valuation rules of section 2702 are patterned after the rules set forth in section 2055 for determining whether a charitable deduction is allowed for split interests in property where an interest is given to a charity. When Congress enacted section 2055 in 1969, there were concerns that it would be inappropriate to give a charitable deduction except in cases where there was some assurance that the interest given to charity could be properly valued. Types of interests for which a deduction was allowed included annuities and unitrusts. Generally, an annuity pays a fixed amount each year while a unitrust pays out a certain fraction of the value of the trust annually. Thus, a charitable deduction is allowed in cases where, for example, an annuity is paid to charity with the remainder going to an individual, or an annuity is paid to an individual with the remainder going to charity, or a unitrust pays out to charity annually with the remainder going to an individual, or a unitrust pays out to an individual annually with the remainder going

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[568] If the grantor dies during the trust term, then the full fair market value of the house at the date of death will be brought back into his estate under section 2036, regardless of whether the grantor has retained a reversionary interest in the property. However, the estate will receive credit for any gift taxes paid (or use of the unified credit) with respect to the initial transfer to the personal residence trust.

to charity. In addition, a charitable deduction is allowed for the contribution of a remainder interest in a personal residence or farm under an exception provided in section 170(f)(3)(B)(i). These same basic rules were adopted in valuing non-charitable gifts for purposes of section 2702.

Proponents of the proposal argue that the use value of the residence retained by the grantor is a poor substitute for an annuity or unitrust interest, and that the actuarial tables overstate the value of the grantor's retained interest in the house. These conclusions are based in part on the fact that in a personal residence trust situation, the grantor ordinarily remains responsible for the insurance, maintenance, and property taxes on the residence, and, thus, the true rental value of the house should be less than the fair market rent. Such proponents also argue that, by completely exempting personal residence trusts from the requirements of section 2702, personal residence trusts are accorded even more beneficial treatment than are GRATs, GRUTs, or remainder interests after a GRAT or a GRUT, because, under those arrangements, it is not possible to reduce the value of the gift by retaining a contingent reversionary interest.

The proposal does not question whether a remainder interest in a personal residence can be appropriately valued for purposes of determining the amount of a charitable contribution, in that no modification of section 2055 is proposed. It is unclear how the same basic valuation rules could produce an acceptable result where a remainder interest is going to charity, yet an unacceptable result where the remainder interest is being transferred to private parties.

Prior Action

An identical proposal was included in the President's Fiscal Year 1999 and 2000 Budget Proposals.

8. Eliminate the Crummey rule and modify requirements for annual exclusion gifts

Present Law

Under present law, the first $10,000 (increased for inflation after 1998) of gifts by a donor to a donee of present interests in property are exempt from the gift tax (known as the gift tax "annual exclusion"). A transfer in trust generally is not considered to be a transfer of a present interest. However, several courts have held that a donee's power to withdraw annual additions to the trust during the year in question gave that donee a present interest in the additions. These withdrawal powers often are referred to as "Crummey powers."[569] This result has been upheld even when the donee is a minor or lacks knowledge of his withdrawal right.

Under the rule established in Crummey, a transfer to a trust is considered a transfer of a present interest if the trust instrument provides the beneficiary with a right to withdraw the

[569] See Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).

transferred amount for a limited period of time (e.g., 30 days or less). In the Crummey case, the holder of the withdrawal right was the ultimate beneficiary of the trust. In recent cases, however, individual trust agreements have been drafted to grant withdrawal rights to individuals who did not have substantial economic interests in the trusts.

If an insured person purchases an insurance policy (or pays premiums on a previously issued policy), the proceeds of which are payable to a beneficiary or beneficiaries other than the insured or the insured's estate, then such premium payments are considered taxable gifts, provided (1) the proceeds of the insurance policy are payable to a beneficiary or beneficiaries other than the insured's estate, (2) the insured retains no reversionary interest in himself or herself or his or her estate, (3) the insured retains no power to receive the economic benefits himself or herself or by his or her estate, and (4) the insured retains no power to change the beneficiaries or their proportionate benefits.[570]

Under the GST tax rules, a direct skip is a transfer that is subject to estate or gift tax of an interest in property to a "skip person."[571] A skip person is either (1) a natural person assigned to a generation which is two or more generations below the generation of the transferor or (2) a trust if all interests are held by skip persons or if there are no skip persons holding such an interest, at no time after the transfer may a distribution be made from the trust to a non-skip person.[572] A generation-skipping transfer ("GST") tax annual exclusion is available for direct skips. Under this provision, in the case of direct skips which are non-taxable gifts, the inclusion ratio is zero.[573] Thus, direct skips are provided a $10,000 exclusion per donee, per year.[574] A transfer to trust, however, will not qualify for the GST annual exclusion unless, with respect to the trust, (1) during the life of the individual skip person, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such individual, and (2) if the trust does not terminate before the individual dies, the assets of such trust will be includible in the gross estate of such individual.[575]

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[570] Treas. Reg. sec. 25.2511-1(h)(8).

[571] Section 2612(c)(1).

[572] Section 2613(a).

[573] Section 2642(c)(1).

[574] In the case of gifts made in a calendar year after 1998, the $10,000 annual exclusion is adjusted for inflation. Section 2503(b)(2).

[575] Section 2642(c)(2).

Description of Proposal

The proposal would eliminate the Crummey rule and subject the gift tax annual exclusion to the same rules that apply for GST tax direct skips. Thus, the gift tax annual exclusion would not apply to a transfer to a trust for the benefit of an individual unless (1) during the life of the individual, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such individual, and (2) if the trust does not terminate before the beneficiary dies, then the assets of such trust will be includible in the gross estate of such individual. No notice of withdrawal right would be necessary for a transfer to such a trust to qualify for the annual exclusion.

Effective date.--The proposal would be effective for transfers to trusts made after December 31, 2000. A grandfather rule would apply, such that Crummey powers may be used to create a present interest; however, the rule would disallow annual exclusions attributable to a withdrawal right in a person who is not a primary, noncontingent beneficiary of the trust. The Secretary would be granted authority to prescribe regulations necessary to carry out the purposes of the proposal, including rules for determining whether an annual exclusion is attributable to a withdrawal right.

Analysis

The legislative history to the gift tax annual exclusion indicates that its size was established to exempt from gift tax numerous small gifts and larger wedding and Christmas gifts. That legislative history also supports the view that the disallowance of the annual exclusion for future interests was necessary because of the need to determine the identity of the donee and the amount of the gift.[576] Opponents to this proposal argue that, in many instances, the existence of a

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576 The Finance Committee report for the Revenue Act of 1932 (S. Rept. No. 665, 72d Cong., 1st Sess., 41) states as follows:

> Such exemption, on the one hand, is to obviate the necessity of keeping account of and reporting numerous small gifts, and, on the other, to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts. The exemption does not apply with respect to a gift to any donee to whom is given a future interest. The term "future interest in property" refers to any interest or estate, whether vested or contingent, limited to commence in possession or enjoyment at a future date. The exemption being available only in so far as the donees are ascertainable, the denial of the exemption in the case of future interests is dictated by the apprehended difficulty, in many instances, of determining the number of eventual donees and the value of their respective gifts." Identical language is contained in the Report of the Committee on Ways and

Crummey power does not make the identity of the donee, or the value of the transfer, unclear and, thus, use of Crummey power is consistent with the annual exclusion.

The principles of the Crummey decision are longstanding; nonetheless, the Administration believes that the use of Crummey powers are often a legal fiction, because, typically by understanding or expectation, it is extremely rare for a Crummey power to be exercised. Those opposed to the proposal, however, would assert that taxpayers have been making use of Crummey powers to minimize gift taxes with respect to certain transfers to trusts for over 30 years and that such established principles of gift tax planning should not be eliminated.

Proponents of this proposal argue that application of the Crummey rule to situations where the withdrawal rights have been given to individuals who do not have substantial economic interests in a trust may be more troubling because it potentially permits an unlimited gift tax exemption through multiple withdrawal rights granted to multiple individuals, while only the intended donee or donees have substantial economic interests in the trust. Treasury's proposal, however, would eliminate all uses of Crummey powers to utilize the gift tax annual exclusion–not just situations in which withdrawal rights are granted to individuals who do not have a substantial economic interest in the trust. To this extent, the proposal may be overbroad, because it may not be appropriate to eliminate Crummey withdrawal powers for those beneficiaries with substantial economic interest in the trust.

The proposal would conform the gift tax annual exclusion rule with the GST tax annual exclusion rule for transfers to trusts that are direct skips. Thus, under the proposal, gift tax annual exclusion would only be allowed for transfers to trusts that would qualify as direct skips. In other words, gift tax annual exclusion would not be available unless (1) during the life of an individual, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such individual, and (2) if the trust does not terminate before the individual dies, the assets of the trust will be includible in the gross estate of such individual. Proponents of the proposal assert that, by conforming the gift tax and GST tax annual exclusion rules, the gift tax is made less complex. Moreover, the Administration would find that taxpayers and practitioners would be relieved of going through the mechanics of having to send Crummey withdrawal notices, which, in many instances, are not acted upon by the holder of the power. Opponents of the proposal, however, argue that the proposal is overbroad in that trusts could have only one beneficiary in order for transfers to the trust to be eligible for the gift tax annual exclusion. If the use of Crummey powers is limited, this concern could be addressed by allowing a trust to have multiple beneficiaries, all of whom must have substantial economic interests in the trust.

Crummey powers frequently are used in conjunction with a trust whose principal asset is a life insurance policy (called an "insurance trust"). These trusts typically first begin making

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Means (H. Rept. No. 708, 72nd Cong., 1st Sess., 29).

income payments after the death of the insured from the insurance proceeds so that interests in such a trust are future interests. Crummey powers are used so that cash contributions to the trust by the insured to be used to pay premiums on the insurance policy will qualify for the annual exclusion. The proposal's repeal of the Crummey rule would cause such cash contributions to cease to qualify for the annual exclusion, resulting in use of the insured's unified credit or payment of gift tax. If the use of Crummey powers are limited or eliminated, further transitional relief may be appropriate in situations where the insurance policy is a whole life policy, especially where the policy has been irrevocably transferred to the trust and the insured individual is no longer insurable.

Prior Action

A similar proposal was included in the President's Fiscal Year 1999 Budget Proposal.

H. Pension Provisions

1. Increase elective withholding rate for nonperiodic distributions from deferred compensation plans

Present Law

Present law provides that income tax withholding is required on designated distributions from employer deferred compensation plans (whether or not such plans are tax qualified), individual retirement arrangements ("IRAs"), and commercial annuities unless the payee elects not to have withholding apply. A designated distribution does not include any payment (1) that is otherwise treated as wages, (2) the portion of which it is reasonable to believe is not includible in gross income,[577] (3) that is subject to withholding of tax on nonresident aliens and foreign corporations (or would be subject to such withholding but for a tax treaty), or (4) that is a dividend paid on certain employer securities (as defined in sec. 404(k)(2)).

Tax is generally withheld on the taxable portion of any periodic payment as if the payment is wages to the payee. A periodic payment is a designated distribution that is an annuity or similar periodic payment.

In the case of a nonperiodic distribution, tax generally is withheld at a flat 10-percent rate unless the payee makes an election not to have withholding apply. A nonperiodic distribution is any distribution that is not a periodic distribution. Under current administrative rules, an individual receiving a nonperiodic distribution can designate an amount to be withheld in addition to the 10-percent otherwise required to be withheld.

Under present law, in the case of a nonperiodic distribution that is an eligible rollover distribution, tax is withheld at a 20-percent rate unless the payee elects to have the distribution rolled directly over to an eligible retirement plan (i.e., an IRA, a qualified plan (sec. 401(a)) that is a defined contribution plan permitting direct deposits of rollover contributions, or a qualified annuity plan (sec. 403(a)). In general, an eligible rollover distribution includes any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan or qualified annuity plan. An eligible rollover distribution does not include any distribution that is part of a series of substantially equal periodic payments made (1) for the life (or life expectancy) of the employee or for the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or (2) over the a specified period of 10 years or more. An eligible rollover distribution also does not include any distribution required under the minimum distribution rules of section 401(a)(9), hardship distributions from section 401(k) plans, or the portion of a distribution that is not includible in income. The payee of an eligible rollover distribution can only elect not to have withholding apply by making the direct rollover election.

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

Description of Proposal

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

Effective date.--The proposal would be effective for distributions made after December 31, 2001.

Analysis

10-percent withholding rate

The present-law rules require a recipient of a nonperiodic distribution (other than an eligible rollover distribution) to have withholding on the nonperiodic distribution at a 10-percent rate or to elect to have no withholding apply. Because this 10-percent withholding rate is less than the lowest individual income tax rate of 15 percent, the rate of withholding will be too low in the case of an individual who would like to have the proper amount withheld from his or her distribution. Such an individual may be required to make estimated tax payments if he or she does not have sufficient wage income from which an adequate amount can be withheld.

An increase in the 10-percent withholding rate will generally ensure that an individual who wants to have withholding apply to a nonperiodic distribution (other than an eligible rollover distribution) will be more likely to have the proper amount withheld. However, an increase in the rate of withholding may also have the effect of causing some individuals who otherwise would not elect out of withholding to make the election out.

Under the present-law rules, distributions from qualified plans will be subject to either the elective withholding rules for periodic distributions or the 20-percent mandatory withholding rate on eligible rollover distributions for which a plan participant does not make a direct rollover election. Thus, the 10-percent elective withholding rate for nonperiodic distributions is primarily applicable only to distributions from nonqualified deferred compensation arrangements, IRAs, commercial annuities and certain hardship distributions from section 401(k) plans. Some may question whether withholding on distributions from such arrangements or annuities should be elective or mandatory. In addition, individuals receiving distributions from such arrangements will often be subject to at least the 28 percent marginal income tax rate, which suggests that the 15-percent rate proposed may still be too low to ensure that an adequate amount of tax is withheld.

Withholding with respect to eligible rollover distributions

The rationale for the 20-percent withholding rate on eligible rollover distributions from qualified pension plans is to encourage individuals to elect the direct rollover option and, thereby, to keep retirement plan assets saved for retirement. It may be appropriate to consider, in connection with a proposal to modify the 10-percent elective withholding rate, whether this 20-percent rate is sufficient incentive to individuals to make the direct rollover election.

Roth IRAs

Under present law, the rule that provides that the amount of a distribution that is subject to withholding does not include any portion that it is reasonable to believe is not includible in gross income does not apply to IRAs. Thus, under the present-law rules, all distributions from IRAs are subject to withholding unless the recipient elects not to have withholding apply. In the case of a qualified distribution from a Roth IRA, the payor is required to have the recipient make the election not to have withholding apply even though the payor has reason to believe that the distribution is not includible in gross income. Thus, consideration should be given to including Roth IRAs under the rule that provides that withholding does not apply if it is reasonable to believe the distribution is not includible in gross income.

Prior Action

A similar provision was included in the President's Fiscal Year 2000 Budget Proposal and in the Taxpayer Refund and Relief Act of 1999 as passed by the Congress and vetoed by the President, the Tax Relief and Extension Act of 1999 as passed by the Senate, and the Trade and Development Act of 1999 as passed by the Senate.

2. Increase section 4973 excise tax on excess IRA contributions

Present Law

Excise tax on excess contributions

Under present law, an excise tax is imposed on an individual equal to six percent of the amount of any excess contributions to such individual's (1) traditional individual retirement arrangement ("IRA"),[578] (2) Roth IRA,[579] (3) medical savings account,[580] (4) custodial account

[578] Section 408.

[579] Section 408A.

[580] Section 220.

treated as an annuity contract under section 403(b)(7), or (5) education IRA.[581][582] The excise tax generally continues to apply in each year until the excess contributions have been distributed to the individual. However, the excise tax cannot exceed 6 percent of the value of such account or annuity at the end of the taxable year.

In general, an excess contribution includes any contribution to an account or annuity that exceeds the applicable contribution limit for such account or annuity for the taxable year. An excess contribution generally does not include any amount that is distributed to the individual before the due date (including extensions) of the individual's tax return for the taxable year. Thus, present law provides a mechanism by which an individual can correct any excess contributions without triggering the excise tax.

Distributions from Roth IRAs

Under present law, a qualified distribution from a Roth IRA is not includible in gross income.[583] A qualified distribution generally includes any distribution (1) on or after the date on which the Roth IRA owner attains age 59-1/2, (2) made to a beneficiary on or after the death of the Roth IRA owner, (3) attributable to the Roth IRA owner's becoming disabled, or (4) qualified first-time homebuyer distributions.[584] A distribution from a Roth IRA is not a qualified distribution if it is made within the first five taxable years beginning with the taxable year for which the individual made a contribution to a Roth IRA (or such individual's spouse made a contribution to a Roth IRA) established for the individual.

A distribution from a Roth IRA that is not a qualified distribution is required to be included in income to the extent such distribution is attributable to earnings on the taxpayer's Roth IRA contributions. A distribution is not a qualified distribution if it is a return of excess contributions that is not subject to the excise tax (i.e., if it is a distribution of excess contributions and net income allocated to such contributions made on or before the due date for the individual's tax return for the year, including extensions). However, if an excess contribution to a Roth IRA is subject to the excise tax and is subsequently withdrawn, such excess contribution could be a qualified distribution from the Roth IRA that is not includible in gross income.

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[581] Section 530.

[582] Section 4973.

[583] Section 408A(d).

[584] Section 72(t)(8).

Description of Proposal

The proposal would increase the section 4973 excise tax on excess contributions to IRAs to 10 percent for each taxable year after the taxable year for which such excess contribution was made. The increase would not apply to excess contributions to medical savings accounts or education IRAs. Thus, the excise tax would be six percent for the taxable year for which such excess contribution was made and 10 percent for each succeeding taxable year.

Effective date.--The proposal would be effective for excess contributions made for taxable years beginning after December 31, 2000.

Analysis

The increase in the excise tax on excess contributions is proposed to prevent taxpayers from making excess contributions to Roth IRAs, paying the excise tax on the excess contributions, and subsequently withdrawing amounts attributable to such excess contributions as a qualified distribution from a Roth IRA that is not includible in gross income. Under present law, if the rate of return on such excess contributions is sufficiently high, the taxpayer is better off by making the excess contributions and paying the excise tax.

Whether the increase in the excise tax on excess contributions will be sufficient to prevent taxpayers from intentionally making excess contributions to Roth IRAs will depend upon the rate of return the taxpayer expects to receive on such contributions. Depending on the rate of return, the taxpayer may still have an incentive to make the excess contributions.

An option that could be adopted in addition to, or in lieu of, the proposal would be to provide that a withdrawal from a Roth IRA that is attributable to an excess contribution is not a qualified distribution and, therefore, not excludable from gross income.

For the 1996 tax year, the amount of the excise tax on excess IRA contributions that was paid totaled approximately $2.5 million. This amount represents the amount of the excise tax collected only with respect to traditional IRAs. In 1997, medical savings accounts were included in the excise tax and in 1998, Roth IRAs and education IRAs were included.

Prior Action

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal.

3. Impose limitation on prefunding of welfare benefits

Present Law

Under present law, contributions to a welfare benefit fund generally are deductible when paid, but only to the extent permitted under the rules of Code sections 419 and 419A. The amount of an employer's deduction in any year for contributions to a welfare benefit fund cannot exceed the fund's qualified cost for the year. The term qualified cost means the sum of (1) the amount that would be deductible for benefits provided during the year if the employer paid them directly and was on the cash method of accounting, and (2) within limits, the amount of any addition to a qualified asset account for the year. A qualified asset account includes any account consisting of assets set aside for the payment of disability benefits, medical benefits, supplemental unemployment compensation or severance pay benefits, or life insurance benefits. The account limit for a qualified asset account for a taxable year is generally the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for benefits with respect to which the account is maintained and the administrative costs incurred with respect to those claims. Specific additional reserves are allowed for future provision of post-retirement medical and life insurance benefits.

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

In Notice 95-34,[585] the IRS identified certain types of trust arrangements that do not satisfy the requirements of the 10-or-more employer exception. In general, these trust arrangements created separate accounts for each employer participating in the plan and had the effect of providing experience rating for these participating employers. In addition, the Tax Court ruled in 1997 that an arrangement that utilized such a separate accounting system did not qualify under the 10-or-more employer exception.[586]

Description of Proposal

Under the proposal, the present-law exception to the deduction limit for 10-or-more employer plans would be limited to plans that provide only medical, disability, and group-term life insurance benefits. This exception would no longer be available with respect to plans that provide supplemental unemployment compensation, severance pay, and disability benefits. Thus, the generally applicable deduction limits (sections 419 and 419A) would apply to plans providing these benefits.

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[585] Notice 95-34, 1995-1 C.B. 309.

[586] Robert D. Booth and Janice Booth v. Commissioner, 108 T.C. No. 25 (June 17, 1997).

Group-term life insurance benefits that qualify for the 10-or-more-employer exception would be group-term life insurance benefits that do not allow any direct or indirect access to any cash surrender value, or to any part of the account value of any life insurance contract, or to other money that can be paid, assigned, borrowed, or pledged for collateral for a loan. It is intended that qualifying group-term life insurance benefits not include any arrangement whereby a current or former plan beneficiary may receive a policy without a stated account value (or with a nominal account value) that has the potential to give rise to an account value whether through the exchange of the policy for another policy that would have an account value, or through insubstantial conditions on the creation of an account value, or otherwise.

It is intended that group-term life insurance benefits not fail to be qualifying group-term life insurance benefits solely as a result of the inclusion of de minimis ancillary benefits, as described in Treasury regulations. Such ancillary benefits would include one-year term insurance coverages (e.g., accidental death and dismemberment insurance, group term life insurance coverage for dependents and directors, business travel insurance, and 24-hour accident insurance) as long as the total premiums for all such insurance coverages for the year do not exceed two percent of the total contributions to the plan for the year. Of course, any ancillary benefits provided would be in the nature of compensation, which would be includible in income unless expressly excluded under a specific provision under the Code.

If any portion of a welfare benefit fund attributable to contributions that are deductible pursuant to the 10-or-more-employer exception (and earnings thereon) is used for a purpose other than for providing medical benefits, disability benefits, or qualifying group-term life insurance benefits to plan beneficiaries, that portion is treated as reverting to the benefit of the employers maintaining the fund, and is subject to the imposition of the 100-percent excise tax. Thus, for example, cash payments to employees upon termination of the fund, and loans or other distributions to the employee or employer, would be treated as giving rise to a reversion that is subject to the excise tax.

Under the proposal, no inference is intended with respect to the validity of any 10-or-more employer arrangement under the provisions of present law.

Effective date.--The proposal would be effective with respect to contributions paid after the date of first committee action.

Analysis

The exception to the present-law deduction limit for 10-or-more employer plans was originally adopted because, under such a plan, the relationship of a participating employer to the plan is more in the nature of the relationship of an insured to an insurer. However, this exception was not intended to apply if the liability of any employer under the plan is determined on the basis of experience rating because, under those circumstances, the employer's interest with respect to the plan is more similar to the relationship of a single employer to a welfare benefit fund than that of an insured to an insurer. If each employer contributing to the plan is, in effect, liable for losses incurred with respect to all other participating employers (e.g., its contributions will be used to pay benefits for other employers' employees), then it is unlikely that any one employer will have an incentive to contribute more than is necessary under the arrangement.

In some cases, the 10-or-more employer exception has been utilized in ways that are not consistent with the original intent of the exception. Promoters have been aggressively marketing multiple employer funds that they claim qualify for the 10-or-more-employer exception, even though these arrangements lack the risk-shifting characteristics of insurance. While many of these arrangements do not satisfy the present-law conditions of the exception, it may be difficult to police and enforce these conditions in some cases, because the complexities of the arrangements used with respect to certain types of benefits, such as certain life and severance benefits, often disguise experience rating.

Opponents of the proposal argue that the 10-or-more employer exception is needed to enable small businesses to provide severance and death benefits to their employees and compete in the marketplace for workers. Large employers typically do not utilize the 10-or-more employer exception. It is argued that such employers do not need the exception because they have sufficient resources or other means with which to provide secure severance or death benefits. Small employers, it is argued, need the exception in order to provide a secure funding mechanism for such benefits (e.g., by allowing larger contributions in years in which the employer has greater cash flow).

On the other hand, proponents of the proposal argue that in many cases these plans do not in fact provide meaning benefits for persons other than the owners of the company and that the abuses of these types of arrangements are significant. The 10-or-more employer exception may be utilized to provide an alternative approach to funding retirement benefits without the dollar limitations and other rules applicable to qualified pension plans. These arrangements are often designed to avoid the deduction rules applicable to traditional employee benefit and nonqualified deferred compensation plans, which would generally require that the deduction for the employer be deferred until benefits are paid. Thus, a participating employer, typically a closely held business) that contributes to such a shelter arrangement is promised a current deduction for benefits intended 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.

The following quotes from advertisements and articles promoting severance and certain death benefit arrangements illustrate the use of these plans for tax shelter opportunities:

- "A large percentage of the contributions--often as much as 90% to 95%--are used to insure benefits for the owner employee(s)."

- "Contributions, which are virtually unlimited, are based upon 'reasonableness.'"

- "Employees are not vested with respect to benefits."

- "Need a $100,000 deduction? (No kidding!) Deductions as low as $15,000 available."

- "Mr./Ms. Business Owner, are you looking for a way to pay for your own life insurance with tax-deductible dollars?"

- "Due to tax law changes, qualified plans and other benefits for highly compensated executives and professionals are subject to significant restrictions. Would you be interested in a way to provide some of the same benefits without caps and penalties?"

- "The designer of the plan 'backs into' the benefit structure after inquiring what the firm wants to put away each year."

- In one example in an article, after 10 years, the employer withdraws from the plan with the following result: "The assets in the VEBA would be distributed in the following proportion: merchant, 97.5%; employee 2.5%. No other qualified plan permitted by present law can achieve this result."

- One article suggests funding rank-and-file benefits with "inexpensive term insurance," while funding the owner's benefit with "cash-value insurance, the cost of which absorbs the lion's share of the desired level of annual contribution to the plan."

<u>Prior Action</u>

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal, except that the prior proposal would have been effective for contributions after the date of enactment. The proposal was included in the Taxpayer Refund and Relief Act of 1999 as passed by the Congress and vetoed by the President, the Patient's Bill of Rights Plus Act as passed by the Senate, the Trade Development Act of 1999 as passed by the Senate, the Caribbean and Central America Relief and Economic Stabilization Act as ordered reported by the House Committee on Ways and Means, and the Tax Relief Extension Act of 1999 as passed by the Senate. A similar proposal was also included in the Affordable Education Act of 1999 as reported by the Senate Committee on Finance, except that that proposal would be effective for contributions after the date of enactment.

4. Subject signing bonuses to employment taxes

<u>Present Law</u>

Under present law, bonuses paid to individuals for signing contracts of employment are required to be included in gross income in the taxable year in which paid. However, the IRS has ruled that if the contract does not contain a provision requiring the performance of future services, then the bonus payment does not constitute remuneration for services performed and, accordingly, does not constitute wages for income tax withholding purposes.[587]

In addition, under present law, taxes under the Federal Insurance Contributions Act ("FICA taxes") are imposed on wages paid to employees. Similar rules apply to taxes under the Federal Unemployment Tax Act ("FUTA taxes"). For these purposes, wages are defined in general as including all remuneration for employment.[588] The term by which such remuneration is defined (e.g., salaries, fees, bonuses, or commissions) is irrelevant;[589] if it is intended to provide remuneration for employment, a payment is treated as wages. For example, the IRS has held that amounts paid to a college on behalf of a professional baseball player under a "College Scholarship Plan" were wages for FICA tax purposes.[590] The Scholarship Plan was considered to be a part of the employment contract under which the player agreed to play baseball for three months for a specified monthly remuneration. Further, the baseball club was relieved of its obligation under the Scholarship Plan if the player failed to report for spring training at the direction of the club.

Description of Proposal

The proposal would provide that signing bonuses are subject to income tax withholding and are included in the definition of wages for FICA and FUTA purposes. The proposal would apply without regard to whether the signing bonus is conditioned upon the performance of services by the recipient. The proposal states that no inference is intended with respect to the application of the present-law withholding rules to such signing bonuses.

Effective date.--The proposal would be effective for signing bonuses paid after the date of enactment.

Analysis

Under present law, the line between whether a signing bonus or similar payment negotiated as part of an employment contract is includible in wages for FICA and FUTA tax purposes and is subject to income tax withholding is determined by whether the payment is contingent upon the performance of future services. If an individual is not required to perform future services after receipt of the signing bonus or other type of payment, then such bonus or payment is not considered remuneration for employment. On the other hand, if the payor is not

[587] Rev. Rul. 58-145, 1958-1 C.B. 360.

[588] Section 3121(a).

[589] Treas. Reg. sec. 31.3121(a)-1(c).

[590] Rev. Rul. 71-532, 1971-2 C.B. 356, modifying Rev. Rul. 69-424, 1969-2 C.B. 15.

obligated to make the payment unless the individual agrees to perform future services for the payor, then the payment is considered remuneration for employment.

It can be argued that payments negotiated in connection with an employment contract are intrinsically linked to the performance of services for the payor. The payor does not make the payment to the individual for altruistic purposes. The payment is inherently related to the expectation that the individual will perform future services for the payor. Thus, it could be argued that any payment to an individual that is made as part of a contract of employment and that is not a reimbursement for expenses or similar payments should be treated as wages subject to income tax withholding and to FICA and FUTA taxes.

On the other hand, signing bonuses are often used, particularly in the case of professional athletics, as an inducement to individuals to sign a contract of employment, not necessarily as advance payment for the performance of future services. For example, most individuals who are selected in the Major League Baseball First Year Player Draft are either graduating high school students or individuals who have completed two or three years of college. These individuals are not required under NCAA rules and regulations to declare their intention to forego eligibility to compete in college in order to be selected in the First Year Player Draft. An individual who is selected in the First Year Player Draft and does not reach an agreement to play in a major league organization may complete his college eligibility. The signing bonuses provided to these individuals could be characterized not so much as remuneration for future services as an incentive to forego eligibility as a college baseball player. There is at least a question whether such payments are, in fact, remuneration or employment and, therefore, should be subject to FICA and FUTA taxes.

Similarly, there is a question whether a signing bonus that is not paid under an employment contract should be subject to FICA and FUTA taxes. For example, if an individual is paid an amount in exchange for an agreement to negotiate an employment contract with only a single organization, then it can be argued that the bonus payment is not remuneration for future services. In such a situation, the payment is clearly not conditioned upon the expected performance of future services. On the other hand, if this type of payment is not considered remuneration for employment, then it would be a relatively simple matter to sever an employment contract into two components--a contract with a signing bonus that is an agreement to negotiate and a separate contract detailing the terms of employment. In such a case, payment under the first contract would then not be subject to FICA and FUTA taxes.

The issue of income tax withholding on signing bonuses is separable from the issue of treating such bonuses as wages for FICA and FUTA tax purposes. Because signing bonuses are included in gross income for the taxable year in which received, compliance could be improved by requiring that such bonuses be treated as wages for income tax withholding purposes. In addition, such an approach might reduce the number of individuals required to make estimated tax payments during a taxable year (and the number of individuals subject to a penalty for failure to make the required estimated tax payments).

Prior Action

A similar provision was included in the President's Fiscal Year 2000 Budget Proposal.

5. Clarify employment tax treatment of choreworkers employed by State welfare agencies

Present Law

Under certain circumstances, State and local agencies provide funds for in-home household or personal care services for disabled and elderly individuals. The persons performing such services are referred to here as "choreworkers." The precise arrangements under which the domestic services are performed varies from State to State. For example, in some States, the State may provide funds to the disabled or elderly individual who then uses the funds to acquire in-home assistance. In other cases, the choreworker may be an employee of the State. In still other cases, the worker may be paid in part by State funds and in part by the individual receiving the services. A variety of other payment arrangements also may be utilized.

For Federal income and payroll tax purposes (i.e., FICA, FUTA, and withholding) whether choreworkers are employees or independent contractors is determined under the generally applicable rules for determining worker status. In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common-law test. Treasury regulations provide that an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished. In other words, an employer-employee relationship generally exists if the person providing the services "is subject to the will and control of the employer not only as to what shall be done but how it shall be done."[591] Whether the requisite control exists is determined based on all the relevant facts and circumstances.[592] Depending on the particular circumstances, a choreworker may be an independent contractor, an employee of the State, an employee of the service recipient, or an employee of another entity (e.g., a private entity).

If the choreworker is considered the employee of the individual receiving the services, then that individual is responsible for applicable employment taxes and withholding under the rules generally applicable to household employees. Under present law, FICA taxes are not required to be paid with respect to cash remuneration of less than $1,200 (for 2000) paid to any household employee in a calendar year. If the cash remuneration paid to any household employee by a household employer is $1,000 or more in a calendar year, all of the cash

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591 Treas. Reg. sec. 31.3401(c)-(1)(b).

592 The IRS has developed a list of 20 factors that may be examined in determining whether an employer-employee relationship exists. Rev. Rul. 87-41, 1987-1 C.B. 296.

remuneration is subject to FICA taxes. FUTA taxes must be paid with respect to household employees if the total cash wages paid to the employee is $1,000 or more in any calendar quarter of 1999 or 2000. Withholding on household employees is required only if the employer and employee agree to withholding. FICA, FUTA, and any income taxes withheld are reported annually by household employers on Schedule H.

In some cases, pursuant to section 3504 of the Code, State and local government health and welfare agencies assume responsibility for reporting and paying FICA and FUTA taxes and any withheld income taxes with respect to choreworkers.[593] These agencies must report FICA taxes and withheld income taxes with respect to these individuals quarterly on a Form 941 and report FUTA taxes annually on Form 940.[594]

If the choreworker is the employee of the State or a private agency, then the generally applicable withholding rules apply.

Description of Proposal

The proposal would clarify that State agencies, and not the disabled or elderly individual receiving the services, are responsible for withholding and employment taxes for choreworkers. For this purpose, all wages paid to a choreworker would be treated as paid by a single employer (the State agency). No inference is intended with respect to the application of prior law withholding rules for choreworkers.

Effective date.--The proposal would be effective for wages paid after December 31, 2000.

Analysis

[593] Section 3504 provides that the Secretary may prescribe procedures under which a person who has the control, receipt, custody, or disposal of, or pays the wages of an employee is treated as the agent of the employee's employer. Except as otherwise provided by the Secretary, all provisions of law (including penalties) and regulations prescribed thereunder applicable to an employer are applicable to the agent and the employer remains subject to all provisions of law (including penalties) and regulations prescribed thereunder. Revenue Procedure 70-6, 1970-1 C.B. 420, as modified by Revenue Procedure 80-4, 1980-1 C.B. 581, set forth the procedures to be followed in requesting authority to act as an agent. Revenue Procedure 80-4 contains rules applicable specifically to State and local health and welfare agencies wishing to act as agents of welfare recipients who become the employers of individuals furnished by the agencies to provide in-home domestic service.

[594] Notice 95-18, 1995-1 C.B. 300, Q & A 5.

Under present law, if a choreworker who is paid with State funds is the employee of the individual receiving the services, the choreworker may earn less social security benefits than if the choreworker were considered an employee of the State with respect to such services. For example, if a choreworker is an employee of several individuals and receives cash payments of less than $1,200 from each of such individuals, then none of the services will count toward social security benefits. However, if the same choreworker were considered an employee of the State with respect to such services, then all the services generally would count toward social security benefits.

The proposal addresses this issue by providing that State agencies are responsible for withholding and employment taxes for choreworkers. Thus, under the proposal, some individuals may earn benefits under social security that they would not earn under present law. However, such individuals would also become subject to FICA taxes on their current wages. To the extent that choreworkers received more than $1,200 from an employer, but for whom FICA taxes were not paid despite the legal obligation to do so, the proposal would help to ensure compliance with the laws as well as ensure that such workers received future social security benefits attributable to such work. Such workers, however, might see their wages decline to reflect the increased taxes paid on their behalf.[595] For recipients of choreworker services that comply with the law in their role as employer, the proposal could provide some simplification as the current recipients of the services would now no longer have to withold employment taxes.

Additional clarifying details would be needed in order for the proposal to be implemented. The precise definition of the workers and the wages subject to the proposal needs to be clarified. For example, it is not clear how the proposal would apply if the worker receives payments both through State funds and from the individual service recipient. Additionally, it is not clear how the proposal would apply with respect to State funds paid by the recipient of the services to private agencies that employ choreworkers and pay employment taxes on their behalf. Similarly, it is not clear whether the proposal would apply with respect to funds received by local agencies. Additional reporting requirements may also be necessary to implement the proposal.

Prior Action

No prior action.

6. Prohibit IRAs from investing in foreign sales corporations

Present Law

Special rules are provided for certain foreign corporations that qualify as foreign sales corporations ("FSCs"). A FSC typically is owned by a U.S. corporation that produces goods in

[595] Most economists believe that taxes on labor, regardless if paid by the employer or the employee, are ultimately borne by workers in the form of lower wages.

the United States. The U.S. corporation either supplies goods to the FSC for resale abroad to unrelated persons or pays the FSC a commission in connection with its sales of the goods to unrelated persons for use outside the United States. Under special tax provisions, a portion of certain income of an eligible FSC is exempt from U.S. income tax.[596] In addition, a U.S. corporation is not subject to U.S. tax on dividends distributed from the FSC out of earnings attributable to certain export income. Thus, there generally is no corporate-level tax imposed on a portion of the income from a FSC.[597]

An individual retirement arrangement ("IRA") is a tax-favored retirement savings vehicle. An IRA generally is exempt from taxation, although the account is subject to unrelated business income tax. Amounts distributed from a traditional IRA are generally subject to tax upon distribution, except to the extent the amount distributed is attributable to nondeductible contributions. In the case of a Roth IRA, distributions of earnings are not taxable if the Roth IRA has been held for at least five years and certain other conditions are satisfied.

Description of Proposal

The proposal would prohibit an IRA from investing in a FSC. No inference would be intended regarding the proper valuation of FSC stock for purposes of the present-law IRA contribution limits and other rules.

Effective date.--The proposal would be effective for the acquisition of FSC stock on or after the date of first committee action. IRAs holding FSC stock on the date of first committee action would be required to divest themselves of the investment within six months after the date of enactment.

Analysis

Present law eliminates corporate-level tax for a portion of the income of a FSC. Thus, in the case of a FSC owned by a C corporation, exempt FSC income is subject to tax only when distributed as dividends to the C corporation's shareholders.[598] In the case of FSC shareholders

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[596] Sections 921-927.

[597] In July 1998, the European Union requested that a World Trade Organization ("WTO") dispute panel investigate the FSC regime and its compliance with WTO rules including the Agreement on Subsidies and Countervailing Measures. A WTO dispute settlement panel was established in September 1998 to address these issues. In October 1999, the panel ruled that the FSC regime was not in compliance with WTO obligations. On February 24, 2000, the WTO Appellate Body affirmed the lower panel's decision on this issue.

[598] Income earned by the C corporation with respect to reinvested FSC dividends would be subject to corporate-level tax.

other than C corporations, FSC dividends generally are includible in income when received by the FSC shareholder.

In some cases, individuals may seek to obtain favorable tax treatment of a FSC by owning a FSC through an IRA. If FSC shares are owned through a traditional IRA, FSC dividends are taxable under present law only when withdrawn from the IRA (rather than when paid to the IRA).[599] If FSC shares are owned through a Roth IRA, then FSC dividends would be excludable from income, provided the applicable Roth IRA requirements are met. In this way, the individual is able to achieve similar tax treatment as the person would achieve if the FSC stock were held through a C corporation, with the additional benefit of tax-free accumulation of earnings on the reinvested FSC distributions.

The proposal would eliminate the ability of individuals to defer or exclude tax on FSC income by providing that an IRA cannot invest in a FSC. Supporters of the proposal argue that the special present-law rules for FSCs ensure that there is only one corporate level of tax. It is argued that ownership of a FSC through an IRA permits inappropriate deferral (or exclusion in the case of Roth IRAs) of FSC income for individuals.

Opponents of the proposal argue that the present-law rules favor ownership of FSCs by C corporations and may make it less desirable for others, particularly S corporations, to own FSCs because the dividends received deduction for FSC dividends is available only to C corporations. It is argued that permitting ownership of a FSC through an IRA "levels the playing field." Proponents of the proposal counter that further tax benefits are not appropriate in the case of owners other than C corporations, because they are only subject to one level of tax.

The tax benefits that are available through a traditional IRA are also available through the use of a qualified retirement plan. In many cases, the nondiscrimination, fiduciary, and other rules applicable to such plans may make it difficult or undesirable for such plans to own a FSC, except in the case of plans covering only a few individuals. However, because such plans provide the same deferral opportunities as a traditional IRA, it may be appropriate to extend the proposal to qualified plans. The proposal also does not address the possibility of indirect ownership of a FSC by an IRA (or other qualified plan). Because indirect arrangements appear to provide the same benefits as direct ownership, such arrangements may also need to be addressed under the proposal.

Prior Action

No prior action.

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[599] In this case, any income earned by the IRA with respect to reinvested FSC dividends would not be subject to tax in the IRA.

I. Compliance Provisions

1. Modify the substantial understatement penalty for large corporations

Present Law

A 20-percent penalty applies to any portion of an underpayment of income tax required to be shown on a return that is attributable to a substantial understatement of income tax. For this purpose, an understatement is considered "substantial" if it exceeds the greater of (1) 10 percent of the tax required to be shown on the return, or (2) $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). Generally, the amount of an "understatement" of income tax is the excess of the tax required to be shown on the return over the tax shown on the return (reduced by any rebates of tax). The substantial understatement penalty does not apply if there was a reasonable cause for the understatement and the taxpayer acted in good faith with respect to the understatement (the "reasonable cause exception"). The determination as to whether the taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.

Description of Proposal

The proposal would treat a corporation's deficiency of more than $10 million as substantial for purposes of the substantial understatement penalty, regardless of whether it exceeds 10 percent of the taxpayer's total tax liability.

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

Analysis

Opponents might argue that altering the present-law penalty to make it apply automatically to large corporate deficiencies might be viewed as violating the policy basis for this penalty, which is to punish an understatement that is substantial or material in the context of the taxpayer's own tax return. Proponents might respond that a deficiency of more that $10 million is material in and of itself, regardless of the proportion it represents of that taxpayer's total tax return.

Prior Action

The proposal was included in the President's Fiscal Year 1998, 1999, and 2000 Budget Proposals.

2. Repeal exemption for withholding on certain gambling winnings

Present Law

In general, proceeds from a wagering transaction are subject to withholding at a rate of 28 percent if the proceeds exceed $5,000 and are at least 300 times as large as the amount wagered. The proceeds from a wagering transaction are determined by subtracting the amount wagered from the amount received. Any non-monetary proceeds that are received are taken into account at fair market value.

In the case of sweepstakes, wagering pools, or lotteries, proceeds from a wager are subject to withholding at a rate of 28 percent if the proceeds exceed $5,000, regardless of the odds of the wager.

No withholding tax is imposed on winnings from bingo, keno, or slot machines.[600] Winnings of $1,200 or more from bingo or a slot machine or $1,500 or more from keno, are, however, subject to information reporting on a Form W-2G.[601]

Description of Proposal

The proposal would impose withholding on proceeds from bingo or keno wagering transactions at a rate of 28 percent if such proceeds exceed $5,000, regardless of the odds of the wager.

Effective date.--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.

Analysis

Many believe that imposing withholding on winnings from bingo and keno exceeding $5,000 will improve tax compliance and enforcement, because withholding will help ensure that taxpayers will be able to pay the tax due on the amounts they have won. In addition, the proposal would treat winnings from bingo and keno similarly to winnings from sweepstakes, wagering pools, and lotteries, which some taxpayers may view as fungible wagering opportunities. Opponents may be concerned that imposing a withholding requirement will impose additional administrative burdens on entities conducting bingo and keno operations (although such entities are already subject to information reporting at lower thresholds). In addition, the 28-percent rate of withholding will be too high for many taxpayers, such as those in the 15-percent tax bracket or those with substantial offsetting gambling losses; these taxpayers

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[600] Section 3402(q)(5).

[601] Treas. Reg. sec. 7.6041-1.

would need to temporarily adjust wage withholding or estimated tax payments to avoid having to wait until their tax return is filed to receive back the excess portion of the withholding. Also, some may be concerned that the proposed effective date provides insufficient time for entities conducting bingo and keno operations to become aware of the withholding requirement and to establish procedures to implement it.

Prior Action

The proposal was included in the President's Fiscal Year 1998, 1999, and 2000 Budget Proposals.

3. Require information reporting for private separate accounts

Present Law

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup").[602] Similar favorable tax treatment is generally accorded an annuity or endowment contract. However, under the investor control doctrine, an annuity contract holder is treated as the owner of the underlying assets (such as mutual fund shares) if the holder's ability to direct the investment of those assets constitutes sufficient control over individual investment decisions.

Life insurance companies generally maintain assets that support liabilities under insurance contracts in a general account, or a separate account (in the case of certain types of contracts such as variable contracts). Present law imposes asset diversification requirements on

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[602] This favorable tax treatment is available only if the policyholder has an insurable interest in the insured when the contract is issued and if the life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includable in income, to the extent that the amounts distributed exceed the taxpayer's investment in the contract; such distributions generally are treated first as a tax-free recovery of the investment in the contract, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than 7 annual level premiums (sec. 7702A). Certain amounts received under a life insurance contract on the life of a terminally or chronically ill individual, and certain amounts paid for the sale or assignment to a viatical settlement provider of a life insurance contract on the life of a terminally ill or chronically ill individual, are treated as excludable as if paid by reason of the death of the insured (sec. 101(g)).

separate accounts with respect to variable contracts. Under these diversification requirements, a variable contract that is based on a separate account is not treated as an annuity, endowment or life insurance contract for which investments made by the separate account are not adequately diversified (as prescribed in Treasury regulations).[603]

Description of Proposal

The proposal would impose reporting requirements with respect to any life insurance, endowment or annuity contract, any portion of the account value of which is invested in a private separate account. For this purpose, a private separate account would be defined as any separate account of an insurance company with respect to which related persons hold annuity, endowment or life insurance contracts whose aggregate cash values represent at least 10 percent of the value of the assets in the separate account. The reporting requirements would apply with respect to any annuity, endowment or life insurance contract whose cash value is partially or wholly invested in a private separate account for any portion of the taxable year.

The proposal would require a life insurance company maintaining a private separate account to report to the IRS with respect to each such contract the taxpayer identification number of the contract holder, the policy number, the total contract account value, the amount of inside buildup, and the portion of the total contract account value for each such contract that is invested in one or more private separate accounts of the life insurance company.

<u>Effective date</u>.--The proposal would be effective for taxable years beginning after the date of enactment.

Analysis

Those in favor of the proposal argue that the level of investor control of assets in private separate accounts of life insurance companies may violate the investor control doctrine. They assert that reporting to the IRS of information about the private separate accounts and the contracts that are based on them is needed to permit investigation of whether the arrangements should be treated as direct holding of the assets, rather than holding of an annuity, endowment or life insurance contract, the inside buildup on which is tax-free. They argue that, without detailed reporting of information about the contracts and the accounts, identification and analysis of these arrangements is more difficult and leads to inefficient use of government resources.

Opponents of the proposal argue that the reporting requirements are significantly broader than needed to identify cases in which the investor control doctrine might apply. If any reporting requirement is needed, some might argue, it should be merely a notation that the arrangement exists. In fact, it could be argued, reporting requirements designed merely to permit IRS identification of arrangements that might be challenged by the IRS is wasteful not only of

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603 Section 817(h).

government resources but also of taxpayer resources. It is unclear that the reported information could actually be processed by the IRS in a useful manner; possibly the information might even be disregarded. They argue that the detailed reporting requirements of the proposal are burdensome for taxpayers and give rise to excessive administrative costs without targeting any identified tax abuse. On the other hand, some might argue that it is a more efficient use of resources to require reporting that immediately identifies arrangements that require further investigation.

Others might argue that the proposal's definition of a private separate account is overbroad. If the purpose of the definition is to identify an insurance company separate account that is owned principally by a particular person or group of related persons that might have the ability to direct the investments in the account in violation of the investor control doctrine, then the proposal's 10-percent ownership threshold could be criticized as too low or as arbitrary. Advocates of the proposal might respond that the definition is for purposes of a reporting requirement, not a substantive provision of law, and that taxpayers who are confident that their arrangement does not violate the investor control doctrine should not be concerned about reporting it. They also point to provisions

Some opponents of the proposal might argue that the investor control doctrine is unlikely to apply with respect to private separate account contracts. One argument for this position might be that the diversification requirements of section 817(h) have superceded the doctrine. Nevertheless, many would acknowledge that the rules of section 817(h) and the investor control doctrine continue to coexist. Another argument might be that the arrangements under private separate accounts are carefully monitored by the contract holder and the life insurance company so that they do not violate either the investor control doctrine or the diversification requirements.

Prior Action

No prior action.

4. Increase penalties for failure to file correct information returns

Present Law

Any person who fails to file a correct information return with the IRS on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the penalty is $15 per return, with a maximum penalty of $75,000 per calendar year. If a person files a correct information return after the date that is 30 days after the prescribed filing date but on or before August 1 of that year, the penalty is $30 per return, with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1, the amount of the penalty is $50 per return, with a maximum penalty of $250,000 per calendar year.

There is a special rule for de minimis failures to include the required, correct information. This exception applies to incorrect information returns that are corrected on or before August 1. Under the exception, if an information return is originally filed without all the required information or with incorrect information and the return is corrected on or before August 1, then the original return is treated as having been filed with all of the correct required information. The number of information returns that may qualify for this exception for any calendar year is limited to the greater of (1) 10 returns or (2) one-half of one percent of the total number of information returns that are required to be filed by the person during the calendar year.

In addition, there are special, lower maximum levels for this penalty for small businesses. For this purpose, a small business is any person having average annual gross receipts for the most recent three taxable years ending before the calendar year that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

If a failure to file a correct information return with the IRS is due to intentional disregard of the filing requirement, the penalty for each such failure is generally increased to the greater of $100 or ten percent of the amount required to be reported correctly, with no limitation on the maximum penalty per calendar year (sec. 6721(e)). The increase in the penalty applies regardless of whether a corrected information return is filed, the failure is de minimis, or the person subject to the penalty is a small business.

Description of Proposal

The proposal would increase the penalty for failure to file information returns correctly on or before August 1 from $50 for each return to the greater of $50 or 5 percent of the amount required to be reported correctly but not so reported. The $250,000 maximum penalty for failure to file correct information returns during any calendar year ($100,000 with respect to small businesses) would continue to apply under the proposal.

The proposal also would provide for an exception to this increase where substantial compliance has occurred. The proposal would provide that this exception would apply with respect to a calendar year if the aggregate amount that is timely and correctly reported for that calendar year is at least 97 percent of the aggregate amount required to be reported under that section of the Code for that calendar year. If this exception applies, the present-law penalty of $50 for each return would continue to apply.

The proposal would not affect the following provisions of present law: (1) the reduction in the $50 penalty where correction is made within a specified period; (2) the exception for de minimis failures; (3) the lower limitations for persons with gross receipts of not more than $5,000,000; (4) the increase in the penalty in cases of intentional disregard of the filing requirement; (5) the penalty for failure to furnish correct payee statements under section 6722; (6) the penalty for failure to comply with other information reporting requirements under section 6723; and (7) the reasonable cause and other special rules under section 6724.

Effective date.--The proposal would apply to information returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment.

Analysis

Some of the information returns subject to this proposed increased penalty report amounts that are income, such as interest and dividends. Other information returns subject to this proposed increased penalty report amounts that are gross proceeds.[604] Imposing the penalty as a percentage of the amount required to be reported might be viewed as disproportionately affecting businesses that file information returns reporting gross proceeds.

Prior Action

The proposal was included in the President's Fiscal Year 1998, 1999, and 2000 Budget Proposals.

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[604] Gross proceeds reports are useful to indicate that a potentially income-producing event has occurred, even though the amount reported on the information return bears no necessary relationship to the amount of income ultimately reported on the income tax return.

J. Miscellaneous Revenue-Increasing Provisions

1. Modify deposit requirement for Federal Unemployment Tax Act ("FUTA")

Present Law

If an employer's liability for FUTA taxes is over $100 for any quarter, the tax must be deposited by the last day of the first month after the end of the quarter. Smaller amounts are subject to less frequent deposit rules.

Description of 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. The deposit with respect to wages paid during a month would be required to be made by the last day of the following month. 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 required to establish a monthly deposit mechanism but would be permitted to adopt a similar safe harbor mechanism for paying State unemployment taxes.

Effective date.--The proposal would be effective for months beginning after December 31, 2005.

Analysis

Proponents of the proposal argue that the proposed deposit requirements would: (1) provide a regular inflow of money to State funds to offset the regular payment of benefits; and (2) reduce losses to the Federal unemployment trust funds caused by employer delinquencies. Opponents respond that the State trust funds already have sufficient funds for the payment of benefits and they also claim that more frequent deposits would not reduce employer delinquencies. Further, opponents contend that the proposal's administrative burden significantly outweighs its benefits.

Prior Action

A substantially similar proposal was included in the President's Fiscal Year 1998, 1999 and 2000 Budget Proposals.

2. Reinstate Oil Spill Liability Trust Fund tax

Present Law

A five-cents-per-barrel excise tax was imposed before January 1, 1995. Revenues from this tax were deposited in the Oil Spill Liability Trust Fund. The tax did not apply during any calendar quarter when the Treasury Department determined that the unobligated balance in this Trust Fund exceeded $1 billion at the close of the preceding calendar quarter.

Description of Proposal

The proposal would reinstate the Oil Spill Liability Trust Fund excise tax during the period after September 30, 2001 and before October 1, 2010. The proposal also would increase the $1 billion limit on the unobligated balance in the Oil Spill Liability Trust Fund to $5 billion.

Effective date.-- The proposal would be effective on the date of enactment.

Analysis

Some view the Oil Spill Liability Trust Fund excise tax as a tax on oil producers and consumers to fund an insurance pool against potential environmental risks that arise from the transport of petroleum. In this view, the tax is an insurance premium in a mandated scheme of risk pooling. While the first liability for damage from an oil spill remains with the owner of oil, the tax funds a Trust Fund that may be drawn upon to meet unrecovered claims that may arise from an oil spill either upon the high seas or from ruptured domestic pipelines. The tax and the Trust Fund represent a social insurance scheme with risks spread across all consumers of petroleum. The analogy to insurance is imperfect, however. The tax assessed reflects an imperfect pricing of risks. For example, the prior-law Oil Spill Liability Trust Fund tax was imposed at the same rate regardless of whether the importer employed more difficult to rupture double-hulled or single-hulled tankers.

Proponents of reimposing the Oil Spill Liability Trust Fund excise tax suggest that the revenues would provide a cushion for future Trust Fund program activities. However, the Congressional authorizing committees have not notified the tax-writing committees of either a shortfall in the amounts required for currently authorized expenditures or of plans to expand or extend those authorizations. Opponents of reimposing the taxes suggest that this action should be undertaken only in combination with such authorizing legislation.

The unobligated balance in the Oil Spill Liability Trust Fund of the close of Fiscal Year 1999 was $972 million.

Prior Action

A similar proposal was included in the President's Fiscal Year 1998, 1999, and 2000 Budget Proposals.

3. Repeal percentage depletion for non-fuel minerals mined on Federal and formerly Federal lands

Present Law

Taxpayers are allowed to deduct a reasonable allowance for depletion relating to the acquisition and certain related costs of mines or other 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 allowance for depletion for the year.

Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the property which 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 statutory percentage for gold, silver, copper, and iron ore is 15 percent; the statutory percentage for uranium, lead, tin, nickel, tungsten, zinc, and most other hard rock minerals is 22 percent. 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 Mining Law of 1872 permits U.S. citizens and businesses to prospect freely for hard rock minerals on Federal lands, and allows them to mine the land if an economically recoverable deposit is found. No Federal rents or royalties are imposed upon the sale of the extracted minerals. A prospecting entity may establish a claim to an area that it believes may contain a mineral deposit of value and preserve its right to that claim by paying an annual holding fee of $100 per claim. Once a claimed mineral deposit is determined to be economically recoverable, and at least $500 of development work has been performed, the claim holder may apply for a "patent" to obtain title to the surface and mineral rights. If approved, the claimant can obtain full title to the land for $2.50 or $5.00 per acre.

Description of Proposal

The proposal would repeal the present-law percentage depletion provisions for non-fuel minerals mined on Federal lands where the mining rights were originally acquired under the Mining Law of 1872, and on private lands acquired under the 1872 law.

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

Analysis

The percentage depletion provisions generally can be viewed as providing an incentive for mineral production. The Mining Act of 1872 also provides incentives for mineral production by allowing claimants to acquire mining rights on Federal lands for less than fair market value. In cases where a taxpayer has obtained mining rights relatively inexpensively under the provisions of the Mining Act of 1872, it can be argued that such taxpayers should not be entitled to the additional benefits of the percentage depletion provisions. However, proposal would appear to repeal the percentage depletion provisions not only for taxpayers who acquired their mining rights directly from the Federal Government under the Mining Act of 1872, but also for those taxpayers who purchased such rights from a third party who had obtained the rights under the Mining Act of 1872. In cases where mining rights have been transferred to an unrelated party for full value since being acquired from the Federal Government (and before the effective date), there is little rationale for denying the benefits of the percentage depletion provisions to the taxpayer currently mining the property on the basis that the original purchaser obtained benefits under the Mining Act of 1872.

Prior Action

A similar proposal was included in the President's Fiscal Year 1997, 1998, 1999, and 2000 Budget Proposals.

4. Impose excise tax on purchase of structured settlements

Present Law

Present law provides tax-favored treatment for structured settlement arrangements for the payment of damages on account of personal injury or sickness.

Under present law, an exclusion from gross income is provided for amounts received for agreeing to a qualified assignment to the extent that the amount received does not exceed the aggregate cost of any qualified funding asset (sec. 130). A qualified assignment means any assignment of a liability to make periodic payments as damages (whether by suit or agreement) on account of a personal injury or sickness (in a case involving physical injury or physical sickness), provided the liability is assumed from a person who is a party to the suit or agreement, and the terms of the assignment satisfy certain requirements. Generally, these requirements are that (1) the periodic payments are fixed as to amount and time; (2) the payments cannot be accelerated, deferred, increased, or decreased by the recipient; (3) the assignee's obligation is no greater than that of the assignor; and (4) the payments are excludable by the recipient under section 104(a)(2) as damages on account of personal injuries or sickness.

A qualified funding asset means an annuity contract issued by an insurance company licensed in the U.S., or any obligation of the United States, provided the annuity contract or obligation meets statutory requirements. An annuity that is a qualified funding asset is not subject to the rule requiring current inclusion of the income on the contract which generally applies to annuity contract holders that are not natural persons (e.g., corporations) (sec. 72(u)(3)(C)). In addition, when the payments on the annuity are received by the structured settlement company and included in income, the company generally may deduct the corresponding payments to the injured person, who, in turn, excludes the payments from his or her income (sec. 104). Thus, neither the amount received for agreeing to the qualified assignment of the liability to pay damages, nor the income on the annuity that funds the liability to pay damages, generally is subject to tax.

The exclusion for recipients of the periodic payments received under a structured settlement arrangement as damages for personal physical injuries or physical sickness can be contrasted with the treatment of investment earnings that are not paid as damages. If a recipient of damages chooses to receive a lump sum payment (excludable from income under sec. 104), and then to invest it himself, generally the earnings on the investment are includable in income. For example, if the recipient uses the lump sum to purchase an annuity contract providing for periodic payments, then a portion of each payment under the annuity contract is includable in income, and the balance is excludable under present-law rules based on the ratio of the individual’s investment in the contract to the expected return on the contract (sec. 72(b)).

Present law provides that the payments to the injured person under the qualified assignment cannot be accelerated, deferred, increased, or decreased by the recipient. Consistent with these requirements, it is understood that contracts under structured settlement arrangements generally contain anti-assignment clauses. It is understood, however, that injured persons may nonetheless be willing to accept discounted lump sum payments from certain “factoring” companies in exchange for their payment streams. The tax effect on the parties of these transactions may not be completely clear under present law.

Description of Proposal

The proposal would impose an excise tax on any person acquiring a payment stream under a structured settlement arrangement. The amount of the excise tax would be 40 percent of the difference between (1) the amount paid by the acquirer to the injured person and (2) the undiscounted value of the acquired income stream. The excise tax would not be imposed if the acquisition were pursuant to a court order finding that the extraordinary and unanticipated needs of the original recipient of the payment stream render the acquisition desirable.

Effective date.--The proposal would be effective for acquisitions occurring after the date of enactment. No inference would be intended as the contractual validity of the acquisition transaction or its effect on the tax treatment of any party other than the acquirer.

Analysis[605]

The economic benefit in the structured settlement arrangement arises because the Federal government forgoes taxation of the earnings component of each year's annual payment. As such, present law provides a tax subsidy for the use of structured settlement arrangements. Economists usually argue that tax subsidies such as that accorded to structured settlement arrangements distort individual choice and lead to inefficient outcomes. They argue that free choice permits individuals to make the highest and most preferred use of economic resources.

Nevertheless, it can be argued that the choice of the lump sum settlement in lieu of periodic payments under a structured settlement arrangement may create an externality, that is, a cost to taxpayers at large, not borne by the individual who chooses the lump sum settlement. This externality could arise as follows. The amount of damages in a case involving personal physical injuries or physical sickness may be based on the lifetime medical needs of the recipient. If a recipient chooses a lump sum settlement, there is a chance that the individual may, by design or poor luck, mismanage his or her funds so that future medical expenses are not met. The individual may be able to rely on Federally financed medical care in lieu of the medical care that was intended to have been provided by the personal injury award. Preventing this externality from arising is a worthwhile goal of the proposal, proponents argue.

Some might argue that defendants' offers of structured settlement arrangements leave recipients largely indifferent between a lump sum settlement and a structured settlement arrangement. That is, in their offering of structured settlement arrangements, the defendants may be trying to retain the entire tax benefit for themselves. Because each recipient only negotiates with one defendant, the recipient cannot comparison shop. The defendant's motivation generally would be to minimize the cost of attaining a settlement, and thus the defendant may have little incentive to offer some of the tax benefit to the recipient. On the other hand, others may argue that the tax benefit generally is shared among the defendant, the recipient, the defendant's insurer, and the structured settlement company, and that the present-law incentive to settle personal injury cases with periodic payments functions appropriately.

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[605] For a more detailed analysis, including related legislative proposals, see Joint Committee on Taxation, *Tax Treatment of Structured Settlement Arrangements* (JCX-15-99), March 16, 1999.

The proposal responds to the social policy concern that injured persons may not be adequately protected financially in transactions in which a long-term payment stream is exchanged for a lump sum. Transfer of the payment stream under a structured settlement arrangement arguably subverts the purpose of the structured settlement provisions of the Code to promote periodic payments for injured persons. The potential for deep discounting of the value of the payment stream may financially disadvantage injured persons that the provision was designed, in part, to protect.

If the market for the sale of rights to structured settlement arrangements is competitive, the seller should receive the full fair market value of his or her annuity. If this is the case, a seeming deep discount may merely reflect the competitive market's pricing of the individual's mortality risk and the opportunity cost of investment funds. The seemingly large discount may only be such in comparison to the sum of an undiscounted stream of annuity payments.

Opponents of the idea of limiting transfers of structured settlement payment streams may argue that competent adults should be free to make their own choices, at no financial penalty. It could also be argued that it is not the function of the tax law to prevent injured persons or their legal representatives from transferring rights to payment. Arguably, consumer protection and similar regulation is more properly the role of the States than of the Federal government. It could further be argued that it is not economically efficient for tax rules to hinder the operation of a market in structured settlement streams.

Proponents of the proposal argue that choices may not be fully informed. If an individual has an unrealistic view of his or her mortality prospects and investment opportunities, that individual may make a poor choice. Further, they may argue, the tax law already provides an incentive for structured settlement arrangements, and if practices have evolved that are inconsistent with its purpose, addressing them should be viewed as proper.

By imposing the excise tax on the amount of the discount, rather than on the entire amount of consideration for acquiring the payment stream, it could be said that this proposal is more targeted than an earlier version of the proposal to the aspect of the transaction that could financially disadvantage the injured person: the amount of the discount. It could nevertheless be argued that acquirers still have an economic incentive to acquire payment streams, so long as the tax on the discount is less than the rate which would discourage the acquisition transactions completely. Thus, if 40 percent is not the tax rate at which transactions could no longer be profitable for the acquirers, it could be said that the provision does not achieve the purpose of protecting the injured person by preventing the sale of the payment stream. Conversely, if 40 percent is that tax rate, then the proposal could be assessed as effective at achieving that purpose. If transactions were to continue after imposition of the tax, sellers of payment streams would be worse off than before the tax, because acquirers would discount more deeply the purchase of the payment stream to achieve the same profit level they did before the tax. Critics could argue that if the tax rate is set at a level that does not totally discourage the transactions, then the proposal would fail to achieve its goal of protecting the original recipients of payment streams.

An additional result of the proposal may be to limit the uncertainty arising under present law from the acquisition with respect to the tax treatment of payors under existing structured settlement arrangements. However, it could be argued that limiting or stopping the acquisition transactions through imposition of tax on them is not the most efficient way to provide certainty in the tax law. Other alternatives might be explicitly to provide that the acquisition of the payment stream either does, or does not, violate the requirement of present law section 130 that the payments cannot be accelerated, deferred, increased, or decreased by the recipient.

Prior Action

A similar proposal was included in the President's Fiscal Year 1999 Budget Proposal, except that under that proposal, the excise tax would have been imposed at a 20 percent rate on the entire consideration for acquiring the payment stream. An identical proposal[606] was included in the President's Fiscal Year 2000 Budget Proposal.

5. Require taxpayers to include rental income of residence in income without regard to period of rental

Present Law

Gross income generally includes all income from whatever source derived, including rents. Present Law provides a de minimis exception to this rule where a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year.[607] In this case, the income from such rental is not included in gross income and no deductions arising from such rental use are allowed as a deduction.

Description of Proposal

The proposal would repeal the 15-day rules of section 280A(g). A taxpayer would include in gross income rental income from the rental of the taxpayer's residence regardless of the period of rental. Also, a taxpayer could deduct a pro rata share of the expenses attributable to the rental of such property. The proposal does not change the present-law treatment of expenses allowable to the taxpayer without regard to the rental of the property (e.g., certain interest, taxes and casualty losses).

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[606] This proposal is similar to H.R. 263, "The Structured Settlement Protection Act," (106th Cong., 1st Sess., introduced by Mr. Shaw and others). H.R. 263 provides for a 50-percent tax on the amount equal to the excess of (1) the aggregate undiscounted amount of structured settlement payments being acquired, over (2) the total amount actually paid by the acquirer to the seller.

[607] Section 280A(g).

Effective date.--The proposal would apply to taxable years beginning after December 31, 2000.

Analysis

Present law allows certain taxpayers to exclude from income rental payments for the short-term rental of the taxpayer's residence. Proponents of the proposal believe that such amounts should be included in income of the taxpayers, like any other source of income. Opponents of the proposal argue that any additional tax revenue from the taxation of the rental payments from the short-term rental of a residence is outweighed by the imposition of the additional complexity placed on affected taxpayers by eliminating the de minimis exception from section 280A.

Prior Action

A similar proposal was included in the Taxpayer Relief Act of 1997, as passed by the House. A substantially similar proposal was included in the President's Fiscal Year 2000 Budget Proposal.

6. Eliminate installment option for payment of heavy vehicle use tax

Present Law

An annual excise tax is imposed on the use of heavy (at least 55,000 pounds) highway vehicles. The tax rate ranges from $100 per year (for a 55,000 pound vehicle) to $550 per year (for vehicles over 75,000 pounds). Revenues from the tax are deposited in the Highway Trust Fund.

The taxable year is July 1-June 30. The tax generally is due on August 31 of the year to which it relates. A taxpayer may, however, elect to pay the tax in quarterly installments. This option allows payment of one-fourth of the tax on each of August 31, December 31, March 31, and June 30.

States are required to obtain evidence, before registering vehicles, that the use tax return has been filed and any tax due with the return has been paid.

Description of Proposal

The installment payment option would be eliminated for tax years beginning after June 30, 2002. Thus, heavy vehicle owners would be required to pay the entire tax with their returns and would be unable to obtain State registration for their vehicles without providing proof of payment.

Effective date.--The proposal would be effective for taxable years beginning after June 30, 2002.

Analysis

Proponents of the proposal observe that under present law a taxpayer may elect to pay the heavy vehicle use tax in quarterly installments, make the first payment, show proof of the first payment, receive a State registration for the vehicle and then be delinquent on subsequent payments. Such delinquent payments place a heavy enforcement burden on the IRS to collect relatively small amounts of tax. In practice, collections may not be made as the IRS may not find it cost effective to pursue delinquent payments. Proponents note that such an outcome is unfair to the many taxpayers who are compliant and deprives the Highway Trust Fund of revenues necessary to fund transportation projects that benefit all highway users.

Opponents of the proposal counter that requiring annual payments may impose cash flow burdens on many taxpayers. They further note that the proposal, by speeding up payments from compliant taxpayers, has the effect of increasing a compliant taxpayer's tax burden by an amount equal to the forgone interest that compliant taxpayers could earn under the election to pay quarterly. Opponents argue that it is unfair to increase the financial burden on existing taxpayers as a compliance effort motivated by the IRS's failure to pursue adequately delinquent accounts. Opponents add that the Code currently provides sufficient remedies for delinquent taxpayers.

Prior Action

No prior action.

7. Require recognition of gain from the sale of a principal residence if acquired in a like-kind exchange within five years of the sale

Present Law

Under present law, a taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence.[608] To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met. The maximum exclusion amounts are not indexed for inflation.

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[608] Section 121.

Description of Proposal

The proposal would deny the principal residence exclusion for gain on the sale or exchange of a principal residence if such principal residence was acquired in a like-kind within the previous five years.

Effective date.--The proposed would be effective for sales or exchanges of principal residences occurring after the date of enactment.

Analysis

Proponents of the proposal want to stop taxpayers from excluding gain on the sale or exchange of a principal residence which is not attributable to the property's use as the taxpayer's principal residence. They argue that a taxpayer should not be allowed to convert a low tax basis property into his or her principal residence in order to exclude gain attributable to that property before it was used as a principal residence. To illustrate, take the example of a taxpayer who holds undeveloped land with a tax basis which is less than its fair market value. Under present law, this taxpayer may engage in a like-kind exchange of that property for a residence and after two years of use as the taxpayer's principal residence exclude up to $250,000 ($500,000 if married filing a joint return) of gain. However, even those who generally agree that the gain attributable to the undeveloped land in this case should be taxed believe that the structure of the proposal is not well tailored to the abusive cases. As currently structured, the proposal would tax both the gain attributable to the undeveloped land and any gain attributable to period when the property was actually used as the taxpayer's principal residence. In contrast, the proposal does not deny the exclusion in an instance which is similar to the above example. For example, if the taxpayer in the above example rather than engaging in a like-kind exchange simply builds a principal residence on the land and after qualifying for the exclusion sells the land and building as the taxpayer's principal residence property the gain attributable to both the land and the building may qualify for the exclusion.

Prior Action

A similar proposal was included in the Financial Freedom Act of 1999 as passed by the House.

K. International Provisions

1. Proposals affecting identified tax havens

Present Law

In general

The United States taxes U.S. citizens, residents, and corporations (collectively, U.S. persons) on all income, whether derived in the United States or elsewhere. By contrast, the United States taxes nonresident alien individuals and foreign corporations only on income with a sufficient nexus to the United States.

Subpart F provisions

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in such corporation. A variety of complex anti-deferral regimes impose current U.S. tax on income earned by a U.S. person through a foreign corporation. Subpart F of the Code establishes an anti-deferral regime for controlled foreign corporations ("CFCs"). A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).

Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a CFC on their pro-rata share of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is actually distributed to the shareholders. Subpart F income typically is passive income or income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income (defined in sec. 954), insurance income (defined in sec. 953), and certain income relating to international boycotts and other violations of public policy (defined in sec. 952(a)(3)-(5)). This includes, for example, income derived from countries with which the United States does not have diplomatic relations or which support international terrorism and for which foreign tax credits are disallowed under section 901(j) (discussed below). In effect, the United States treats the U.S. 10-percent shareholders of a CFC as having received a current distribution of the CFC's subpart F income. As discussed below, the U.S. tax on such amounts may be reduced through foreign tax credits.

Foreign sales corporations

Special rules are provided for certain foreign corporations that qualify as foreign sales corporations ("FSCs"). A FSC typically is owned by a U.S. corporation that produces goods in the United States. The U.S. corporation either supplies goods to the FSC for resale abroad to unrelated persons or pays the FSC a commission in connection with its sales of the goods to unrelated persons for use outside the United States. Under special tax provisions, a portion of certain income of an eligible FSC is exempt from U.S. income tax (secs. 921-927). In addition, a U.S. corporation is not subject to U.S. tax on dividends distributed from the FSC out of earnings attributable to certain export income. Thus, there generally is no corporate level tax imposed on a portion of the income from a FSC.[609]

Foreign tax credit

The foreign tax credit generally allows U.S. taxpayers to reduce the U.S. income tax on their foreign-source income by the foreign income taxes they pay on that income. The foreign tax credit, however, does not operate to offset U.S. income tax on U.S.-source income. A credit against U.S. tax on foreign-source income is allowed for foreign taxes directly paid or accrued by a U.S. person (the "direct" foreign tax credit).[610] In addition, a credit is allowed to a U.S. corporation for foreign taxes paid by certain foreign subsidiary corporations and deemed paid by the U.S. corporation upon a dividend received by, or certain other income inclusions of, the U.S. corporation with respect to earnings of the foreign subsidiary (the "deemed-paid" or "indirect" foreign tax credit).[611]

A foreign tax credit limitation, which is calculated separately for various categories of income, is imposed to prevent the use of foreign tax credits to offset U.S. tax on U.S.-source income.[612] Under this limitation, the credit for foreign taxes on income in a particular category may not exceed the same proportion of the taxpayer's U.S. tax liability which the taxpayer's foreign-source taxable income in that category bears to the taxpayer's worldwide taxable income for the taxable year. The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back to the two immediately preceding taxable years and carried forward to the five succeeding taxable years, and credited in such years to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years. For purposes of determining excess foreign tax credit limitation amounts, the foreign tax credit separate limitation category rules (often referred to as separate

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[609] In July 1998, the European Union requested that a World Trade Organization ("WTO") dispute panel investigate the FSC regime and its compliance with WTO rules including the Agreement on Subsidies and Countervailing Measures. A WTO dispute settlement panel was established in September 1998 to address these issues. In October 1999, the panel ruled that the FSC regime was not in compliance with WTO obligations. On February 24, 2000, the WTO Appellate Body affirmed the lower panel's decision on this issue.

[610] Section 901.

[611] Sections 902 and 960.

[612] Section 904.

"basket" rules) apply.[613] Under these rules, the foreign tax credit provisions are applied separately with respect to (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain noncontrolled foreign corporations, (6) income from a domestic international sales corporation, (7) certain taxable income attributable to foreign trade income, (8) certain distributions from a FSC, (9) and any other (i.e., "general basket") income.

The foreign tax credit provisions are elective annually. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes.

Denial of foreign tax credit with respect to certain foreign countries

Pursuant to special rules applicable to taxes paid to certain foreign countries, no foreign tax credit is allowed for taxes paid, accrued, or deemed paid to a country which satisfies specified criteria, to the extent that the taxes are paid with respect to income attributable to a period during which such criteria were satisfied.[614] Section 901(j) applies with respect to any foreign country: (1) the government of which the United States does not recognize, unless such government is otherwise eligible to purchase defense articles or services under the Arms Export Control Act, (2) with respect to which the United States has severed diplomatic relations, (3) with respect to which the United States has not severed diplomatic relations but does not conduct such relations, or (4) which the Secretary of State has, pursuant to section 6(j) of the Export Administration Act of 1979, as amended, designated as a foreign country which repeatedly provides support for acts of international terrorism (a "section 901(j) foreign country"). The denial of credits applies to any section 901(j) foreign country during the period beginning on the later of January 1, 1987, or six months after such country becomes a section 901(j) foreign country, and ending on the date the Secretary of State certifies to the Secretary of the Treasury that such country is no longer a section 901(j) foreign country.

Taxes treated as noncreditable under section 901(j) generally are permitted to be deducted notwithstanding the fact that the taxpayer elects use of the foreign tax credit for the taxable year with respect to other taxes. In addition, in order to prevent income for which foreign tax credits are denied generally to be sheltered from U.S. tax by other creditable foreign taxes, the foreign tax credit limitation[615] and the indirect credit (secs. 902 and 960) are to be

[613] Section 904(d).

[614] Section 901(j).

[615] Sections. 904(a), (b) and (c).

applied separately with respect to income from sources within section 901(j) foreign countries.[616]

International boycott provisions

Special rules are provided to deny any person who agrees to participate in or cooperate with any international boycott the benefits of the foreign tax credit, deferral of earnings of foreign subsidiaries, and tax benefits associated with FSCs, and to require operations in or related to a boycotting country to be reported to the Treasury Secretary.[617] If a taxpayer or any member of its controlled group participates in or cooperates with an international boycott, the benefits of the foreign tax credit are denied by reducing the otherwise allowable foreign tax credit to which the taxpayer would be entitled.[618] As discussed above, the benefits of deferral are denied (with respect to U.S. shareholders of CFCs) by treating as subpart F income the earnings attributable to boycott participation.[619] Similarly, the exempt foreign trade income of a FSC is reduced if the FSC or a member of its controlled group participates in or cooperates with a boycott.[620] The amount of tax benefits that are related to an international boycott and thus are denied to the taxpayer generally are determined by a proration formula referred to as the "international boycott factor".[621] The international boycott factor is a fraction, determined under Treasury regulations, the numerator of which generally reflects the taxpayer's operations in boycotting countries and the denominator of which reflects the total foreign operations of the taxpayer.[622] However, if a taxpayer can clearly demonstrate that the foreign taxes paid and income earned for the taxable year are attributable to specific operations, then, in lieu of applying the international boycott factor, the tax benefits denied shall be those attributable to the specific boycott operations.

If a taxpayer or member of its controlled group has operations in, or related to, a country (or with the government, a company, or a national of that country) which the person knows or

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[616] Section 902(j)(1)(B). As discussed above, deferral benefits are denied under subpart F in the case of income of a CFC derived from a section 901(j) country (sec. 952(a)(5)).

[617] Section 999.

[618] Section 908.

[619] Section 952(a)(3).

[620] Section 927(e)(2).

[621] Section 999(c).

[622] See Temp. Treas. Reg. sec. 7.999-1 for the computation of the international boycott factor.

has reason to know is a boycotting country or which is on a list of boycotting countries maintained by the Treasury Secretary, then the taxpayers must report such operations to the Treasury Secretary in a manner prescribed by regulations. Any person who willfully fails to make such report is, in addition to other penalties provided by law, subject to a $25,000 penalty and/or imprisonment for not more than one year.[623] The Treasury Secretary is required to maintain and publish (at least quarterly) a current list of boycotting countries.[624]

Reporting of payments to tax havens

The Code requires taxpayers to file tax returns according to the forms and regulations prescribed by the Secretary of the Treasury.[625] Taxpayers must include on those returns the information required by the forms or regulations. There is no statutory provision requiring reporting to the IRS of payments made to so-called "tax havens."

Description of Proposal

Reduction in foreign tax credits and other tax benefits

The proposal would deny a foreign tax credit for taxes paid to jurisdictions that have been identified in a list of jurisdictions to be published by the Treasury Secretary ("Identified Tax Havens"). The proposal would apply the foreign tax credit limitation rules, including the separate limitation categories (sec. 904(d)), separately to income earned in or through any Identified Tax Havens. This separate limitation rule would apply collectively to income from all Identified Tax Havens, and not on a country-by-country basis.

In addition, the proposal would reduce a taxpayer's (1) otherwise allowable foreign tax credit attributable to income from an Identified Tax Haven, (2) FSC benefit attributable to income from an Identified Tax Haven, and (3) income, attributable to an Identified Tax Haven, that is otherwise eligible for deferral. The amount by which such benefits would be reduced would be determined by a factor similar to the present-law international boycott factor. The numerator of this fraction would be the sum of the taxpayer's income and gains from an Identified Tax Haven, and the denominator would be the taxpayer's total foreign-source income and gains.

List of "Identified Tax Havens"

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[623] Section 999(f).

[624] The most recent list published by Treasury released December 29, 1999 (64 F.R. 73121) includes Bahrain, Iraq, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Syria, the United Arab Emirates, and the Republic of Yemen.

[625] Section 6011(a).

The operative provisions of the proposal would apply only to income that is earned in or through an Identified Tax Haven. The list of Identified Tax Havens would be determined and published by the Treasury Secretary. A jurisdiction would be considered a tax haven and included in the list if the jurisdiction both (1) imposes no or nominal taxation, either generally or on specific classes of capital income, and (2) has strict confidentiality rules and practices and/or has ineffective information exchange practices. Other yet unspecified criteria may also apply in making the determination as to whether to include a jurisdiction on the list.

Reporting of payments to "Identified Tax Havens"

The proposal would require that all payments (broadly defined to encompass money as well as tangible and intangible property) to entities (including partnerships, disregarded entities, branches, trusts and estates), accounts, or individuals that are resident or located in Identified Tax Havens be reported on the taxpayer's income tax return. The proposal states that there are three exceptions to this information reporting requirement; satisfying any one of the three is sufficient to provide for an exception. The first is that the Identified Tax Haven has in force with the United States an agreement providing for the exchange of tax information that is effective for both criminal tax and civil tax administration purposes.[626] The second exception is that the payee certifies to the payer that information about the payment would be available to the IRS upon request. The certification may be made via a legally effective waiver of confidentiality or through an alternative mechanism. The third exception is whether the payment is less than $10,000. Related payments would be required to be aggregated for purposes of determining whether this threshold is exceeded.

Failure to report a payment on a tax return that was required to be reported would result in the imposition of a penalty on the payor equal to 20 percent of the gross payment.

Effective date.--The proposal relating to foreign tax credits and other tax benefits would be effective for taxable years beginning after the date of enactment. The proposal with respect to requiring the reporting of payments to "Identified Tax Havens" would be effective for payments made after the date of enactment. However, because the proposal is limited to tax benefits attributable to income from Identified Tax Havens that are included on a published list, these provisions, although effective after their enactment, would apply only to taxable years beginning after the publication of the list.

Analysis

[626] It is unclear how this exception would interact with the second element of the criteria for initial qualification for listing as an identified tax haven. If a country has an effective agreement with the United States providing for the exchange of information, it is not apparent why that country would have failed the second element of the criteria and be listed as a tax haven.

In general

The proposal reflects an increased concern on the part of the Administration with the use of tax havens. Proponents of the proposal maintain that tax havens facilitate tax avoidance and evasion. In addition, many tax havens have both strict confidentiality rules and restrictive information exchange practices that can inhibit the United States' ability to enforce effectively its domestic laws. The proposal is intended to encourage tax havens to reform certain harmful practices, including bank secrecy and restrictive information exchange policies, by discouraging U.S. taxpayers from engaging, directly or indirectly, in activity in tax havens. Proponents of the proposal would argue that the proposal is consistent with an international movement toward recognizing harmful tax competition and identifying offensive tax jurisdictions.[627]

The operative rules of the proposal are modeled after and combine concepts from present law addressing jurisdictions with which the United States does not have or has severed relations or which support international terrorism,[628] and jurisdictions that require, as a condition of doing business with or in the jurisdiction, participation or cooperation in an international boycott.[629] The reliance on these provisions not only provides an arguable precedent for the methodology advocated in the proposal (i.e., denial of tax credits, separate basket treatment, denial of deferral and FSC benefits), but also signals an intention to treat tax havens similarly to jurisdictions that support terrorism or require cooperation in boycotts and to shift the market away from such jurisdictions. Some, however, may question the fairness of putting the characteristics of no or nominal taxation and secrecy provisions in the same category as international terrorism or boycotts. Moreover, some would argue that by, in effect, combining the concepts of section 901(j) and section 999, the proposal actually subjects Identified Tax Havens to a more onerous regime than that applicable to boycotting countries or countries that support international terrorism.

List of "Identified Tax Havens"

The proposal requires the Treasury Secretary to publish a list of Identified Tax Havens. The proposal indicates that certain criteria would be used by the Secretary in determining whether a jurisdiction is to be included on the list. These criteria would include, but would not be limited to, whether a jurisdiction (1) imposes no or nominal taxation, either generally or on specific classes of income, and (2) has strict confidentiality rules and practices, and/or has ineffective information exchange practices. It is not clear what types of information exchange

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[627] The Organization for Economic Cooperation and Development ("OECD"), for example, is scheduled to publish a formal list of tax havens following its ministerial meetings in June 2000. See also, OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998).

[628] Section 901(j).

[629] Section 999.

practices would be considered to be "ineffective." Other criteria are not specified in the proposal. Some would argue that the proposal is overreaching and that it is inappropriate for the United States government to formally label countries as "tax havens." Some may argue that the attempt to influence these countries' tax policies and commercial issues such as banking secrecy could be viewed as an inappropriate infringement on sovereignty.[630]

In addition, the proposal grants considerable authority to the Treasury Secretary with respect to the determination of which countries are included on the list. Depending on how that authority is used, the scope of the proposal arguably could be too broad. For example, some have expressed concern that it would appear that a country that has a low tax or does not tax capital gains could be labeled as an Identified Tax Haven (provided it has confidentiality rules), notwithstanding that the country has an otherwise conventional income tax system or perhaps imposes its taxes through a value added tax system, and have argued that treatment of such countries as tax havens would be inappropriate. Under this view, the degree of discretion that the proposal would grant to the Secretary of the Treasury is problematic.[631] How one evaluates whether the provision grants the Secretary a high degree of discretion or merely provides the Secretary with the ministerial duty of fulfilling a legislative mandate is based in large part on the degree of specificity that is in the legislative provision authorizing the Secretary to list a country. While too much specificity could prevent the Secretary from responding to new circumstances unforseen in the legislative process, insufficient specificity could cause some to perceive that the listing process is arbitrary or politically motivated and not based on objective criteria. Some may question whether the proposal's degree of specificity is sufficient to achieve an appropriate balance between flexibility and certainty. At a minimum, it could be expected that there would be considerable pressure on the determination of which countries are included in the Identified Tax Haven list.[632]

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[630] Some countries with bank secrecy protections strongly defend their policies. For example, it is reported that Switzerland, Austria, and Luxembourg have intervened to obtain the dismissal by the OECD Council of a report relating to taxation and the abusive use of bank secrecy. See Sebastien Moerman, "The Main Characteristics of Tax Havens," 27 Intertax 368, 370 (1999). Similarly, representatives of Gibraltar, Guernsey, and Jersey reacted negatively to characterizations as "tax havens" and news that the U.K. government plans to pressure them to stop offering tax breaks to citizens and companies from other countries. See Michael Peel, "Offshore Centers Lash Out at U.K. Tax Reform Pressure," Financial Times, Oct. 9, 1999.

[631] The identification of countries with no diplomatic relations or that support international terrorism or boycotts arguably is based on more objective, independently verifiable criteria or, at a minimum, arguably affords the Secretary less discretion.

[632] In addition, there is no indication in the proposal of the interaction with treaties which reduce tax; however, this would not seem to present a significant concern because it is generally the U.S. policy not to enter into treaties with tax haven countries.

The second element in the proposal's definition of an Identified Tax Haven is that it "has strict confidentiality rules and practices, and/or has ineffective information exchange practices."[633] Some might question whether this portion of the definition is sufficiently targeted. For example, under this definition, either strict confidentiality or ineffective information exchange would be sufficient to satisfy this element of the listing criteria. Strict confidentiality in and of itself, however, may not be objectionable and may in fact be desirable, depending on the nature of the exceptions to confidentiality. The United States, as well as most other developed countries, have strict confidentiality rules to protect against unauthorized disclosure of tax information.[634] In fact, the United States generally assures that other countries will observe the confidentiality of U.S. tax information before entering into agreements with other countries permitting the exchange of tax information. Some may question whether strict confidentiality by itself is an appropriate criteria for inclusion in the definition.

Reduction in foreign tax credits

In order to discourage any activity in an Identified Tax Haven (and thereby encourage the Identified Tax Haven to reform its policies), the proposal appears to have an intended punitive effect. The proposal would deny a foreign tax credit for taxes paid to an Identified Tax Haven. To the extent that taxes actually are paid, it is not clear why credits should not be allowed (other than for punitive reasons intended to deter certain behavior) given that the foreign tax credit's purpose is to reduce double taxation. This aspect of the proposal, however, is of relatively unimportant consequence assuming the tax haven imposes little or no tax.

More importantly, the proposal creates a separate limitation regime for foreign tax credit purposes with respect to all income collectively earned in or through an Identified Tax Haven. This would prevent "cross-crediting" or "averaging" of taxes whereby taxpayers can credit high foreign taxes paid (to a non-tax-haven country) on one stream of foreign income (which credits would otherwise be limited) against the low taxed foreign income earned in a tax haven (which income would otherwise be subject to residual U.S. tax), thereby reducing the overall U.S. tax and subsidizing the high-tax jurisdiction. Separate baskets parallel to the separate baskets under present law would to apply within the separate Identified Tax Haven limitation rules to prevent cross-crediting among baskets on income within a tax haven country, income from one tax haven country to the next, or income that might otherwise be earned in a high tax jurisdiction but that flows through a tax haven. As a result, a second entire set of foreign tax credit limitation categories would be created with respect to all income earned in or through an Identified Tax Haven. That is, in addition to the present-law baskets under section 904(d), there would be an Identified Tax Haven passive basket, an Identified Tax Haven high withholding tax interest basket, and Identified Tax Haven financial services income basket, and so on. Thus, for

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[633] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals*, February 2000, at 203.

[634] See section 6103.

example, it appears that passive income earned in a non-tax-haven jurisdiction which is distributed to a CFC located in an Identified Tax Haven would be recharacterized as "Identified Tax Haven Income," subject to the new, separate limitation regime. Such income would then appear to be treated as part of a new, separate Identified Tax Haven passive basket, after application of the CFC look-through rule of section 904(d)(3). The necessity of this potentially complicated restriction in the proposal seems to be somewhat diluted given that (1) income earned in Identified Tax Havens is not likely to be subject to significant taxation, and (2) as discussed below, the proposal could reduce foreign tax credits with respect to taxes paid to non-tax havens. On the other hand, the separate basket treatment may serve as a back stop for situations in which the foreign tax credit would not be sufficiently reduced through application of the formula discussed below.

The denial of the foreign tax credit and creation of a separate limitation rule discussed above are essentially modeled after the section 901(j) foreign tax credit sanction with respect to nations with which the United States does not have relations or which support international terrorism. Advocates of the proposal, however, maintain that such a sanction is not sufficient with respect to Identified Tax Havens. The proposal combines that regime with the denial of benefits approach under the international boycott provisions in a manner which some would argue may go too far. Under the proposal, similar to the international boycott rules, certain tax benefits are reduced based on a fraction, the numerator of which is the sum of the taxpayer's income and gains from an Identified Tax Haven, and the denominator of which is the taxpayer's total foreign income and gains (the "Identified Tax Haven factor").[635] The Identified Tax Haven factor would be used to reduce the otherwise allowable foreign tax credit. Thus, if a taxpayer had income from a non-tax-haven jurisdiction that flowed through an Identified Tax Haven, the taxpayer's foreign tax credits (or deemed-paid credits) attributable to that income would be reduced or, in certain circumstances, eliminated through operation of the Identified Tax Haven factor. To the extent of the reduction or elimination of the credit, there appears to be some overlap with the foreign tax credit separate limitation approach of the proposal. Moreover, this could be the case with respect to income earned in legitimate business activities in a non-tax-haven, high-tax jurisdiction that does not flow through an Identified Tax Haven at all. To the extent that a taxpayer earning such income also earns other, unrelated income in or through a tax haven, the credit for taxes paid to the high-tax jurisdiction would be reduced by the Identified Tax Haven factor, thereby resulting in excessive double taxation of that business income -- notwithstanding that such income was not directly associated with the tax haven. Thus, although there would be no ability to cross-credit with respect to that income because of the separate limitation proposal and, therefore, no potential to use the tax haven income to raise the foreign tax credit limitation to absorb excess foreign tax credits and reduce residual U.S. taxation, the taxpayer's overall foreign tax credit would be reduced resulting in higher taxes. In effect, this

[635] Although it is not entirely clear from the proposal, because the proposal is modeled after the international boycott provisions, it is presumed that, like the international boycott factor, the proposal's factor would apply not just to the taxpayer, but also to the controlled group which includes the taxpayer.

operates as a penalty. Opponents of the proposal would argue that this punitive aspect of the proposal is overreaching and is not justified. On the other hand, proponents of this "penalty" suggest that it is a warranted means of encouraging taxpayers to avoid doing business in or investing in or through tax havens.

In addition, there is no exception for use of the Identified Tax Haven factor. Unlike the proposal, under the international boycott rules, if the taxpayer can show its separate benefits from boycott operations, the taxpayer is not required to use the international boycott factor. In some cases, the factor could result in a greater reduction in benefits than a denial of the actual benefits with respect to a separate operation. Moreover, the proposal with respect to requiring reporting of payments to Identified Tax Havens provides certain exceptions. Some would argue that some exceptions should equally apply to this aspect of the proposal. At the same time, exceptions could dilute the deterrent effect of the proposal.

Denial of FSC benefits and deferral

The Identified Tax Haven factor is also used to reduce FSC benefits attributable to Identified Tax Havens and to reduce the income attributable to an Identified Tax Haven that is eligible for deferral. Insofar as this aspect of the proposal is modeled after the international boycott provisions, the denial of deferral benefits appears to be accomplished through treating income attributable to an Identified Tax Haven as subpart F income. Thus, a portion of a controlled foreign corporation's income determined by application of the Identified Tax Haven factor (that is not otherwise treated as a subpart F inclusion) would be treated as subpart F income. Some question this expansion of subpart F and whether this proposal represents an indication of a view that subpart F, as currently enacted, is ineffective at achieving its intended goals or is obsolete and in need of reform. Opponents of the proposal might argue that any advantages gained by the proposed expansion of subpart F would be outweighed by the potentially negative effect on competitiveness of U.S.-based multinational companies in relation to foreign-based multinationals that are not subject to similarly stringent rules.[636]

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[636] Some also argue that the proposal's expansion of subpart F could have an adverse effect on hybrid branches of CFCs located in Identified Tax Havens. Such persons would argue that this result is inconsistent with the agreed moratorium on hybrid branch rules reflected in proposed Treasury regulations (REG-113909-98) issued on July 9, 1999. On the other hand, the proposal is not a regulatory initiative and, therefore, arguably is not inconsistent with a moratorium with respect to the effective date of the hybrid branch regulations. Moreover, the proposal does not operate to recharacterize payments from a hybrid branch; rather, the treatment of income as subpart F income under the proposal would result from income earned in or through an Identified Tax Haven, regardless of whether a hybrid branch, an actual branch, or no branch were involved. In other words, there is nothing specific to hybrid arrangements under the proposal. In addition, like the section 901(j) rules and the section 999 rules (and unlike the hybrid branch regulations), the proposal is not focused on transactions; rather, it is focused on specific jurisdictions.

On the other hand, advocates of the proposal argue that the proposal is not targeted solely at the subpart F provisions, but rather is intended to discourage dealings with Identified Tax Havens generally, and to encourage such jurisdictions to reform their policies. To this end, the proposal requires not only that a jurisdiction have no or nominal taxation, but also that it have confidentiality or secrecy rules or ineffective information exchange practices. Thus, a jurisdiction could impose no tax, but have adequate access to information and, therefore, would not be included on the Identified Tax Haven list. It could be argued that rather than being designed to expand subpart F, this proposal would simply make low-tax jurisdictions without secrecy protections more attractive than low-tax jurisdictions with secrecy protections, putting the latter at a competitive disadvantage to the former, and thereby encouraging a reform in its rules. This premise would become highly questionable if the existence of ineffective information exchange practice rules were no longer a prerequisite to inclusion on the Identified Tax Haven List.

If the proposal is not focused on deferral (or, for that matter, cross-crediting), but rather is focused on reform of tax havens with strict confidentiality rules, some question why "no or nominal taxes" would be a criterion for inclusion on the Identified Tax Haven list at all. Furthermore, some question whether the rules with respect to international boycotts and countries that have no relations with the United States or that support international terrorism -- or the tax system in general for that matter -- provide the appropriate mechanism for addressing this issue.

In addition, some argue that the proposal is not sensitive to the fact that, in some circumstances, U.S. businesses may establish operations in "tax haven" countries for business reasons entirely independent from nominal taxation or bank secrecy. The proposal would increase the cost of doing business for such U.S. enterprises. This effect is exacerbated by (as discussed above) the lack of exceptions to the proposal's operative provisions.

Reporting of payments to "Identified Tax Havens"

In general, taxpayers are required to report amounts on their tax returns because the amounts have a bearing on the taxpayer's tax liability. That is not the case with the proposal's reporting of payments to Identified Tax Havens. It is possible that the information could be utilized to review potentially suspicious behavior, but the principal purpose of the provision appears to be to cause U.S. taxpayers to encourage tax havens to adopt effective exchange of information provisions. As stated above, some may question whether this is an appropriate use of the tax system.

One issue is the scope and administrability of the proposal, particularly as it would apply to businesses with normal business relationships with other entities inside the Identified Tax Haven. For example, a U.S. business could own an operation, such as a tourism facility, in an Identified Tax Haven. The nature of the operation could necessitate frequent transfers back and forth between the U.S. office and the operation in the tax haven. This could make the reporting of every payment back and forth very burdensome and could subject the U.S. taxpayer to a large penalty for inadvertent omissions from the reporting requirement. Although the proposal states that special rules would apply to certain financial services businesses to permit reporting on an aggregate basis, the proposal does not articulate any exception from the reporting requirement (or permit aggregate reporting) for the frequent, routine transfers of funds that would occur in other businesses. Some may consider it appropriate to expand the aggregate reporting rule beyond financial services businesses to other businesses that have legitimate business operations in the identified tax haven.

Some may question whether the reporting and penalty structure is best designed to accomplish the policy objectives behind the proposal without being needlessly punitive on U.S. taxpayers with legitimate business operations in Identified Tax Havens. Insofar as the proposal is designed to bring pressure on tax havens to reform their practices to permit effective exchange of information, some may argue that there are less burdensome and more direct ways of doing so than via the information reporting and penalty provisions of the proposal. For example, direct inter-governmental discussions might be more direct. Even if the tax system must be used, there may be alternative mechanisms that might be more direct. For example, an alternative structure might be to require a U.S. taxpayer to check a box as to whether that person engaged in transactions in an identified tax haven and impose a flat dollar amount penalty for the failure to report that information correctly. An alternative structure such as this could be less burdensome on U.S. taxpayers and would impose the penalty on a potentially less arbitrary basis while at the same time comporting with the policy objective of the proposal, which is to cause U.S. taxpayers to encourage tax havens to adopt effective exchange of information provisions. Proponents of the proposal might respond that the burdensome nature of the proposal is intentional, in that it is designed to provide a strong incentive for U.S. taxpayers affected by the proposal to maximize their efforts in encouraging tax haven jurisdictions to change.

Several issues arise with respect to the penalty. One issue is whether the penalty would be imposed if the taxpayer had reasonable cause for the omission. A reasonable cause exception is provided for nearly all the penalties in the Code under present law. The proposal does not specify that a reasonable cause exception would be available to taxpayers. Another issue is the extent to which the amount of the penalty could be perceived as arbitrary or inappropriate to the nature of the offense. Consider a U.S. taxpayer conducting an ongoing tourism-related business in an Identified Tax Haven. Because payments frequently flow back and forth, the taxpayer inadvertently omits reporting on several payments out of hundreds. Under the proposal, the amount of the penalty depends on the dollar amount of the omitted payments: the penalty would be very large if the omitted payments were large or the penalty would be very small if the omitted payments were small. Whether the payments were in fact large or small had no bearing on the omission; reporting the payments was not done because there were a large number and a few were overlooked. Absent a reasonable cause exception, taxpayers penalized for omissions such as these could view these variations in the level of the penalty as arbitrary. A related issue is whether 20 percent of the amount that should have been reported but was not is the appropriate level for a penalty for a failure such as this. The amount of many penalties in the

Code[637] is computed on the basis of the amount of tax that was misreported, rather than the amount of a transaction. A more analogous situation may be the penalties for failure to file correct information returns.[638] Although the basic penalty is a flat dollar amount, the penalties for intentional disregard of the filing requirements (a more severe offense) are generally computed as a percentage of the amount required to be reported.[639] In the case of information reporting on the gross proceeds of certain transactions (such as sales of securities or real estate), the penalty is 5 percent of the amount. Some may view the amount of the penalty in the proposal as excessive, in comparison with the level of other civil penalties in the Code.

Some taxpayers may find it difficult to be certain whether their transactions are required to be reported. For example, the proposal requires reporting not only of cash transactions but also of tangible and intangible property transactions. Issues regarding the proper valuation of transfers of property may arise, such as whether the value of the property exceeds the exception from reporting for property valued at less than $10,000. In addition, the proposal requires reporting of "payments." It is unclear from the proposal whether this term is to be construed broadly (in the sense of any type of transfer) or more narrowly (in the sense of exchanges for value). Absent further specificity, disputes may arise as to whether a transfer is appropriately characterized as a payment or as something else.

Prior Action

No prior action.

2. Modify treatment of built-in losses and other attribute trafficking

Present Law

U.S. persons are subject to U.S. tax on their worldwide income. Foreign persons are subject to U.S. tax, calculated in the same manner and at the same graduated rates as the U.S. tax on U.S. persons, on income that is effectively connected with the conduct of a U.S. trade or business ("U.S.-effectively connected income"). Foreign persons also are subject to a U.S. 30-percent withholding tax on the gross amount of certain U.S.-source income that is not U.S.-effectively connected income.

Tax-exempt organizations (such as section 501(c) nonprofit organizations and pension plans) generally are not subject to Federal income tax, for example, on dues and contributions they receive from their members, as well as other income from activities that are substantially

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[637] See, e.g., section 6662.

[638] Sections 6721-6724.

[639] Sections 6721(e) and 6722(c).

related to the purpose of their tax exemption. However, tax-exempt organizations are subject to the unrelated business income tax ("UBIT") on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions.[640] In addition, Native American Indian tribes, as well as wholly owned tribal corporations chartered under Federal law, generally are not subject to Federal income taxes.[641]

Detailed rules apply to limit a taxpayer's ability to use certain tax attributes, such as net operating losses, built-in losses and various credit items (secs. 269 and 381 through 384). In addition, in determining U.S. taxable income, various rules are aimed at preventing U.S. taxpayers from transferring appreciated property outside the U.S. taxing jurisdiction to escape U.S. tax on the built-in gain with respect to such property. Section 367(a) limits the application of nonrecognition provisions to corporate reorganizations and transfers involving foreign corporations. In addition, under section 864(c)(7), the gain with respect to property that was used in connection with a U.S. trade or business may be considered to be effectively connected with a U.S. trade or business, and therefore subject to U.S. tax, even though the property is no longer so used at the time of its disposition. Moreover, section 877 includes rules to limit the ability of former U.S. citizens to avoid U.S. tax on appreciated property.

The Code does not include analogous provisions specifically aimed at preventing taxpayers from transferring property with built-in losses, or transferring other favorable tax attributes such as deficits in earnings and profits and foreign tax credits, into the U.S. taxing jurisdiction. Such built-in losses or other tax attributes could be used to offset income or gain that otherwise would be subject to U.S. tax.

Taxpayers also may transfer property with built-in gains or other unfavorable tax attributes into the U.S. taxing jurisdiction. Such transfers could result in the imposition of U.S. taxes. However, many taxpayers can trigger recognition of built-in gain assets in a manner that is not subject to U.S. or foreign tax, or can obtain a step-up in basis in all of its assets through a section 338 election, when such election is beneficial and available.

Description of Proposal

The proposal would provide a new regime for assets, entities, and attributes that are brought into the U.S. taxing jurisdiction. In this regard, the proposal would provide that assets

[640] Sections 511-514.

[641] See Rev. Rul. 94-65, 1994-2 C.B. 14; Rev. Rul. 94-16, 1994-1 C.B. 19; Rev. Rul. 81-295, 1981-2 C.B. 15; Rev. Rul. 67-284, 1967-2 C.B. 55. The IRS recently clarified that tribal corporations chartered under tribal law also can qualify for exemption as section 501(c)(3) organizations. See General Information Letter to First Nations Development Institute (September 8, 1998).

would be marked to fair market value and other tax attributes would be eliminated, as may be applicable, when assets or entities become "relevant" for U.S. tax purposes (so-called "fresh start" rules). An entity would become "relevant" for U.S. tax purposes in two general situations. First, an entity would become relevant when a "tax-exempt entity" becomes a "taxable U.S. entity" (as defined). Second, an entity would become relevant when 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 individual, and a foreign corporation that is not a member of a qualified group under section 902(b)(2) (i.e., a foreign corporation in which there is no U.S. shareholder who would be entitled to indirect foreign tax credits). A "taxable U.S. entity" would be a U.S. person (e.g., a U.S. citizen or resident, a U.S. corporation, and a U.S. partnership, but not a section 501 tax-exempt organization), a foreign corporation that is a member of a qualified group under section 902(b)(2) (i.e., a foreign corporation in which a U.S. shareholder would be entitled to indirect foreign tax credits), and a CFC.

The proposal thus would apply in several cases where a tax-exempt entity becomes a taxable U.S. entity, including where: (1) a U.S. corporation acquires a 10-percent or greater voting interest in the stock of a foreign corporation with no U.S. shareholders, (2) a foreign corporation with no U.S. shareholders domesticates in an F reorganization, (3) a nonresident alien individual becomes a U.S. resident, and (4) a section 501 tax-exempt organization loses its tax-exempt status. In addition, the proposal would apply where a noncontrolled section 902 corporation (a "10/50 company") becomes a CFC or a U.S. corporation (e.g., through stock acquisitions by U.S. persons or through reorganization transactions).

The proposal also would apply to the transfer of assets and liabilities by tax-exempt entities to taxable U.S. entities or operations. For example, assets or liabilities that are transferred by a foreign person to a U.S. corporation (such as in a section 351 transaction), or to a business unit that generates UBIT or U.S.-effectively connected income, would be marked to market at the time of transfer. In addition, the proposal would apply to the transfer of assets and liabilities by a 10/50 company to a CFC, U.S. resident, or a business unit that generates UBIT or U.S.-effectively connected income.

Several special rules would apply. First, special valuation rules would be provided with respect to the transfer of intangible assets. Second, the proposal generally would not apply to assets or other attributes held by a tax-exempt entity to the extent such items were or would be subject to net U.S. income tax. Thus, a special rule would be provided to exclude from the fresh start rules items that are related to UBIT or U.S.-effectively connected income prior to the time an asset or its owner becomes relevant for U.S. tax purposes, as well as for personal assets in the case of a nonresident alien who becomes a U.S. resident.

Third, special rules would be provided to preserve the tax attributes of certain U.S. shareholders who held an interest in a foreign corporation before and after a fresh start event. In this regard, the proposal would require 10-percent or greater (determined by voting power) U.S. shareholders of a foreign corporation to maintain a shareholder-level suspense account that contains such shareholder's pro rata share of the corporation's tax attributes (e.g., earnings and profits and foreign taxes) immediately after the marking of assets, but prior to the elimination of the tax attributes of the corporation. These rules would not affect the attributes of other shareholders of the foreign corporation.

For example, assume that in year one a U.S. corporation ("US1") acquires 20 percent of the stock of a foreign corporation with no U.S. shareholders. The acquisition would trigger the fresh start rules, causing all of the foreign corporation's assets and liabilities to be marked to fair market value, and all of such corporation's tax attributes (e.g., earnings and profits and taxes) to be eliminated for U.S. tax purposes. Assume that in year five an unrelated U.S. corporation ("US2") acquires the remaining 80 percent of the foreign corporation's stock from its non-U.S. shareholders. This stock acquisition would cause the foreign corporation to become a CFC, which would trigger a second fresh start event. In year five, all of the foreign corporation's assets and liabilities would again be marked to fair market value, and all of its tax attributes would be eliminated. However, because US1 was a 10-percent or greater shareholder in the foreign corporation after this fresh start event, a shareholder-level suspense account would be created with respect to US1 that would reflect US1's pro rata share (i.e., 20 percent) of the foreign corporation's earnings and profits (including earnings and profits created by the second fresh start) and related foreign taxes.

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 to 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 also would 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 proposal. This would include, for example, trafficking in favorable tax attributes among CFCs. The proposal further would provide the Secretary with authority to identify the circumstances under which transfers to partnerships and transfers of partnership interests would be subject to these rules. Moreover, the proposal would provide the Secretary with authority to prescribe regulations in cases in which certain tax-exempt entities would not be subject to these rules, such as in the case of a section 501(c)(12) corporation that changes between taxable and tax-exempt status from year-to-year based on income earned.

No inference would be intended as to the treatment under present law of transactions that result in the use for U.S. tax purposes of tax attributes arising outside the U.S. taxing jurisdiction.

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

Analysis

The proposal would represent a fundamental change in the manner in which the United States treats assets or entities that are brought into the U.S. taxing jurisdiction. In this regard, the proposal would apply a mandatory set of rules to mark assets to fair market value, and eliminate tax attributes, as applicable, upon the occurrence of certain defined events, such as when a tax-exempt entity becomes a taxable U.S. entity. The proposal thus would impose a mark-to-market income tax regime on unrealized gains. The taxation of unrealized gains under the proposal is a departure from the normative U.S. income tax system, which generally imposes tax only on realized gains.[642]

Some argue that legislative rules are needed to address the use of built-in losses and other tax attributes which economically accrue outside the U.S. taxing jurisdiction, in order to prevent purposeful tax avoidance by U.S. and foreign persons. For example, foreign persons investing in the United States may reduce U.S. tax on U.S. operations (e.g., U.S. subsidiary operations or U.S. branch operations giving rise to U.S.-effectively connected income), by importing built-in loss assets and other tax attributes, and triggering, for example, recognition of losses and deductions to offset U.S. income. Similar issues may arise in transactions involving tax-exempt organizations or other tax-exempt entities. Taxpayers can obtain mark-to-market treatment if desired (e.g., in the case of appreciated assets) such that present law can offer, in certain cases, selectivity as between gain and loss assets.

Some also argue that tax attributes which accrue outside the U.S. taxing jurisdiction, whether favorable or unfavorable, should not affect U.S. tax liability. There also is administrative complexity for taxpayers and the government in attempting to track tax attributes for U.S. tax purposes that accrue outside the U.S. taxing jurisdiction. This includes recreating records reflecting tax attributes such as earnings and profits under U.S. tax principles that may span several years, which could be costly and of questionable accuracy. Limiting the use of such tax attributes could reduce administrative and compliance burdens under present law. On the other hand, the proposal presents enforceability issues of its own. Because the proposal would mark assets to fair market value (and, thus, an arm's-length sales price for the assets may not be available), there may be significant valuation disputes between taxpayers and the IRS.

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[642] There are certain provisions under present law that are exceptions from the realization requirement, including the mark-to-market regime for securities dealers under section 475, the mark-to-market taxation of certain regulated futures contracts, foreign currency contracts, nonequity options, and dealer equity options under section 1256, and the rules for taxing original issue discount under sections 1271-1275.

In addition, the rules would not be limited to abusive tax avoidance transactions, but would apply equally to legitimate business transactions. Moreover, the proposal would significantly differ from present-law rules addressing trafficking in tax attributes (such as net operating losses under,[643] which generally operate to defer the use of such attributes for U.S. tax purposes. The proposal would eliminate tax attributes altogether in certain cases (e.g., in the case of certain entity transfers). Some argue that rules addressing trafficking in various tax attributes should be similar.

The proposal would mandate the application of the fresh start rules, for example, upon the acquisition by a U.S. corporation of at least 10 percent of the voting stock of a foreign corporation. Ten percent may be viewed as a relatively low threshold for purposes of requiring assets to be marked to market and tax attributes to be eliminated. Under present law, taxpayers generally can mark to market assets and eliminate tax attributes, at the taxpayer's election, only when, among other things, 80 percent of the stock of a corporation is acquired (sec. 338). On the other hand, some might argue that a 10-percent threshold is appropriate to identify the first time there is meaningful U.S. ownership.

The proposal would introduce considerable complexity and compliance burdens. For example, the fresh start rules would be invoked when a 10/50 company becomes either a CFC or a U.S. person, resulting potentially in a second separate fresh start event (i.e., the first fresh start event occurring when a foreign corporation becomes a 10/50 company, and a second fresh start event occurring when such 10/50 company becomes either a CFC or a U.S. person). In addition, the requirement of maintaining shareholder-level suspense accounts to preserve tax attributes (whether favorable or unfavorable) for certain 10-percent or greater U.S. shareholders would introduce further complexity.

Some have observed that mark-to-market events mandated by the proposal could give rise to potential adverse consequences, such as potential current inclusions to U.S. persons (e.g., under the passive foreign investment company rules), or causing a foreign corporation to become a passive foreign investment company. The proposal would grant regulatory authority to address such types of issues. Some argue that these types of issues would need to be addressed as part of any proposed legislative rules and not through regulatory authority.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

3. Simplify taxation of property that no longer produces income effectively connected with a U.S. trade or business

Present Law

[643] Sections 381 through 384.

Foreign persons generally are subject to a 30-percent U.S. tax on their gross income, gains, or profits from U.S. sources that are fixed or determinable annual or periodical income ("FDAP" income). In addition, foreign persons that are engaged in the conduct of a trade or business within the United States are subject to U.S. net-basis taxation on the income that is "effectively connected" with such business. Specific statutory rules govern the determination of whether income is so effectively connected.[644]

In the case of U.S.-source capital gain or loss and U.S.-source income of a type that would be subject to gross basis U.S. taxation, the factors taken into account in determining whether the income, gain, deduction, or loss is effectively connected with a U.S. trade or business include whether the amount is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a material factor in the realization of the amount.[645] In making this determination, due regard is given to whether the asset or income, gain, deduction, or loss was accounted for through the U.S. trade or business. In the case of any other U.S.-source income, gain, deduction, or loss, such amounts are all treated as effectively connected with the conduct of the trade or business in the United States.[646]

Foreign-source income of a foreign person that is effectively connected with the conduct of a trade or business in the United States may also be taxed by the United States, subject to a credit for any foreign income taxes (secs. 864(c)(4) and 906). However, only specific types of foreign-source income are considered to be effectively connected with a U.S. trade or business (sec. 864(c)(4)(A)). Foreign-source income of a type not specified generally is exempt from U.S. tax.

Income, gain, deduction, or loss for a particular year generally is not treated as effectively connected if the foreign person is not engaged in a U.S. trade or business in that year.[647] However, if income or gain taken into account for a taxable year is attributable to the sale or exchange of property, the performance of services, or any other transaction that occurred in a prior taxable year, the determination whether such income or gain is taxable on a net basis is required to be made as if the income were taken into account in the earlier year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the later taxable year.[648]

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[644] Section 864(c).

[645] Section 864(c)(2).

[646] Section 864(c)(3).

[647] Section 864(c)(1)(B).

[648] Section 864(c)(6).

In addition, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States and the property is disposed of within ten years after the cessation, the determination of whether any income or gain attributable to the disposition of the property is taxable on a net basis is required to be made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a trade or business in the United States and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the taxable year for which the income or gain is taken into account.[649]

Description of Proposal

The proposal would replace the present-law rules under sections 864(c)(6) and (c)(7) with a mark-to-market regime for property that is no longer effectively connected with a U.S. trade or business. Under the proposal, the net unrealized gain in any property (including rights to deferred income) that ceases to be used in, or attributable to, a U.S. trade or business would be subject to tax as if such property were sold for fair market value on the date of cessation. Similarly situated losses would also be recognized under the proposal. The proposal would not alter the present-law treatment of deferred compensation for personal services of an individual.

Effective date.--The proposal would be effective for property that ceases to be used in, or attributable to, a U.S. trade or business after the date of enactment.

Analysis

The proposal would impose a mark-to-market income tax regime on unrealized gains when property that was previously used in a U.S. trade or business is no longer used in a U.S. trade or business. Under present law, gain that is recognized with respect to property that was used in connection with a U.S. trade or business (in the previous ten-year period) may be considered to be effectively connected with a U.S. trade or business and, thus, subject to U.S. tax, even though the property is no longer so used at the time of its disposition. The proposed new tax would replace that approach and would instead tax unrealized gains. The taxation of unrealized gains under the proposal is a departure from the normative U.S. income tax system, which generally imposes tax only on realized gains.[650]

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[649] Section 864(c)(7).

[650] There are certain provisions under present law that are exceptions from the realization requirement, including the mark-to-market regime for securities dealers under section 475, the mark-to-market taxation of certain regulated futures contracts, foreign currency contracts, nonequity options, and dealer equity options under section 1256, and the rules for taxing original issue discount under sections 1271-1275.

The proposal is intended to ease administration of the present-law rules that require tracking of property for a period of ten years following the cessation of a U.S. trade or business. Under the proposal, any gains or losses with respect to U.S. trade or business property would be recognized at the time the property is no longer used in a U.S. trade or business and, thus, no subsequent tracking would be required.

The proposal reflects the view that it is appropriate to tax gains that accrue during the period the property to which such gains are attributable was subject to U.S. taxation. The present-law rules could have the effect of subjecting to U.S. tax any appreciation that accrues with respect to property during the ten-year period following the cessation of the U.S. trade or business. In fact, there may be no gain at all at the time the property ceases to be used in the U.S. trade or business. Proponents of the proposal argue that it is not appropriate to tax appreciation that accrues after an asset is no longer used in a U.S. trade or business. On the other hand, the proposal does not provide any exceptions from mark-to-market treatment when property that is no longer used in a U.S. trade or business still remains subject to the U.S. taxing jurisdiction.[651] For example, U.S. stock or other securities may be treated as effectively connected with a U.S. trade or business under certain conditions. Such assets would be marked-to-market under the proposal upon the termination of the U.S. trade or business even in cases where such assets would, following such termination, be subject to U.S. withholding taxes if held by a foreign person.

Critics of the proposal argue that the proposal presents enforceability issues of its own. First, because the proposal would impose a tax on unrealized gains (and, thus, an arm's-length sales price for the assets may not be available), there may be significant valuation disputes between taxpayers and the IRS. In the absence of a traditional realization event (e.g., a taxable sale to an unrelated party for cash), the property may not have a readily ascertainable fair market value.

Second, the proposal raises liquidity problems for taxpayers, because the assets held at the time of expatriation may not be liquid and, thus, the taxpayer may not have sufficient resources to pay the tax upon cessation of the association of the property with a U.S. trade or business. The proposal does not provide a mechanism to defer payment of any tax otherwise due under the new mark-to-market regime in order to address these liquidity issues.

Third, the proposal's imposition of a mark-to-market tax would be based on factual determinations that may be difficult to apply and enforce in practice. The determination of whether property is no longer used in a U.S. trade or business for purposes of the proposal would

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[651] This is in contrast, for example, to present-law rules relating to the liquidation of non-U.S. trade or business assets of a U.S. corporation into its controlling foreign parent corporation. The general rule in such cases is that gain or loss is recognized upon the liquidation (Treas. Reg. sec. 1.367(e)-2(b)(1)). An exception to this general rule, however, is available with respect to assets that continue to be used in the conduct of a U.S. trade or business after the liquidation (Treas. Reg. sec. 1.367(e)-2(b)(2)).

be subjective and based on all relevant facts and circumstances. Thus, the proposal could create uncertainty for taxpayers and present enforcement issues for the imposition of a new tax on unrealized gains. On the other hand, similar determinations of when property is no longer used in a U.S. trade or business apply under the present-law rules.

Prior Action

No prior action.

4. Impose mark-to-market tax on individuals who expatriate

Present Law

In general

U.S. citizens and residents generally are subject to U.S. income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign-source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. business.[652]

Income tax rules with respect to expatriates

An individual who relinquishes his or her U.S. citizenship or terminates his or her U.S. residency with a principal purpose of avoiding U.S. taxes is subject to an alternative method of income taxation for the 10 taxable years ending after the expatriation under section 877. The alternative method of taxation for expatriates modifies the rules generally applicable to the taxation of nonresident aliens in several ways. First, the expatriate is subject to tax on his or her U.S.-source income at the rates applicable to U.S. citizens rather than the rates applicable to other nonresident aliens. Unlike U.S. citizens, however, individuals subject to section 877 are not taxed on foreign-source income. Second, the scope of items treated as U.S.-source income for section 877 purposes is broader than those items generally considered to be U.S.-source income under the Code.[653] Third, individuals subject to section 877 are taxed on exchanges of

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[652] Section 871.

[653] For example, gains on the sale of personal property located in the United States, and gains on the sale or exchange of stocks and securities issued by U.S. persons, generally are not considered to be U.S.-source income under the Code. However, if an individual is subject to the alternative taxing method of section 877, such gains are treated as U.S.-source income with respect to that individual. Section 877 also applies to treat as U.S.-source certain income and gains derived from stock in a foreign corporation if the individual losing citizenship or terminating residency owns, directly or indirectly, more than 50 percent of the vote or value of

certain types of property that give rise to U.S.-source income for property that gives rise to foreign-source income. Fourth, an individual subject to section 877 that contributes property to a controlled foreign corporation is treated as receiving income or gain from such property directly and is taxable on such income or gain. The alternative method of taxation for expatriates applies only if it results in a higher U.S. tax liability than would otherwise be determined if the individual were taxed as a nonresident alien.

The expatriation tax provisions apply to long-term residents of the United States whose U.S. residency is terminated.[654] For this purpose, a long-term resident is any individual who was a lawful permanent resident of the United States for at least 8 out of the 15 taxable years ending with the year in which such termination occurs. In applying the 8-year test, an individual is not considered to be a lawful permanent resident for any year in which the individual is treated as a resident of another country under a treaty tie-breaker rule (and the individual does not elect to waive the benefits of such treaty).[655]

An individual will be presumed to have expatriated with a principal purpose of avoiding U.S. taxes if either: (1) the individual's average annual U.S. Federal income tax liability for the 5 taxable years ending before the date of the individual's loss of U.S. citizenship or termination of U.S. residency is greater than $100,000 (the "tax liability test"), or (2) the individual's net worth as of the date of such loss or termination is $500,000 or more (the "net worth test").[656] The dollar amount thresholds contained in the tax liability test and the net worth test are indexed for inflation in the case of a loss of citizenship or termination of residency occurring in any calendar year after 1996. For calendar year 2000, the dollar thresholds for the tax liability test and the net

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the stock of the corporation on the date of such loss or termination or at any time during the 2-year period preceding such date. Such income and gains are recharacterized as U.S.-source only to the extent of the amount of earnings and profits attributable to such stock earned or accumulated prior to the date of loss of citizenship (or termination of residency, as applicable) and while such ownership requirement is satisfied.

[654] An individual's U.S. residency is considered to be terminated when the individual either (1) ceases to be a lawful permanent resident pursuant to section 7701(b)(6) (i.e., the individual loses his or her green-card status), or (2) is treated as a resident of another country under a tie-breaker provision of a tax treaty (and the individual does not elect to waive the benefits of such treaty).

[655] For purposes of determining any tax imposed under the alternative method of taxation, any property held by a long-term resident on the date he or she becomes a U.S. resident is treated as having a tax basis of no less than its fair market value on such date. However, the individual may irrevocably elect not to have this provision apply.

[656] Section 877(a)(2).

worth test are $112,000 and $562,000, respectively.[657] An individual who falls below these thresholds is not presumed to have a principal purpose of tax avoidance, but nevertheless is subject to the expatriation tax provisions if the individual's loss of citizenship or termination of residency in fact did have as one of its principal purposes the avoidance of tax.

Certain exceptions from the presumption that an individual relinquished his or her U.S. citizenship for tax purposes may also apply. For example, a U.S. citizen who loses his or her citizenship and who satisfies either the tax liability test or the net worth test (described above) is nevertheless not presumed to have a principal purpose of tax avoidance if the individual falls within certain categories (such as being a dual citizen)[658] and the individual, within one year from the date of loss of citizenship, submits a ruling request for a determination by the Secretary of the Treasury as to whether such loss had as one of its principal purposes the avoidance of taxes.[659]

<u>Estate tax rules with respect to expatriates</u>

Nonresident aliens generally are subject to estate tax on certain transfers at death of U.S.-situated property. Such property includes real estate and tangible property located within the United States. Moreover, for estate tax purposes, stock held by nonresident aliens are treated as U.S.-situated if issued by a U.S. corporation.

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[657] See Rev. Proc. 99-42, 1999-46 I.R.B. 568.

[658] The categories include (1) an individual who was born with dual citizenship and retains only the non-U.S. citizenship; (2) an individual who becomes, within a reasonable period after expatriation, a citizen of the country in which the individual, the individual's spouse, or one of the individual's parents, was born; (3) an individual who was present in the United States for no more than 30 days during each year in the 10-year period immediately preceding the date of his or her loss of citizenship; (4) an individual who relinquishes his or her U.S. citizenship before reaching age 18 and a half; or (5) any other category of individuals prescribed by Treasury regulations. In all of these situations, the individual would have been subject to U.S. tax on his or her worldwide income (as are all U.S. citizens) until the time of expatriation.

[659] Sec. 877(c)(1)(B). The ruling procedures to qualify for these exceptions are detailed in Notice 97-19, 1997-1 C.B. 394, which was subsequently revised by Notice 98-34, 1998-2 C.B. 29. Under Notice 98-34, if an expatriate's tax liability or net worth exceeds applicable thresholds, the presumption that the expatriate had a principal purpose of tax avoidance will not apply if the expatriate (1) is eligible to submit a ruling request that his or her expatriation did not have for one of its principal purposes the avoidance of U.S. taxes (because of one of the reasons stated above), (2) submits such a request in a timely manner, and (3) provides the IRS with a complete and good faith ruling request.

Special rules apply to U.S. citizens who relinquish their citizenship and long-term residents who terminate their U.S. residency within the 10 years prior to the date of death, unless such loss of status did not have as one its principal purposes the avoidance of tax. Under these rules, the decedent's estate includes the proportion of the decedent's stock in a foreign corporation that the fair market value of the U.S.-situs assets owned by the corporation bears to the total assets of the corporation. This rule applies only if (1) the decedent owned, directly, at death 10 percent or more of the combined voting power of all voting stock of the corporation and (2) the decedent owned, directly or indirectly, at death more than 50 percent of the total voting stock of the corporation or more than 50 percent of the total value of all stock of the corporation.[660]

Taxpayers are presumed to have a principal purpose of tax avoidance if they meet the five-year tax liability test or the net worth test, discussed above. Exceptions from the presumption of tax avoidance apply in the same circumstances as those described above (relating to certain dual citizens and other individuals who submit a timely and complete ruling request with the IRS as to whether their expatriation had a principal purpose of tax avoidance).

Gift tax rules with respect to expatriates

Nonresident aliens generally are subject to gift tax on certain transfers by gift of U.S.-situated property. Such property includes real estate and tangible property located within the United States. Unlike the estate tax rules for U.S. stock held by nonresidents, however, nonresident aliens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.

Special rules apply to U.S. citizens who relinquish their U.S. citizenship or long-term residents of the United States who terminate their U.S. residency within the 10 years prior to the date of transfer, unless such loss did not have as one of its principal purposes the avoidance of tax.[661] Under these rules, nonresident aliens are subject to gift tax on transfers of intangibles, such as stock or securities. Taxpayers are presumed to have a principal purpose of tax avoidance if they meet the five-year tax liability test or the net worth test, discussed above. Exceptions from the presumption of tax avoidance apply in the same circumstances as those described above (relating to certain dual citizens and other individuals who submit a timely and complete ruling request with the IRS as to whether their expatriation had a principal purpose of tax avoidance).

Other tax rules with respect to expatriates

The expatriation tax provisions permit a credit against the U.S. tax imposed under such provisions for any foreign income, gift, estate, or similar taxes paid with respect to the items

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[660] Section 2107(b).

[661] Section 2501(a)(3)(A).

subject to such taxation. This credit is available only against the tax imposed solely as a result of the expatriation tax provisions, and is not available to be used to offset any other U.S. tax liability.

In addition, certain information reporting requirements apply. Under these rules, a U.S. citizen who loses his or her citizenship is required to provide a statement to the State Department (or other designated government entity) that includes the individual's social security number, forwarding foreign address, new country of residence and citizenship, a balance sheet in the case of individuals with a net worth of at least $500,000, and such other information as the Secretary may prescribe.[662] The information statement must be provided no later than the earliest day on which the individual (1) renounces the individual's U.S. nationality before a diplomatic or consular officer of the United States, (2) furnishes to the U.S. Department of State a statement of voluntary relinquishment of U.S. nationality confirming an act of expatriation, (3) is issued a certificate of loss of U.S. nationality ("CLN") by the U.S. Department of State, or (4) loses U.S. nationality because the individual's certificate of naturalization is canceled by a U.S. court. The entity to which such statement is to be provided is required to provide to the Secretary of the Treasury copies of all statements received and the names of individuals who refuse to provide such statements. A long-term resident whose U.S. residency is terminated is required to attach a similar statement to his or her U.S. income tax return for the year of such termination. An individual's failure to provide the required statement results in the imposition of a penalty for each year the failure continues equal to the greater of (1) 5 percent of the individual's expatriation tax liability for such year, or (2) $1,000.

The State Department is required to provide the Secretary of the Treasury with a copy of each CLN approved by the State Department. Similarly, the agency administering the immigration laws is required to provide the Secretary of the Treasury with the name of each individual whose status as a lawful permanent resident has been revoked or has been determined to have been abandoned. Further, the Secretary of the Treasury is required to publish in the Federal Register the names of all former U.S. citizens with respect to whom it receives the required statements or whose names or CLNs it receives under the foregoing information-sharing provisions.

<u>Immigration rules with respect to expatriates</u>

Under U.S. immigration laws, any former U.S. citizen who officially renounces his or her U.S. citizenship and who is determined by the Attorney General to have renounced for the purpose of U.S. tax avoidance is ineligible to receive a U.S. visa and will be denied entry into the

[662] Section 6039G.

United States. This provision was included as an amendment (the "Reed amendment") to immigration legislation that was enacted in 1996.[663]

Description of Proposal

In general

The proposal would replace the present-law expatriation income tax rules under section 877 with rules that generally would subject U.S. citizens who relinquish their U.S. citizenship and long-term U.S. residents who relinquish their U.S. residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the expatriation date. The new mark-to-market tax on individuals who expatriate would apply regardless of the taxpayer's subjective motive for expatriating. The proposal would provide certain rules and exclusions similar to those provided in the Senate amendment to the Health Insurance Portability and Accountability Act of 1996 (H.R. 3103).

The proposal would repeal the special estate and gift tax rules that currently apply to tax-motivated expatriates. Thus, the special estate tax rules relating to an expatriate's estate including stock in certain foreign corporations would be repealed. The application of the gift tax for certain intangibles of tax-motivated expatriates would also be repealed. In addition, if an expatriate subsequently makes a gift or bequest to a U.S. person, the proposal would treat the gift as taxable gross income to the U.S. recipient, taxable at the highest marginal tax rates applicable to gifts and bequests (and not the marginal income tax rates).

Finally, the proposal would amend the immigration rules that deny tax-motivated expatriates reentry into the United States by removing the requirement that the expatriation be tax-motivated. In addition, the proposal would coordinate the revised immigration rules with those applicable to the proposed income, estate and gift tax rules for expatriates. In this regard, it is understood that the proposal would deny expatriates reentry into the United States (regardless of their subjective motive for expatriating) if the expatriate did not comply with their tax obligations under the expatriation tax provisions. Reentry would be permitted for those individuals who first satisfied their tax obligations, if any, under these tax provisions.

Individuals covered

The proposal would apply the mark-to-market tax to U.S. citizens and long-term residents who terminate their U.S. citizenship or U.S. residency. For this purpose, a long-term resident is any individual who was a lawful permanent resident of the United States for at least 8 out of the 15 taxable years ending with the year in which the termination of residency occurs. In

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[663] Section 352 of the Illegal Immigration Reform and Immigrant Responsibility Act of 1996, Division C of the Omnibus Budget Reconciliation Act, 1997, Pub. L. No. 104-208, 110 Stat. 3009.

applying this 8-year test, an individual is not considered to be a lawful permanent resident of the United States for any year in which the individual is taxed as a resident of another country under a treaty tie-breaker rule. Under the proposal, an individual is treated as having relinquished U.S. citizenship on the date that the individual first notifies a U.S. consular officer of his or her intention to relinquish U.S. citizenship. An individual's U.S. residency is considered to be terminated when either the individual ceases to be a lawful permanent resident pursuant to section 7701(b)(6) (i.e., the individual loses his or her green card status) or the individual is treated as a resident of another country under a tie-breaker provision of a tax treaty (and the individual does not elect to waive the benefits of such treaty).

Deemed sale of property upon expatriation

Under the proposal, U.S. citizens who expatriate and long-term U.S. residents who terminate their U.S. residence generally would be treated as having sold all their property at fair market value immediately prior to the relinquishment of citizenship or termination of residency. Gain or loss from the deemed sale of property would be recognized at that time, generally without regard to provisions of the Code that would otherwise provide nonrecognition treatment. The net gain, if any, on the deemed sale would be subject to U.S. tax at such time to the extent it exceeds $600,000 ($1.2 million in the case of married individuals filing a joint return, both of whom expatriate).

The deemed sale rule of the proposal generally would apply to all property interests held by the individual on the date of relinquishment of citizenship or termination of residency, provided that the gain on such property interest would be includible in the individual's gross income if such property interest were sold for its fair market value on such date. Special rules would apply in the case of trust interests. U.S. real property interests, which remain subject to U.S. taxing jurisdiction in the hands of nonresident aliens, generally are excepted from the proposal. An exception also would apply to interests in qualified retirement plans and, subject to a limit of $500,000, interests in certain foreign pension plans as prescribed by regulations. The Treasury Secretary would be authorized to except other property interests as appropriate.

Deferral of payment of tax

Under the proposal, an individual would be permitted to elect to defer payment of the expatriation tax with respect to the deemed sale of property. Under this election, the expatriation tax with respect to a particular property, plus interest thereon, would be due when the property is subsequently disposed. In order to elect deferral of the expatriation tax, the individual would be required to provide adequate security (e.g., a bond) to ensure that the deferred expatriation tax and interest will ultimately be paid.

Effective date

The proposal would apply to U.S. citizens who relinquish their U.S. citizenship and to long-term residents of the United States who cease to be subject to tax as U.S. residents on or after the date of first committee action.

Analysis

Income tax rules

The proposal would impose a mark-to-market income tax on unrealized gains when an individual expatriates, regardless of the taxpayer's subjective motivation for expatriating. Present law applies special tax rules to individuals who expatriate with a principal purpose of avoiding taxes for a 10-year period following the expatriation; these special tax rules apply to certain U.S.-source income and gains realized during such 10-year period and not to unrealized income or gains. The proposal thus would replace the present-law expatriation tax rules with a mark-to-market tax upon expatriation and would eliminate the requirement that the expatriation be tax-motivated in order for the deemed sale rules to apply. The taxation of unrealized gains under the proposal is a departure from the normative U.S. income tax system, which generally imposes tax only on realized gains.[664]

The proposal has been justified on certain grounds.[665] Some argue that it is appropriate to collect U.S. tax with respect to those individuals who have enjoyed the benefits of U.S. citizenship (e.g., traveling on a U.S. passport) or with respect to U.S. citizens and long-term residents whose assets have enjoyed the protection of being within U.S. borders. In addition, some argue that it is appropriate to collect tax from certain U.S. citizens who relinquish U.S. citizenship but maintain a significant continuing relationship with the United States. Moreover, some argue that it is appropriate to tax gains from assets (foreign or domestic) that accrue during the period an individual was subject to U.S. residence-based taxation. However, the proposal could affect U.S. citizens who have lived abroad their entire lives and who have very tenuous

[664] There are certain provisions under present law that are exceptions from the realization requirement, including the mark-to-market regime for securities dealers under section 475, the mark-to-market taxation of certain regulated futures contracts, foreign currency contracts, nonequity options, and dealer equity options under section 1256, and the rules for taxing original issue discount under sections 1271-1275.

[665] Some would argue that an exit tax based on a mark-to-market regime would be more appropriately considered in the context of a broader policy initiative that would mark to market items that are both entering as well as exiting the U.S. taxing jurisdiction. For related proposals in this regard, see the President's Fiscal Year 2001 Budget Proposals regarding modifying the treatment of built-in losses and other attribute trafficking and simplifying the taxation of property that no longer produces income effectively connected with a U.S. trade or business.

ties to the United States.[666] The proposal also would affect expatriates who sever all ties with the United States. Moreover, the proposal may subject to tax assets that have no relationship with the United States.[667] For example, the proposal would subject to tax assets acquired by long-term U.S. residents that were acquired outside the United States and were never brought into the United States.

Proponents of the proposal argue that the proposal would simplify the taxation of expatriates by eliminating the subjective inquiry into the intent of the expatriate. Because there is no intent requirement under the proposal, the IRS would not have to delve into specific factual details for each expatriating individual to determine if the individual had a tax avoidance motive. Instead, in order to assess the expatriation tax the IRS would simply be required to show that an individual expatriated. Removing the intent requirement might also lead to increased voluntary compliance, because individuals would no longer be able to rationalize that they are not subject to the tax because they had other reasons for expatriating.

Proponents of the proposal also argue that a special expatriation tax is more appropriately collected at the time of expatriation, as compared to collection of an expatriation tax over a 10-year period following an individual's expatriation (as under present law) when the individual may be outside the United States and collection of such taxes may be more difficult. To the extent that an individual does not intend to return to the United States, however, the IRS will likely have the same enforcement problems that may exist under present law with respect to monitoring and investigating individuals who have physically departed from the United States. On the other hand, the proposal would not require monitoring of transactions over a 10-year period as under present law. To some extent, enforcement may be improved, however, through the requirement of posting a bond.

The proposal also would reduce a taxpayer's ability to avoid taxation through tax planning, because a more comprehensive tax base would be utilized. Thus, it would be more difficult to structure one's holdings in a manner designed to avoid the expatriation tax.

Critics of the proposal argue that the proposal presents enforceability issues of its own that do not exist under present law. Because the proposal would impose a tax on unrealized gains (and, thus, an arm's-length sales price for the assets may not be available), there may be significant valuation disputes between taxpayers and the IRS.[668] The proposal also raises

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[666] It is unclear from the proposal whether any exceptions from the mark-to-market expatriation tax (such as for these types of individuals) would apply.

[667] It is noted that assets that have no relationship with the United States would remain subject to U.S. tax if the individual remains a U.S. citizen or long-term U.S. resident.

[668] These valuation disputes are likely to be even more problematic in the case of interests in trusts.

liquidity problems for taxpayers because the assets held at the time of expatriation may not be liquid and, thus, the taxpayer may not have sufficient resources with which to pay the tax upon expatriation. These liquidity concerns are alleviated to some degree by the ability to defer payment of the expatriation tax if certain conditions are met.

The proposal also presents serious administrability concerns with respect to its application to green-card holders. Unlike the procedures for relinquishing citizenship, there are no formal procedures when an alien terminates U.S. residency by which such an individual is required to relinquish a green card, nor is there any incentive for an individual to actually turn in a green card upon leaving the United States. If such individuals were made aware that a special tax would be imposed upon the relinquishment of a green card, it may be even more likely that these individuals would simply leave the United States without ever notifying the authorities of their departure. Thus, it may be extremely difficult for the IRS to determine the identity of individuals who terminate their long-term U.S. residency absent any voluntary compliance by these individuals.[669] Similar difficulties may exist, however, with respect to the administration of present law in connection with green-card holders.

Some have observed that under certain circumstances a mark-to-market expatriation tax might conflict with rights to emigrate or expatriate recognized by U.S. and international law.[670] In addition, potential constitutional issues have been noted with respect to such a tax.[671]

Estate and gift tax rules

The proposal would repeal the special estate and gift tax rules that apply to U.S. citizens and long-term residents who give up their U.S. status with a principal purpose of avoiding U.S. tax. Thus, the present-law estate and gift tax rules that apply to nonresidents would continue to apply. These individuals generally would continue to be subject to estate and gift tax on the transfer of U.S.-situated property.

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[669] An additional difficulty arises in the context of green-card holders in that some individuals who would otherwise obtain green-cards could instead obtain certain types of nonimmigrant visas if the proposal was enacted and, thus, escape taxation under the proposal.

[670] For a discussion of these issues, see Joint Committee on Taxation, *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation*, at 89-100 (JCS-17-95), June 1, 1995.

[671] *Id.*, at 69-89 (noting certain potential constitutional issues, but stating that judicial decisions and legal commentary represent a substantial line of authority for the position that the concept of realization is not constitutionally mandated, and that prior mark-to-market expatriation tax proposals would not appear to lead to a colorable constitutional challenge under the due process clause of the Fifth Amendment).

In addition to the imposition of the mark-to-market tax upon expatriation, the proposal would impose a second tax on the property of an expatriate, regardless of whether the individual's departure was tax motivated, that is transferred back to a U.S. person. Under the proposal, if an expatriate subsequently makes a gift or bequest to a U.S. person, the property would be treated as "gross income" to the U.S. recipient, taxable at the highest marginal rate applicable to gifts and bequests (currently 55 percent). This "inheritance-type" tax would be imposed when a former citizen or resident makes a gift or leaves property from his or her estate to a U.S. person. Thus, under the proposal, property could be taxed twice, once (based on gain) upon expatriation and again (based on value) upon receipt by a U.S. person. Under present law, property also may be taxed multiple times. For example, property sold at a gain may be subject to income tax at one point and, subsequently, may be subject to estate or gift tax on its entire value. However, applying a similar regime to former citizens and former long-term residents would be a vast departure from the present-law regime for expatriates. In some instances, property that is subject to both income and estate and gift tax could be taxed at combined rates of over 80 percent under the proposal.

Some have asserted that enforcement of the present-law estate and gift tax rules for expatriates during the 10-year period after transfer or after death can be difficult. However, the proposal to assess an estate and gift tax any time property flows back to a U.S. person from a former citizen or long-term resident would present enforcement problems of its own. For example, the inheritance-type estate and gift tax would apply to property that flows back to a U.S. person at any time after expatriation. Moreover, it may be difficult to track whether a former U.S. citizen or long-term resident made a gift or bequest of property to the benefit of a U.S. person.

Immigration rules

The proposal would modify the immigration rules with respect to expatriates by eliminating the requirement that the individual's expatriation be tax-motivated before denying the expatriate reentry into the United States. The proposal also would coordinate the modified immigration provision with the new expatriation tax rules described above. It is understood that under these coordination rules, an expatriate would be denied reentry into the United States if he or she did not comply with his or her tax obligations under the mark-to-market expatriation tax. Some argue that this type of coordination between the immigration and tax rules would enhance enforcement and collection of the mark-to-market expatriation tax. It is also argued that the ability of expatriates to reenter the United States should be conditioned on their ability to satisfy their obligations (including tax obligations) upon leaving the United States. On the other hand, some might question the appropriateness of such an immigration provision, particularly if the goal of the immigration provision is to deter tax-motivated expatriations. If, as under the proposal, tax motivation would no longer be a relevant inquiry, denying expatriates reentry into the United States as a backstop to enforcement of the mark-to-market income tax could be viewed as a punitive measure.[672] Some might question using non-tax provisions (particularly immigration provisions) to enforce collection of taxes in these circumstances. In addition, certain issues may need to be addressed to the extent that the individual elects to defer payment of the mark-to-market expatriation tax but also seeks reentry into the United States.

Prior Action

A similar proposal was included in the President's Fiscal Year 1996 Budget Proposal.

5. Expand U.S.-effectively connected income rules to include more foreign-source income

Present Law

Nonresident alien individuals and foreign corporations (collectively, foreign persons) are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons.[673] Foreign persons also are subject to a 30-percent gross-basis tax, collected by withholding, on certain U.S.-source income, such as interest, dividends and other fixed or determinable annual or periodical ("FDAP") income, that is not effectively connected with a U.S. trade or business. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable tax treaty. Foreign persons generally are not subject to U.S. tax on foreign-source income that is not effectively connected with a U.S. trade or business.

Detailed rules apply for purposes of determining whether income is treated as effectively connected with a U.S. trade or business (so-called "U.S.-effectively connected income").[674] The rules differ depending on whether the income at issue is U.S-source or foreign-source income. Under these rules, U.S.-source FDAP income, such as U.S.-source interest and dividends, and U.S.-source capital gains are treated as U.S.-effectively connected income if such income is derived from assets used in or held for use in the active conduct of a U.S. trade or business, or from business activities conducted in the United States. All other types of U.S.-source income are treated as U.S.-effectively connected income (sometimes referred to as the "force of attraction rule").

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[672] Some, however, may also view the present-law immigration provision for expatriates as a punitive measure and may argue that it is more difficult to apply due to the subjective nature of the tax-motivated inquiry.

[673] Sections 871(b) and 882.

[674] Section 864(c).

In general, foreign-source income is not treated as U.S.-effectively connected income.[675] However, foreign-source income, gain, deduction, or loss generally is considered to be effectively connected with a U.S. business only if the person has an office or other fixed place of business within the United States to which such income, gain, deduction, or loss is attributable and such income falls into one of three categories described below.[676] For these purposes, income generally is not considered attributable to an office or other fixed place of business within the United States unless such office or fixed place of business is a material factor in the production of the income, and such office or fixed place of business regularly carries on activities of the type that generate such income.[677]

The first category consists of rents or royalties for the use of patents, copyrights, secret processes, or formulas, good will, trade-marks, trade brands, franchises, or other like intangible properties derived in the active conduct of the U.S. trade or business.[678] The second category consists of interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States, or received by a corporation whose principal business is trading in stocks or securities for its own account.[679] Notwithstanding the foregoing, foreign-source income consisting of dividends, interest, or royalties is not treated as effectively connected if the items are paid by a foreign corporation in which the recipient owns, directly, indirectly, or constructively, more than 50 percent of the total combined voting power of the stock.[680] The third category consists of income, gain, deduction, or loss derived from the sale or exchange of inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business where the property is sold or exchanged outside the United States through the foreign person's U.S. office or other fixed place of business.[681] Such amounts are not treated as effectively connected if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country materially participated in the sale or exchange.

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[675] Section 864(c)(4).

[676] Section 864(c)(4)(B).

[677] Section 864(c)(5).

[678] Section 864(c)(4)(B)(i).

[679] Section 864(c)(4)(B)(ii).

[680] Section 864(c)(4)(D)(i).

[681] Section 864(c)(4)(B)(iii).

The Code provides sourcing rules for enumerated types of income, including interest, dividends, rents, royalties, and personal services income.[682] For example, interest income generally is sourced based on the residence of the obligor. Dividend income generally is sourced based on the residence of the corporation paying the dividend. Thus, interest paid on obligations of foreign persons and dividends paid by foreign corporations generally are treated as foreign-source income.

Other types of income are not specifically covered by the Code's sourcing rules. For example, fees for accepting or confirming letters of credit have been sourced under principles analogous to the interest sourcing rules.[683] In addition, under regulations, payments in lieu of dividends and interest derived from securities lending transactions are sourced in the same manner as interest and dividends, including for purposes of determining whether such income is effectively connected with a U.S. trade or business.[684] Moreover, income from notional principal contracts (such as interest rate swaps) generally is sourced based on the residence of the recipient of the income.[685]

Description of Proposal

The proposal would expand each current category of foreign-source income that could be treated as effectively connected with a U.S. trade or business to include economic equivalents of such income (i.e., economic equivalents of certain foreign-source (1) rents and royalties, (2) dividends and interest, and (3) income on sales or exchanges of goods in the ordinary course of business). Thus, such economic equivalents would be treated as U.S.-effectively connected income in the same circumstances that foreign-source rents, royalties, dividends, interest, or certain inventory sales are treated as U.S.-effectively connected income. For example, foreign-source interest and dividend equivalents would be treated as U.S.-effectively connected income if the income is attributable to a U.S. office of the foreign person, and such income is derived by such foreign person in the active conduct of a banking, financing, or similar business within the United States, or the foreign person is a corporation whose principal business is trading in stocks or securities for its own account.

The proposal also would add a new category of foreign-source income that would be treated as U.S.-effectively connected income that would be comprised of foreign-source income that is attributable to a U.S. office or fixed place of business. The proposal would not affect the present-law rules regarding the circumstances in which U.S.-source income is treated as U.S.-

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682 Sections 861 through 865.

683 See Bank of America v. United States, 680 F.2d 142 (Ct. Cl. 1982).

684 Treas. Reg. sec. 1.864-5(b)(2)(ii).

685 Treas. Reg. sec. 1.863-7.

effectively connected income. In addition, the proposal would not affect the determination of whether items are treated as U.S.-source or foreign-source income.

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

Analysis

The proposal would expand the types of foreign-source income that may be taxed as U.S.-effectively connected income to include any economic equivalents of the three categories of foreign-source income that currently are treated as U.S.-effectively connected income. Some argue that present law creates arbitrary distinctions between economically similar transactions that are equally related to a U.S. trade or business. It is argued that the rules for determining whether income that is economically equivalent to certain types of foreign-source income (e.g., interest and dividends) that are treated as U.S.-effectively connected income should be the same as the rules for determining whether such foreign-source income is U.S.-effectively connected income.

The proposal would further expand the types of foreign-source income that may be taxed as U.S.-effectively connected income to include foreign-source income that is attributable to a U.S. office or fixed place of business. The proposal reflects the view that the United States should be permitted to tax income generated from material business activities that take place in the United States through a U.S. office or other fixed place of business, regardless of the source of such income.

The scope of the proposal is unclear. It is unclear what items would be treated as "economic equivalents" for purposes of applying the rules in the proposal. The proposal presumably would apply to certain foreign-source interest equivalents (including letter of credit fees) and dividend equivalents, although no specific definition for these types of equivalents is provided. Guarantee fees, as well as loan commitment fees (for loans not actually made), may not be viewed as interest equivalents per se, but could be treated as economic equivalents of interest for purposes of the proposal. In addition, other payments may fall under the rules depending on how broadly or narrowly the term "economic equivalents" is interpreted. For example, swap payments that replicate such types of foreign-source income could also be included under the new rules. Some might argue that such a broad approach is necessary to impose U.S. tax in economically similar situations. On the other hand, it is recognized that not all economically similar transactions are treated the same for U.S. tax purposes. The lack of specificity as to the types of foreign-source economic equivalents that may be subject to U.S. tax under the proposal may create an environment of uncertainty and could potentially stifle legitimate business transactions.

The proposal represents a significant departure from the present-law rules for determining whether foreign-source income is U.S.-effectively connected income. Under present law, only certain types of foreign-source income are treated as U.S.-effectively income, and only in certain cases. The proposal would significantly modify this approach and treat as U.S.-effectively connected income foreign-source income that is attributable to a U.S. office or fixed place of business. It is unclear how this new "attributable to" standard for foreign-source income would interact with the present-law rules that treat certain enumerated categories of foreign-source income (or, under the proposal, their economic equivalents) as U.S.-effectively connected income. In addition, no particular definition is provided as to what constitutes "attributable to" a U.S. office or fixed place of business for purposes of these new rules. Given the significant shift in the proposal's treatment of foreign-source income, this standard would need to be more clearly articulated.[686] Moreover, the proposal is unclear regarding whether there would be any further limits on the general rule such as the conditions that currently apply with respect to foreign-source rents, royalties, dividends, and interest attributable to a U.S. office or fixed place of business. Further, the proposal does not provide any exceptions from the general rule, even though exceptions from treatment as U.S.-effectively connected income may apply to certain U.S.-source income.[687] Some might also question why the proposal would apply a different standard to determine whether foreign-source income is treated as U.S.-effectively connected income, as compared to the standards that currently apply to U.S.-source income as described above.

Prior Action

A related proposal was included in the President's Fiscal Year 2000 Budget Proposal to expand the categories of foreign-source income that are treated as effectively connected with a U.S. trade or business to include interest equivalents and dividend equivalents.

6. Limit basis step-up for imported pensions

Present Law

Distributions from retirement plans are includible in gross income under the rules relating to annuities[688] and, thus, are generally includible in income, except to the extent the amount received represents investment in the contract (i.e., the participant's basis). The participant's basis includes amounts contributed by the participant, together with certain amounts contributed

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[686] The standards under section 864(c)(5) (described above) could be applied, although other standards could be considered.

[687] For example, certain inventory sales of nonresident aliens attributable to a U.S. office or other fixed place of business are treated as U.S.-source effectively connected income; however, this treatment 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 the foreign country materially participates in the sale.

[688] Sections 72 and 402.

by the employer, minus the aggregate amount (if any) previously distributed to the extent that such amount was excludable from gross income. Amounts contributed by the employer are included in the calculation of the participant's basis to the extent that such amounts were includible in the gross income of the participant, or to the extent that such amounts would have been excludable from the participant's gross income if they had been paid directly to the participant at the time they were contributed.

Distributions received by nonresidents from U.S. qualified plans and similar arrangements are generally subject to tax to the extent that the amount received is otherwise includible in gross income (i.e., is in excess of the basis) and is from a U.S. source. Employer contributions to qualified plans and other payments for services performed outside the United States generally are not treated as income from a U.S. source, and therefore generally are not subject to U.S. tax.

Under the 1996 U.S. model income tax treaty and many U.S. income tax treaties in force, pension distributions beneficially owned by a resident of a treaty country in consideration for past employment generally are taxable only by the individual recipient's country of residence.[689] Under the 1996 U.S. model income tax treaty and some U.S. income tax treaties, this exclusive residence-based taxation rule is limited to the taxation of amounts that were not previously included in taxable income in the other country. For example, if a treaty country had imposed tax on a resident individual with respect to some portion of a pension plan's earnings, subsequent distributions to a resident of the other country would not be taxable in that country to the extent the distributions were attributable to such amounts.

Description of Proposal

Under the proposal, an amount distributed from a foreign pension plan would be included in the calculation of the recipient's basis only to the extent that the recipient previously has been subject to taxation, either in the United States or the foreign jurisdiction, on such amount.

Effective date.--The proposal would be effective for distributions occurring on or after the date of enactment.

Analysis

The present-law rules governing the calculation of basis provide an inflated basis in pension assets for many individuals who become U.S. residents after accruing benefits under foreign pension plans. Compensation paid by a foreign employer to an individual who is a nonresident alien and who performs all services outside the United States is not includible in the individual's gross income for Federal income tax purposes. If such an individual later becomes a

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[689] Some treaties permit source-country taxation but merely reduce the rate of tax imposed on pension benefits.

U.S. resident when the individual receives distributions from the foreign employer's pension plan, all of the foreign employer's contributions are included in the individual's basis because basis includes employer contributions that would have been excludable from the individual's gross income if they had been paid directly to the individual at the time they were contributed. If the contributions also were excludable from the individual's taxable income under the laws of the foreign country, the individual will not pay any tax with respect to the contributions.

The ability of former nonresidents to receive tax-free distributions from foreign pension plans under present law is inconsistent with the taxation of retirement benefits paid to individuals who both accrue and receive distributions of qualified plan benefits as U.S. residents, i.e., basis generally includes only previously-taxed amounts. Therefore, the proposal would provide for more equitable taxation of retirement plan distributions. The proposal, however, would result in additional and potentially complex record-keeping requirements for recipients of foreign pension plan distributions because the determination of the taxable portion of such distributions would be based upon the existence of documentation of prior taxation.

Prior Action

No prior action.

7. Replace sales-source rules with activity-based rules

Present Law

U.S. persons are subject to U.S. tax on their worldwide income. Foreign taxes may be credited against U.S. tax on foreign-source income of the taxpayer. For purposes of computing the foreign tax credit, the taxpayer's income from U.S. sources and from foreign sources must be determined.

Income from the sale or exchange of inventory property that is produced (in whole or in part) within the United States and sold or exchanged outside the United States, or produced (in whole or in part) outside the United States and sold or exchanged within the United States, is treated as partly from U.S. sources and partly from foreign sources. Treasury regulations provide that 50 percent of such income is treated as attributable to production activities and 50 percent is treated as attributable to sales activities. Alternatively, the taxpayer may elect to determine the portion of such income that is attributable to production activities based upon an available independent factory price (i.e., the price at which the taxpayer makes a sale to a wholly independent distributor in a transaction that reasonably reflects the income earned from the production activity). With advance permission of the IRS, the taxpayer instead may elect to determine the portion of its income attributable to production activities and the portion attributable to sales activities based upon its books and records.

The portion of the income that is considered attributable to production activities generally is sourced based on the location of the production assets. The portion of the income that is considered attributable to sales activities generally is sourced where the sale occurs. Treasury regulations provide that the place of sale will be presumed to be the United States if the property is wholly produced in the United States and is sold for use, consumption, or disposition in the United States.

Specific rules apply for purposes of determining the source of income from the sale of products derived from natural resources within the United States and sold outside the United States or derived from natural resources outside the United States and sold within the United States.

Description of Proposal

Under the proposal, income from the sale or exchange of inventory property that is produced in the United States and sold or exchanged abroad, or produced abroad and sold or exchanged in the United States, would be apportioned between production activities and sales activities based on actual economic activity. The proposal would not modify the rules regarding the source of income derived from natural resources.

Effective date.--The proposal would apply to taxable years beginning after the date of enactment.

Analysis

The 50/50 source rule of present law may be viewed as drawing an arbitrary line in determining the portion of income that is treated as attributable to production activities and the portion that is treated as attributable to sales activities. The proposal could be viewed as making this determination more closely reflect the economic components of the export sale. Some further argue that the present-law rule is advantageous only to U.S. companies that also have operations in high-tax foreign countries. In many cases, the income from a taxpayer's export sales is not subject to tax in the foreign jurisdiction and therefore does not give rise to foreign tax credits. The present-law treatment of 50 percent of the income from a taxpayer's export sales of property it manufactured in the United States as foreign-source income therefore has the effect of allowing the taxpayer to use excess foreign tax credits, if any, that arise with respect to other operations. It is argued that the proposal would prevent what might be viewed as the inappropriate use of such excess foreign tax credits.

Others argue that the 50/50 source rule of present law is important to the U.S. economy and should be retained. It is further argued that the rule is needed to counter-balance various present-law restrictions on the foreign tax credit that can operate to deny the taxpayer a credit for foreign taxes paid with respect to foreign operations, thereby causing the taxpayer to be subject to double tax on such income. Moreover, the 50/50 source rule of present law can be viewed as having the advantage of administrative simplicity; the proposal to apportion income between the taxpayer's production activities and its sales activities based on actual economic activity has the potential to raise complex factual issues similar to those raised under the section 482 transfer pricing rules that apply in the case of transactions between related parties.

Prior Action

An identical proposal was included in the President's Fiscal Year 1998, 1999, and 2000 Budget Proposals.

8. Modify rules relating to foreign oil and gas extraction income

Present Law

U.S. persons are subject to U.S. income tax on their worldwide income. A credit against U.S. tax on foreign-source income is allowed for foreign taxes paid or accrued (or deemed paid). The foreign tax credit is available only for foreign income, war profits, and excess profits taxes and for certain taxes imposed in lieu of such taxes. Other foreign levies generally are treated as deductible expenses only. Treasury regulations provide detailed rules for determining whether a foreign levy is a creditable income tax. A levy generally is a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and is not compensation for a specific economic benefit provided by a foreign country. A taxpayer that is subject to a foreign levy and that also receives a specific economic benefit from such country is considered a "dual-capacity taxpayer." Treasury regulations provide that the portion of a foreign levy paid by a dual-capacity taxpayer that is considered a tax is determined based on all the facts and circumstances. Alternatively, under a safe harbor provided in the regulations, the portion of a foreign levy paid by a dual-capacity taxpayer that is considered a tax is determined based on the foreign country's generally applicable tax or, if the foreign country has no general tax, the U.S. tax.[690]

The amount of foreign tax credits that a taxpayer may claim 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. The foreign tax credit limitation is calculated separately for specific categories of income. The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and carried forward five years. Under a special limitation, taxes on foreign oil and gas extraction income are creditable only to the extent that they do not exceed a specified amount (e.g., 35 percent of such income in the case of a corporation). For this purpose, foreign oil and gas extraction income is income derived from foreign sources from the extraction of minerals from oil or gas wells or the sale or exchange of assets used by the taxpayer in such extraction. A taxpayer must have excess limitation under the special rules applicable to foreign extraction taxes and excess limitation under the general foreign tax credit provisions in order to utilize excess foreign oil and gas extraction taxes in a carryback or carryforward year. A recapture rule applicable to foreign oil and gas extraction losses treats income that otherwise would be foreign

[690] Treas. Reg. sec. 1.901-2A(e).

oil and gas extraction income as foreign-source income that is not considered oil and gas extraction income; the taxes on such income retain their character as foreign oil and gas extraction taxes and continue to be subject to the special limitation imposed on such taxes.

Description of Proposal

The proposal would deny the foreign tax credit with respect to all amounts paid or accrued (or deemed paid) to any foreign country by a dual-capacity taxpayer if the country does not impose a generally applicable income tax. A dual-capacity taxpayer would be a person that is subject to a foreign levy and also receives (or will receive) directly or indirectly a specific economic benefit from such foreign country. A generally applicable income tax would be an income tax that is imposed on income derived from business activities conducted within that country, provided that the tax has substantial application (by its terms and in practice) to persons who are not dual-capacity taxpayers and to persons who are citizens or residents of the foreign country. If the foreign country imposes a generally applicable income tax, the foreign tax credit available to a dual-capacity taxpayer would not exceed the amount of tax that is paid pursuant to the generally applicable income tax or that would be paid if the generally applicable income tax were applicable to the dual-capacity taxpayer. Amounts for which the foreign tax credit is denied could constitute deductible expenses. The proposal would not apply to the extent contrary to any treaty obligation of the United States.

The proposal would replace the special limitation rules applicable to foreign oil and gas extraction income with a separate foreign tax credit limitation under section 904(d) with respect to foreign oil and gas income. For this purpose, foreign oil and gas income would include foreign oil and gas extraction income and foreign oil related income. Foreign oil related income is income derived from foreign sources from the processing of minerals extracted from oil or gas wells into their primary products, the transportation, distribution or sale of such minerals or primary products, the disposition of assets used by the taxpayer in one of the foregoing businesses, or the performance of any other related service. The proposal would repeal both the special carryover rules applicable to excess foreign oil and gas extraction taxes and the recapture rule for foreign oil and gas extraction losses.

Effective date.--The proposal with respect to the treatment of dual-capacity taxpayers would apply to foreign taxes paid or accrued in taxable years beginning after the date of enactment. The proposal with respect to the foreign tax credit limitation generally would apply to taxable years beginning after the date of enactment.

Analysis

The proposal with respect to the treatment of dual-capacity taxpayers addresses the distinction between creditable taxes and non-creditable payments for a specific economic benefit. The proposal would modify rules currently provided under the Treasury regulations and would deny a foreign tax credit for amounts paid by a dual-capacity taxpayer to any foreign country that does not have a tax that satisfies the definition of a generally applicable income tax.

Thus, neither the present-law facts and circumstances test nor the present-law safe harbor based on the U.S. tax rate would apply in determining whether any portion of a foreign levy constitutes a tax.

Proponents of the proposal argue that the safe harbor of the present regulations allows taxpayers to claim foreign tax credits for payments that are more appropriately characterized as royalty expenses. Opponents of the proposal argue that the mere fact that a foreign country does not impose a tax that qualifies under the specific definition of a generally applicable income tax should not cause all payments to such country by a dual-capacity taxpayer to be treated as royalties rather than taxes. Moreover, applying such a rule to dual-capacity taxpayers could disadvantage them relative to other persons that are subject to a levy in a country that does not impose a tax that satisfies the specific definition of a generally applicable income tax but that do not also receive a specific economic benefit from such country (e.g., a taxpayer that is not in a natural resources business); a taxpayer that is not a dual-capacity taxpayer would not be subject to this disallowance rule and therefore could continue to claim foreign tax credits for payments to a foreign country that does not impose a generally applicable income tax. In addition, issues necessarily would continue to arise in determining whether a taxpayer is a dual-capacity taxpayer and whether a foreign country has a generally applicable income tax.

Under the proposal, a separate foreign tax credit limitation (or “basket”) would apply to foreign oil and gas income, which would include both foreign oil and gas extraction income and foreign oil related income. In addition, the present-law special limitation for extraction taxes would be eliminated. The proposed single basket rule may provide some simplification by eliminating issues that arise under present law in distinguishing between income that qualifies as extraction income and income that qualifies as oil related income. The proposal also would have the effect of allowing the foreign taxes on extraction income, which may be imposed at relatively high rates, to be used to offset the U.S. tax on foreign oil related income, which may be subject to lower-rate foreign taxes.

Prior Action

An identical proposal was included in the President's Fiscal Year 1998, 1999, and 2000 Budget Proposals. The proposal in the Fiscal Year 1998 Budget Proposal also included an additional modification with respect to the treatment of foreign oil and gas income under subpart F of the Code which is not included in this proposal.

9. Recapture overall foreign losses when controlled foreign corporation stock is disposed

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. The amount of foreign tax credits generally is limited to the portion of the taxpayer's U.S. tax which the taxpayer's foreign-source taxable income (i.e., foreign-source gross income less allocable expenses or deductions) bears to the taxpayer's worldwide taxable income for the year.[691] Separate limitations are applied to specific categories of income.

Special recapture rules apply in the case of foreign losses for purposes of applying the foreign tax credit limitation.[692] Under these rules, losses for any taxable year in a limitation category which exceed the aggregate amount of foreign income earned in other limitation categories (a so-called "overall foreign loss") are recaptured by resourcing foreign-source income earned in a subsequent year as U.S.-source income.[693] The amount resourced as U.S.-source income generally is limited to the lesser of the amount of the overall foreign losses not previously recaptured, or 50 percent of the taxpayer's foreign-source income in a given year (the "50-percent limit"). Taxpayers may elect to recapture a larger percentage of such losses.

A special recapture rule applies to ensure the recapture of an overall foreign loss where property which was used in a trade or business predominantly outside the United States is disposed of prior to the time the loss has been recaptured.[694] In this regard, dispositions of trade or business property used predominantly outside the United States are treated as having been recognized as foreign-source income (regardless of whether gain would otherwise be recognized upon disposition of the assets), in an amount equal to the lesser of the excess of the fair market value of such property over its adjusted basis, or the amount of unrecaptured overall foreign losses. Such foreign-source income is resourced as U.S.-source income without regard to the 50-percent limit. For example, if a U.S. corporation transfers its foreign branch business assets to a foreign corporation in a nontaxable section 351 transaction, the taxpayer would be treated for purposes of the recapture rules as having recognized foreign-source income in the year of the transfer in an amount equal to the excess of the fair market value of the property disposed over its adjusted basis (or the amount of unrecaptured foreign losses, if smaller). Such income would be recaptured as U.S.-source income to the extent of any prior unrecaptured overall foreign losses.[695]

Detailed rules apply in allocating and apportioning deductions and losses for foreign tax credit limitation purposes. In the case of interest expense, such amounts generally are apportioned to all gross income under an asset method, under which the taxpayer's assets are

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[691] Section 904(a).

[692] Section 904(f).

[693] Section 904(f)(1).

[694] Section 904(f)(3).

[695] Coordination rules apply in the case of losses recaptured under the branch loss recapture rules. Section 367(a)(3)(C).

characterized as producing income in statutory or residual groupings (i.e., foreign-source income in the various limitation categories or U.S.-source income).[696] Interest expense is apportioned among these groupings based on the relative asset values in each. Taxpayers may elect to value assets based on either tax book value or fair market value.

Each corporation that is a member of an affiliated group is required to apportion its interest expense using apportionment fractions determined by reference to all assets of the affiliated group. For this purpose, an affiliated group generally is defined to include only domestic corporations. Stock in a foreign subsidiary, however, is treated as a foreign asset that may attract the allocation of U.S. interest expense for these purposes. If tax basis is used to value assets, the adjusted basis of the stock of certain 10-percent or greater owned foreign corporations or other non-affiliated corporations must be increased by the amount of earnings and profits of such corporation accumulated during the period the U.S. shareholder held the stock.

Description of Proposal

The proposal would apply the special recapture rule for overall foreign losses that currently applies to dispositions of foreign trade or business assets to the disposition of controlled foreign corporation stock. Thus, dispositions of controlled foreign corporation stock would be recognized as foreign-source income in an amount equal to the lesser of the fair market value of the stock over its adjusted basis, or the amount of prior unrecaptured overall foreign losses. Such income would be resourced as U.S.-source income for foreign tax credit limitation purposes without regard to the 50-percent limit.

Effective date.--The proposal would be effective as of the date of enactment.

Analysis

Dispositions of stock of a corporation generally are not subject to the special recapture rules for overall foreign losses under section 904(f)(3). Ownership of stock in a foreign subsidiary can lead to, or increase, an overall foreign loss as a result of interest expenses allocated against foreign-source income under the interest expense allocation rules. The recapture of overall foreign losses created by such interest expense allocations may be avoided if, for example, the stock of the foreign subsidiary subsequently were transferred to unaffiliated parties in non-taxable transactions. The proposal would recapture such overall foreign losses where stock of a controlled foreign corporation is disposed, regardless of whether such stock is disposed in a non-taxable transaction.

Some have observed that the interest expense allocation rules can operate to restrict a taxpayer's ability to claim foreign tax credits. Expanding the special recapture rules to include

[696] Section 864(e) and Temp. Treas. Reg. sec. 1.861-9T.

dispositions of controlled foreign stock could be viewed as further limiting the ability of taxpayers to claim relief from potential double taxation.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

10. Modify foreign office material participation exception applicable to certain inventory sales

Present Law

Foreign persons are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons.[697] Detailed rules apply for purposes of determining whether income is treated as effectively connected with a U.S. trade or business.[698] Under these rules, foreign-source income is treated as effectively connected with a U.S. trade or business only in limited circumstances.[699]

Income derived from the sale of personal property other than inventory property generally is sourced based on the residence of the seller.[700] Income derived from the sale of inventory property generally is sourced where the sale occurs (i.e., where title to the property passes from the seller to the buyer).[701] However, a special rule applies in the case of certain sales by foreign persons. If a foreign person maintains an office or other fixed place of business in the United States, income from a sale of personal property (including inventory property) attributable to such office or place of business is sourced in the United States.[702] This special rule does not apply, however, in the case of inventory property that is sold by the foreign person for use, disposition or consumption outside the United States if an office or other fixed place of business of such person outside the United States materially participated in the sale.[703] Accordingly, income from the sale by a foreign person of inventory property attributable to an office or other

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[697] Sections 871(b) and 882.

[698] Section 864(c).

[699] Section 864(c)(4).

[700] Section 865(a).

[701] Sections 865(b) and 861(a)(6).

[702] Section 865(e)(2)(A).

[703] Section 865(e)(2)(B).

fixed place of business of such foreign person in the United States is sourced based on where the sale occurs, provided that the inventory property is sold for use outside the United States and a foreign office or other fixed place of business of such person materially participated in the sale. Income that is sourced outside the United States under this rule is not treated as effectively connected with a U.S. trade or business.

Description of Proposal

Under the proposal, the foreign office material participation rule would apply only if an income tax equal to at least 10 percent of the income from the sale actually is paid to a foreign country with respect to such income. Accordingly, income from the sale by a foreign person of inventory property attributable to an office or other fixed place of business of such person in the United States would be sourced in the United States if an income tax of at least 10 percent of the income from the sale is not paid to a foreign country. Income sourced in the United States under this proposal would be treated as effectively connected with a U.S. trade or business conducted by the foreign person.

Effective date.--The proposal would be effective for transactions occurring on or after the date of enactment.

Analysis

Under present law, a foreign person that maintains an office in the United States is not subject to U.S. tax on income derived from sales of inventory property attributable to such office provided that the property is sold for use outside the United States and a foreign office materially participated in the sale. The foreign person is not subject to U.S. tax on such income even if no foreign country imposes tax on the income. The proposal would modify this material participation rule so that it would apply only if an income tax of at least 10 percent is paid to a foreign country with respect to such income.

The proposal reflects the view that the United States should not cede its jurisdiction to tax income from sales of inventory property attributable to an office in the United States unless the income from such sale is subject to foreign tax at some minimal level. Under present law, a similar rule applies in the case of certain sales by a U.S. person of personal property (other than inventory property) attributable to an office or other fixed place of business outside the United States; such income is sourced outside the United States, but only if a foreign income tax of at least 10 percent is paid with respect to such income.

Prior Action

An identical proposal was included in the President's Fiscal Year 1999 and 2000 Budget Proposals.

L. Other Provisions Requiring Amendment of the Internal Revenue Code[704]

1. Reinstate superfund excise taxes and corporate environmental income tax

Present Law

Before January 1, 1996, four taxes were imposed to fund the Hazardous Substance Superfund Trust Fund ("Superfund") program:

(1) An excise tax on petroleum and imported refined products;[705]

(2) An excise tax on certain hazardous chemicals, imposed at rates that varied from $0.22 to $4.87 per ton;[706]

(3) An excise tax on imported substances made with the chemicals subject to the tax in (2), above;[707] and

(4) An income tax on corporations calculated using the alternative minimum tax rules.[708]

Description of Proposal

The proposal would reinstate the three Superfund excise taxes during the period after the date of the proposal's enactment and before October 1, 2010. The corporate environmental

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704 The President's Fiscal Year 2001 Budget Proposal also contains a proposal "to permanently extend current legal provisions due to expire in 2003" that provide the authority to disclose tax information to the Department of Veterans Affairs ("DVA") (p. 872 of the Appendix to the Fiscal Year 2001 Budget). A letter from OMB dated March 2, 2000, states: "Despite this reference, the Budget does not include a permanent extension of income verification authority in the Internal Revenue Code, section 6103 of title 26, USC. Rather, the Administration proposes to extend the parallel provision in section 5317(g) of title 38 USC through FY 2003 to make it coextensive with the existing section 6103. Thus this Administration proposal does not propose any change to title 26 USC. The Department of Veterans Affairs has informed the House and Senate Committees on Veterans' Affairs of this error." Accordingly, because it does not amend a tax provision, this DVA disclosure provision is not described in this pamphlet.

705 Section 4611(c)(2)(A).

706 Section 4661.

707 Section 4671.

708 Section 59A.

income tax would be reinstated for taxable years beginning after December 31, 1999, and before January 1, 2011.

Revenues from reinstatement of these taxes would be deposited in the Superfund.

Effective date.--The proposal would be effective on the date of enactment.

Analysis

The Superfund provides for certain environmental remediation expenses. The prior-law taxes were imposed on petroleum products, chemical products, and more generally on large businesses. Thus, the taxes were imposed on those taxpayers who generally were believed to represent the parties liable for past environmental damage rather than on taxpayers perceived to benefit from the expenditure program. Depending on their incidence, these taxes may inexactly recoup damages from parties held responsible for past environmental damage. For example, the burden may fall on the current owners of enterprises rather than those who were the owners at the time the damage occurred. On the other hand, to the extent that taxable products continue to create environmental harm, the taxes may discourage overuse of such products.

Proponents of reimposing the Superfund excise taxes suggest that the revenues can provide a cushion for ongoing Superfund program costs, and that reimposition of these taxes is a necessary complement to reauthorization and possible modification of the Superfund program. Opponents suggest that the taxes should be reimposed only as part of pending program reform legislation. These persons suggest, in particular, that proposals to address issues associated with so-called "retroactive liability" may require budgetary offsets which could be provided by reimposing the Superfund taxes as a component of such authorizing legislation.

The current unappropriated balance in the Superfund at the close of the 1999 fiscal year was $800 million.

Prior Action

A similar proposal was included in the President's Fiscal Year 1998, 1999, and 2000 Budget Proposals.

2. Convert a portion of the excise taxes deposited in the Airport and Airway Trust Fund to cost-based user fees

Present Law

Airport and Airway Trust Fund excise taxes with scheduled expiration dates

Excise taxes are imposed on commercial and noncommercial[709] aviation to finance programs administered through the Airport and Airway Trust Fund (the "Airport Trust Fund"). These excise taxes were modified and extended (through September 30, 2007) by the Taxpayer Relief Act of 1997 (the "1997 Act"). The following describes the current aviation excise taxes.

Commercial air passenger transportation

Commercial passenger air transportation generally is subject to one of two taxes. First, domestic air passenger transportation is subject to a tax equal to the total of 7.5 percent of the gross amount paid by the passenger for the transportation plus a $3 per flight segment tax.[710] The flight segment tax rate currently is being phased-in, as follows: $2.50 (January 1, 2000-December 31, 2000), to $2.75 (January 1, 2001-December 31, 2001), and to $3 (January 1, 2002-December 31, 2002). On January 1, 2003, and on each January 1 thereafter, the fixed dollar amount per flight segment will be indexed annually for inflation occurring after 2001.

Second, commercial air passengers arriving in the United States from another country or departing the United States for another country are subject to a $12.40 tax per arrival or departure. This rate, which was $12.00 when enacted in 1997, is indexed annually for inflation after 1997.

Further, amounts paid to air carriers (in cash or in kind) for the right to award or otherwise distribute free or reduced-rate air transportation are treated as amounts paid for taxable air transportation, subject to a 7.5-percent *ad valorem* rate. This tax applies to payments, whether made within the United States or elsewhere, if the rights to transportation for which payments are made can be used in whole or in part for transportation that, if purchased directly, would be subject to either the domestic or international passenger taxes, described above.

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709 Noncommercial aviation is defined to include transportation that does not involve the carrying of passengers or freight "for hire" (e.g., corporate aircraft transporting corporate employees).

710 A flight segment is transportation involving a single take-off and a single landing.

Commercial air cargo transportation

Domestic commercial transportation of cargo by air is subject to a 6.25-percent excise tax.

Noncommercial aviation

Noncommercial aviation is subject to taxes on fuels consumed. Aviation gasoline is taxed at 15 cents per gallon and aviation jet fuel is taxed at 17.5 cents per gallon.

Permanent aviation fuels excise tax

In addition to the taxes described above, aviation gasoline and jet fuel are subject to a permanent 4.3-cents-per-gallon excise tax rate. Receipts from this tax, like the aviation taxes with scheduled expiration dates, are deposited in the Airport Trust Fund.

Airport Trust Fund expenditures

For the past several Fiscal Years, Airport Trust Fund revenues have provided funds for approximately 60 percent of Federal Aviation Administration ("FAA") program costs.

Description of Proposal

The proposal states that legislation to reduce aviation excise taxes and to supplement the remaining tax revenues with "cost-based user fees" will be proposed at a later date. The proposal contemplates funding 100 percent of FAA Airport Trust Fund program costs with the present taxes and the new user fees. Additional details of the proposal have not been specified.

Effective date.--The proposal would be effective on October 1, 2000.

Analysis

Because details of the proposal have not been transmitted to the Congress, it is not possible to comment on specifics; however, several general issues regarding substitution of aviation user fees for excise taxes which were raised before the Congress during consideration of the 1997 Act may be noted.[711]

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[711] For a more complete discussion of these issues, see, Joint Committee on Taxation, *Present Law and Background Information on Federal Transportation Excise Taxes and Trust Fund Expenditure Programs* (JCS-10-96), November 14, 1996.

Budget Act scorekeeping

The current excise taxes imposed to finance FAA activities are classified as Federal revenues, with gross receipts from the taxes being deposited in the Airport Trust Fund. Because of interactions with the Federal income tax, net revenues to the Federal Government are less than the gross receipts from these taxes (i.e., "net revenues" equal approximately 75 percent of gross excises taxes). Spending from the Airport Trust Fund is classified as discretionary domestic spending, subject to aggregate annual appropriation limits ("caps") that apply to this spending as well as other types of discretionary domestic spending. These caps most recently were set as part of the 1997 balanced budget agreement. Because spending from the Airport Trust Fund is subject to the discretionary domestic spending caps, deposit of amounts in excess of net revenues from these taxes in the Airport Trust Fund does not impact Federal budget scorekeeping.

Proponents of changing FAA financing to user fees typically argue that current spending levels are too low because of the general discretionary spending caps. These persons suggest that, if the FAA were permitted to impose cost-based user fees, it could spend the entire amount collected outside of the regular budgetary process. However, if FAA financing and spending were restructured using user fees and expenditures not requiring appropriation, the discretionary domestic spending caps established by the 1997 balanced budget agreement would have to be reduced to prevent increases in other programs that might produce deficit spending. Further, if the user fees were classified as Federal revenues and the FAA were allowed to spend more than the net revenues produced (as opposed to the gross receipts), from a budgetary standpoint, the agency would be engaged in deficit spending.

Under the current financing and spending structure, Airport Trust Fund spending levels may be less than net excise tax revenues. Any excess net revenues received are included in calculations of the Federal deficit or surplus under the Budget Enforcement Act. If the excise taxes were repealed, and were not replaced by similarly treated revenue sources equal at least to the excess of collections over expenditures, Federal deficit or surplus calculations would be affected.

Tax v. fee

Proponents of cost-based user fees suggest that the FAA, not the Congress, should establish and collect appropriate fees for the services it provides. These persons suggest that imposition of fees by the FAA would enable that agency to operate in a more businesslike manner. However, others point out that care must be taken to ensure that any FAA-imposed fees are not legally "taxes" because the taxing power cannot constitutionally be delegated by the Congress.[712] In general, a true user fee (which an Executive agency may be authorized to levy) may be imposed only on the class that directly avails itself of a governmental program and may

[712] Article I, Section 8 of the U.S. Constitution includes the enumerated powers of Congress the "... Power To lay and collect Taxes, Duties, Imposts, and Excises .... "

be used solely to finance that program rather than to finance the costs of Government generally. The amount of the fee charged to any payor generally may not exceed the costs of providing the specific services with respect to which the fee is charged. Fees are not imposed on the general public; there must be a reasonable connection between the payors of the fee and the agency or function receiving the fee. Those paying a fee must have the choice of not utilizing the governmental service or avoiding the regulated activity and thereby avoiding the charge. If the FAA were authorized to establish and collect cost-based user fees, the fees would have to satisfy these criteria to avoid being subject to challenge as unconstitutional delegations of the taxing power. When the Congress modified and extended the aviation excise taxes in 1997, the FAA was reported to have no comprehensive cost accounting system upon which it could base such fees. Further, over 50 percent of FAA costs were identified in the then most recently conducted cost allocation study as "common" costs to many sectors, requiring allocation rules. Such allocation rules may be viewed by some as imprecise and subject to challenge.[713]

Cost allocation and Airport and Airway Trust fund excise tax efficiency

Setting taxes or fees on the basis of cost allocation generally is an attempt to have the tax or fee reflect the average cost of providing the service. Many view such pricing as an equitable manner to recover costs. However, cost allocation as a basis of air transportation excise tax design may create an economically inefficient tax structure. The provision of transportation services often requires substantial capital investments. Fixed costs tend to be large compared with marginal costs. For example, the construction of a bridge across the Mississippi River requires a substantial fixed capital investment. The additional resource costs (wear and tear) imposed by one additional automobile on an uncongested bridge, once the bridge has been built, is quite small in comparison. This means that the provision of many transportation services is often characterized by "economies of scale." Provision of a good or service is said to be characterized by economies of scale when the average cost of providing the good or service exceeds the marginal cost of providing that good or service. When this occurs, the average cost of providing the good or service is falling with each additional unit of the good or service provided. Economists proffer setting prices or taxes equal to marginal cost to obtain economically efficient outcomes. However, in the presence of substantial economies of scale, the marginal cost is less than the average cost of providing the transportation service and the revenues collected from equating taxes to marginal costs would not cover the full expenditure required to provide the service. That is, provision of the service may require a subsidy beyond the revenues provided by the economically efficient tax.[714]

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[713] See, e.g., Asiana Airlines v. Federal Aviation Administration, No. 97-135 (D.C. Cir., January 30, 1998), holding that certain international overflight fees imposed by the FAA based on this cost allocation study violated a statutory requirement that the fees be cost-based.

[714] Some argue that the presence of economies of scale justify Government involvement in certain infrastructure investments. They argue that when the economies of scale are great, the potential for cost recovery and profit from market prices may be insufficient for private providers

Cost allocation would set the price or taxes for air transportation services at rates equal to the average cost of services. In the presence of substantial economics of scale, average cost pricing implies that consumers are being charged prices in excess of marginal resource costs and that less than the economically efficient level of transportation services are provided. Indeed, an expansion of services would lead to a decline in the average cost of the service to each user. If each user could be charged that lower average price, the price paid would still exceed the marginal cost of the provision of the service, all costs would be recovered and net economic well-being (efficiency) would increase. Thus, the principle of cost allocation involves a trade-off between economic efficiency and cost recovery.[715]

Congressional oversight

The current financing and Airport Trust Fund spending process involves oversight of at least four Congressional committees in each House of Congress. Taxes are imposed and dedicated to the Airport Trust Fund by the tax-writing committees. Overall expenditure levels for domestic spending are set by the budget committees. Specific expenditure purposes are authorized by the House Committee on Transportation and Infrastructure and the Senate Committee on Commerce, Science and Transportation. Further, expenditures are appropriated by the appropriations committees of each House. Proponents of changing FAA financing and spending authority as proposed by the Administration suggest that such extensive Congressional oversight is unnecessary. At a minimum, the proposal could eliminate or reduce the oversight roles of the tax-writing and appropriations committees. Others suggest that the involvement of multiple Congressional committees promotes better prioritization of actual FAA spending needs within the framework of the overall system of Federal revenues and outlays and a more efficient use of FAA resources.

The balance in the Airport and Airway Trust Fund at the close of the 1998 fiscal year was $9.1 billion.

Prior Action

A similar proposal was included in the President's Fiscal Year 1998, 1999, and 2000 Budget Proposals, for which details were not submitted to the Congress.

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to undertake the investment, even though provision of the service would create marginal benefits that exceed marginal costs.

[715] For a discussion of ways of decreasing the inefficiencies that arise from diverging from marginal cost pricing while raising revenue to cover substantial fixed costs, see Congressional Budget Office, *Paying for Highways, Airways and Waterways: How Can Users Be Charged?* May 1992.

The structure and level of aviation excise taxes to support the FAA were addressed in the Taxpayer Relief Act of 1997. That Act enacted the current excise tax structure, provided that the taxes with scheduled expiration dates would be imposed through September 30, 2007, and transferred receipts from the permanent 4.3-cents-per-gallon aviation fuels tax (previously retained in the General Fund) to the Airport Trust Fund.

3. Increase excise taxes on tobacco products

Present Law

Excise taxes on tobacco products

Excise taxes are imposed on cigarettes, cigars, chewing tobacco and snuff, pipe tobacco, and cigarette papers and tubes (Code sec. 5701). These taxes are imposed upon removal[716] of the taxable tobacco products by the manufacturer, or on importation into the United States.[717] The current tax rates are shown in the table below.

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[716] Taxable tobacco products are removed when they are taken from the factory, from internal revenue bond, or are released from customs custody. Removal also occurs at the time such articles are smuggled or otherwise unlawfully imported into the United States. Section 5702(k).

[717] The term United States includes the 50 States and the District of Columbia.

Tobacco product	*Tax rate*
Cigarettes:	
Small cigarettes	$17.00 per thousand (34 cents per pack of 20)
Large cigarettes	$35.70 per thousand
Cigars:	
Small cigars	$1.594 per thousand
Large cigars	18.063% of manufacturer's price, up to $42.50 per thousand
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
Cigarette papers	$0.0106 per 50 papers or fraction thereof
Cigarette tubes	$0.0213 per 50 tubes or fraction thereof

Effective on January 1, 2002, a further increase of $2.50 per thousand (to 39 cents per pack of 20 small cigarettes) is scheduled to become effective. Tax rates on other taxable tobacco products will increase proportionately on that date as well.

Description of Proposal

The proposal would accelerate the scheduled January 1, 2002, tobacco tax increases and increase these tax rates further, both effective as of October 1, 2000. The proposed new tobacco products excise tax rates are shown in the following table.

Tobacco product	*Tax rate*
Cigarettes:	
Small cigarettes	$32.00 per thousand (64 cents per pack of 20)
Large cigarettes	$67.20 per thousand
Cigars:	
Small cigars	$3.00 per thousand
Large cigars	34% of manufacturer's price, up to $80 per thousand
Chewing tobacco	$0.32 per pound
Snuff	$0.96 per pound
Pipe tobacco	$1.80 per pound
Roll-your-own tobacco	$1.80 per pound
Cigarette papers	$0.02 per 50 papers or fraction thereof
Cigarette tubes	$0.04 per 50 tubes or fraction thereof

A floor stocks tax would be imposed to conform the tax on tobacco products held for sale on the October 1, 2000 effective date with the tax on tobacco products that are acquired for sale after that date.

In addition, the Budget Proposal states that the Administration will transmit a separate proposal for a nondeductible assessment to be imposed on tobacco manufacturers that fail to meet prescribed youth smoking reduction targets. Details of this separate proposal have not been specified.

Effective date.--The proposals would be effective on October 1, 1999.

Analysis

Taxation of tobacco products, health implications, and consumer choice

In general.--Medical research has linked the use of tobacco products to a number of diseases--including cancer of the lungs, mouth and throat, emphysema, chronic bronchitis, and heart disease.[718] In addition, smoking is believed to be a contributing factor to low birth weight babies. The public's increased awareness of these health hazards has led to substantial declines over the past 35 years in the percentage of the United States population that currently uses tobacco products.

The medical research cited above has motivated many public health analysts to advocate greater governmental action to help reduce the use of tobacco among the population. Such non-tax action could range from increased expenditures on public service announcements detailing the risks associated with tobacco use to increased penalties for sales of tobacco products to minors. Some analysts advocate increasing tobacco taxes to provide a market incentive to individuals to reduce their consumption of products that can harm one's health. Taxes on the consumption of specific products, as opposed to broadly imposed consumption taxes, distort consumer behavior by disfavoring certain goods in the economy relative to other goods. Generally, market price distortion through taxes reduces consumer well-being because the change in relative prices introduced by the tax causes consumers to choose a less preferred good than they would have in the absence of the tax. This general economic analysis is based on assumptions that consumers are fully informed about the product and that consumption of the product imposes no externalities, i.e., additional costs on society as a whole. Some public health analysts question the validity of these assumptions in the case of tobacco use.

Informed versus uninformed choice.--Some proponents of higher taxation of tobacco products argue that consumers are not fully informed about the true costs and benefits of the use of tobacco products, and that consumers do not fully account for the harm such products can have on their health. They argue that the higher prices that increased taxation will produce are necessary to help potential consumers see the true cost of tobacco products. They argue that this particularly may be the case among younger individuals who do not recognize the addictive power of nicotine or who otherwise might be expected to be less informed about the potential health dangers of tobacco use. There is evidence that younger individuals may be more likely than the population at large to reduce their consumption of tobacco products if the price rises.[719]

There is some survey evidence, however, that both smokers and nonsmokers overestimate the probability of death and illness from tobacco use. Moreover, that survey

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[718] Department of Health and Human Services, *Reducing the Health Consequences of Smoking: 25 Years of Progress. A Report of the Surgeon General*, DHHS Publication No. (CDC) 89-8411 (prepublication version, January 11, 1989).

[719] Department of Finance, Canada, *Tobacco Taxes and Consumption*, June 1993. Also see, Eugene M. Lewit, Douglas Coate, and Michael Grossman, ``The Effects of Government Regulation on Teenage Smoking," The Journal of Law and Economics, 24, December 1981. Because nicotine is addictive, the price response of addicted consumers should be less than that of nonaddicted consumers. It is probable that older smokers are more likely to be addicted than would younger smokers.

suggested that teenagers attach a higher risk to smoking than do adults.[720] Opponents of higher tobacco taxes also argue that if the primary concern is to reduce the demand by young individuals who may be uninformed, a tax increase is inefficient because the tax also imposes large costs on older, informed individuals who derive pleasure from tobacco products. They argue that more targeted remedies such as greater penalties for sales to minors may be more efficient. Some argue for both higher tobacco taxes and greater penalties for sales to minors.

Externality.--Economists say that an externality arises when the consumption (or production) of a good by one individual imposes a cost (or benefit) on society as a whole. For example, emissions of volatile organic compounds from automobiles contribute to urban smog, which imposes health and other costs on society at large. When all such external costs (or benefits) are not accounted for by the individual purchaser/user, there is too much (or too little) of the good produced and consumed. Recent medical research has suggested that "second-hand smoke," that is, the smoke from smokers inhaled by nonsmokers, creates health risks and costs for nonsmokers.[721] Thus, while potential health damage of smoking is a direct cost to the smoker, second-hand smoke creates a cost for nonsmokers for which the smoker does not account when he makes the decision to smoke. Such costs are referred to by economists as negative externalities.

Economists often propose corrective taxation as a remedy for existence of a negative externality.[722] The idea is that if a tax is imposed on the product that creates the externality at a rate equal to the additional harm created by the externality, then the market price will fully reflect all benefits and costs to society from the production and consumption of the product. Assuming that second-hand smoke is a case of an externality, a tax on smoking tobacco could improve economic efficiency. However, the difficulty is in choosing the correct level of the tax. Too great a tax could reduce economic efficiency by discouraging more tobacco use than the harm caused by second-hand smoke might justify. Critics of increases in tobacco taxes contend that there are no good measures of the value of possible external harms from tobacco products.

Some suggest that current pricing practices for medical insurance may create a negative externality. Whereas life insurance policy premium rates often vary based upon whether the consumer is a smoker or a nonsmoker, medical insurance premium rates typically are the same

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720 W. Kip Viscusi, *Smoking: Making the Risky Decision*, (London: Oxford University Press), 1992.

721 Department of Health and Human Services, *The Health Consequences of Involuntary Smoking. A Report of the Surgeon General*, DHHS Publication No. (CDC) 87-8398, 1986.

722 These taxes often are called ``Pigouvian taxes" after economist Alfred Pigou who first proposed such a policy. In the case of a beneficial externality, a subsidy would be provided instead of a tax to encourage the behavior producing the beneficial externality.

regardless of tobacco use by the consumer. If tobacco users have greater insured medical expenses than other consumers, then some of the increased health costs of tobacco use may be borne, not by the tobacco user, but by all consumers in the form of higher insurance premiums.[723] By reducing the incidence of tobacco use, increased tobacco taxes would reduce the magnitude of this problem but, given the current pricing practices for health insurance, the problem will exist as long as anyone uses tobacco.

Other issues related to tobacco taxation

Regressivity.--Excise taxes are perceived as imposing a larger burden on lower-income families (relative to income) than on middle- and higher-income families. Some economists argue that family expenditures may be a better measure of ability to pay than is annual family income. Measured against expenditures, tobacco taxes appear less regressive than when measured against income.[724] Tobacco excise taxes also have a varying impact on families with similar incomes, because the incidence of tobacco use varies across families.

Uneven geographic economic effects.--If increases in tobacco excise taxes succeed in reducing consumption of tobacco products, the domestic tobacco industry may be expected to contract. To the extent that the farming of tobacco and production of tobacco products is geographically specialized, reduction in demand may lead to at least short-term economic dislocations in these geographic areas. For example, unemployment may rise among those currently employed in tobacco farming and tobacco product manufacturing. The severity of this economic dislocation would depend in part on the ability of the affected individuals to gain employment in different industries. Finding new employment may require some individuals to relocate to another region and/or undergo substantial retraining. The major tobacco growing States are North Carolina, Kentucky, and South Carolina, followed by Virginia, Georgia, and Tennessee.

State revenue losses.--In addition to possible economic dislocations in tobacco producing States, substantial reductions in tobacco consumption may be expected to reduce the revenues of all State governments, as all States impose tobacco taxes at the State level. At the present, tobacco taxes are a more important revenue source for States than for the Federal Government. In 1995, States collected $7.3 billion in tobacco tax revenues, representing 1.8 percent of all

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[723] The pricing of many employer-provided retirement annuities has an effect opposite that of the pricing of health insurance. When a retirement annuity is valued based on average life expectancy after retirement, on average, nonsmokers benefit at the expense of smokers, because smokers have a shorter life expectancy. In the case of retirement annuities, such pricing of annuities would overcharge smokers and undercharge nonsmokers.

[724] United States Congress, Congressional Budget Office, *Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels*, June 1990.

State tax receipts. By contrast, the Federal Government collected $5.9 billion in tobacco tax revenues in 1995, representing less than four tenths of one percent of Federal tax receipts.[725]

Higher tobacco prices should induce fewer people to begin to use tobacco products. Thus, even if no existing tobacco users altered their behavior through time, a smaller percentage of the population would use tobacco products. Therefore, an increase in tobacco taxes could be expected to reduce the incidence of tobacco use in the long run, by a greater amount than any reduction achieved in the short run.[726] In the past, in the United States, population growth generally has made up for a reduced incidence of smoking such that the revenue yield of tobacco taxes has increased through time.[727] However, if higher prices induce substantial declines in the incidence of smoking, the short-run revenue yield may overstate the long-run revenue yield. If the tobacco taxes are earmarked for certain programs, the potential for lower revenue in the long run than in the short run may be an important consideration for Government policy.

Reduced use of tobacco products may have an additional effect on State revenues. Pursuant to the 1999 Master Tobacco Settlement cigarette manufacturers are scheduled to make annual payments to States over an extended period. The amount of these ongoing payments is determined in part by reference to production by the signatory manufacturers for domestic consumption. Some States have used Tobacco Settlement payments as security on indebtedness or have based long-term State spending plans on presently projected levels of payments under the settlement. If cigarette consumption declines, which can be expected if cigarette prices rise, payments to the States likewise will decline. Lost revenue from anticipated Tobacco Settlement payments may have to made up from other State sources to avert default on such indebtedness or to fulfill spending commitments.

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[725] Tax Foundation, *Facts & Figures on Government Finance*, (Washington, D.C.: The Tax Foundation), 1995. Some local governments assess additional tobacco taxes. These revenues also would be expected to be reduced by reductions in tobacco consumption.

[726] The Canadian study finds that the price elasticity, that is the behavioral response to price changes, is greater in the short run than in the long run. The study attributes this to the habitual nature of tobacco and argues that at first smokers quit, but that they eventually start smoking again. (See, *Tobacco Taxes and Consumption*.) This analysis does not appear to account for long run aggregate behavior, such as fewer new-starting tobacco users.

[727] This is absent an accounting of tax rate increases. However, if the downward trend in the incidence of smoking continues, lower rates of population growth in the future could cause tobacco revenues to fall in the absence of change in tobacco tax rates.

Prior Action

The President's Fiscal Year 2000 Budget Proposal would have accelerated the January 1, 2000, and January 1, 2002 scheduled tax increases, and would have increased cigarette excise tax rates by an additional 55 cents per pack of 20 cigarettes. Proportional tax increases were proposed on other tobacco products.

4. Repeal harbor maintenance excise tax and authorize imposition of cost-based harbor services user fee

Present Law

Under present law, an excise tax (the "harbor maintenance tax") of 0.125 percent is imposed on the value of commercial cargo (including the value of passenger fares) loaded or unloaded at U.S. ports.[728] The statute provides that the tax applies equally to imported and exported cargo. The tax does not apply to cargo donated for overseas use. The tax also does not apply to cargo (other than cargo destined for a foreign port) shipped between the U.S. mainland and Alaska (other than crude oil), Hawaii, or a U.S. possession. In addition, the tax does not apply to passenger ferry boats operating between points within the United States or between the United States and Canada or Mexico.

Revenues from the harbor maintenance excise tax go to the Harbor Maintenance Trust Fund to finance costs of operating and maintaining U.S. ports.

Art. I, sec. 9, cl. 5 of the United States Constitution provides that "No Tax or Duty shall be laid on Articles exported from any State." In 1998, the U.S. Supreme Court ruled that the harbor maintenance tax, as applied to goods loaded at U.S. ports for export, violated the Constitution's export clause (Art. I, sec. 9, cl. 5), as such tax did not qualify as a user fee.[729]

Description of Proposal

The proposal would replace the current *ad valorem* harbor maintenance excise tax with a "cost-based user fee" referred to as the "harbor services user fee." The new user fee would be available to finance harbor construction, operation, and maintenance activities performed by the Army Corps of Engineers, the costs of operating and maintaining the Saint Lawrence Seaway, and the costs of administering the fee. Additional details of the fee were not included in the President's Budget Proposal.

Effective date.--The proposal would apply after the date of enactment.

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[728] Section 4461.

[729] United States v. United States Shoe Corp., 118 S. Ct. 1290 (1998).

Analysis

In general, a true user fee is a charge levied on a class that directly avails itself of a governmental program, and is used solely to finance that program rather than to finance the costs of government generally. The amount of the fee charged to any payor generally may not exceed the costs of providing the services with respect to which the fee is charged. Fees are not imposed on the general public; there must be a reasonable connection between the payors of the fee and the agency or function receiving the fee.[730]

In United States v. United States Shoe Corp.,[731] the U.S. Supreme Court ruled that the harbor maintenance excise tax of section 4461 was an ad valorem tax on exports which violated the Export Clause of the Constitution (Art. I., sec. 9, cl. 5). In so holding, the Court noted that the section 4461 expressly "imposed a tax on any port use," which was determined solely on an *ad valorem* basis. The Supreme Court did recognize that exporters could legally be subject to user fees which help defray the cost of harbor development and maintenance, so long as these fees "fairly match the exporters" use of port services and facilities" and lack the attributes of a generally applicable tax or duty. The charges must be designed as compensation for government-supplied services, facilities, or benefits.

Prior Action

An identical proposal was included in the President's Fiscal Year 2000 Budget Proposal.

5. Accelerate rum excise tax coverover payments to Puerto Rico and the U.S. Virgin Islands

Present Law

A $13.50 per proof gallon[732] excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States. The excise tax does not apply to distilled spirits that are exported from the United States or to distilled spirits that are consumed in U.S. possessions (e.g., Puerto Rico and the Virgin Islands).

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[730] For a discussion of the constitutional limitations on and congressional jurisdiction over fees and taxes, see Joint Committee on Taxation, *Present Law and Background Information on Federal Transportation Excise Taxes and Trust Fund Expenditure Programs* (JCS-10-96), November 14, 1996, and Joint Committee on Taxation, *Background and Present Law Relating to Funding Mechanisms of the "E-Rate" Telecommunications Program* (JCX-59-98), July 31, 1998.

[731] 118 S. Ct. 1290 (1998).

[732] A proof gallon is a liquid gallon consisting of 50 percent alcohol.

The Code provides for coverover (payment) of $13.25 per proof gallon of the excise tax imposed on rum imported (or brought) into the United States (without regard to the country of origin) to Puerto Rico and the Virgin Islands during the period July 1, 1999 through December 31, 2001. Effective on January 1, 2002, the coverover rate is scheduled to return to its permanent level of $10.50 per proof gallon. The maximum amount attributable to the increased coverover rate over the permanent rate of $10.50 per proof gallon that can be paid to Puerto Rico and the Virgin Islands before October 1, 2000 is $20 million. Payment of this amount was made on January 3, 2000.

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

Description of Proposal

The proposal would repeal the $20 million limit on amounts attributable to the increased coverover rate that can be paid in Fiscal Year 2000.

Effective date.--The proposal would be effective on the date of enactment.

Prior Action

The President's Fiscal Year 2000 Budget Proposal included a proposal that would have increased the coverover rate from $10.50 to $13.50 per proof gallon during a five year period.

The Carribean and Central America Relief and Economic Stabilization Act, as passed by the House of Representatives in 1999, would have increased the rum coverover rate to $13.50 for the period July 1, 1999 through September 30, 1999. The Trade and Development Act of 1999, as passed by the Senate in 1999, included an identical provision to that in the Carribean and Central America Relief and Economic Stabilization Act. The Tax Relief Extension Act of 1999 increased the coverover rate to $13.25 per proof gallon for the period July 1, 1999 through December 31, 2001.

6. Restore premiums to UMWA benefit fund

Present Law

The United Mine Workers of America ("UMWA") Combined Benefit Fund was established by the Coal Industry Retiree Health Benefit Act of 1992 to assume responsibility of payments for medical care expenses of retired miners and their dependents who were eligible for health care from the private 1950 and 1974 UMWA Benefit Plans. The Combined Benefit Fund is financed by assessments on current and former signatories to labor agreements with the UMWA, past transfers from an overfunded United Mine Workers pension fund, and transfers from the Abandoned Mine Land reclamation fund.

Description of Proposal

The proposal would provide for a specified annual transfer general Federal funds to the UMWA Combined Benefit Fund and reverse the effects of the court decision in National Coal v. Chater regarding the calculation of the premiums charged coal companies that had contractually agreed to pay for their miner employees' retirement health benefits.

Prior Action

A similar proposal was included in the President's Fiscal Year 2000 Budget Proposal.