[JOINT COMMITTEE PRINT]

DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1999 BUDGET PROPOSAL

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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CONTENTS

INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of the revenue provisions contained in the President's Fiscal Year 1999 Budget proposal, as submitted to the Congress on February 2, 1999. [2] For the revenue provisions, there is a description of present law and the proposal (including effective date), a reference to any recent prior legislative action or budget proposal submission, and some analysis of related issues. The staff budget estimates of the President's revenue proposals for fiscal years 1998–2008 will be a separate document.

This pamphlet does not include a description of certain proposed user fees (other than those associated with the financing of the Airport and Airway Trust Fund) contained in the President's Fiscal Year 1999 Budget.

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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 1999 Budget Proposal* (JCS–4–98), February 24, 1998.

[2] See Department of the Treasury, *General Explanations of the Administration's Revenue Proposals*, February 1998. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1999: Analytical Perspectives* (H. Doc. 105–177, Vol III), pp. 41–77.

I. PROVISIONS REDUCING REVENUES

A. Child Care Provisions

1. Expand the dependent care tax credit

Present Law

In general

A taxpayer who maintains a household which includes one or more qualifying individuals may claim a nonrefundable credit against income tax liability for up to 30 percent of a limited amount of employment-related dependent care expenses (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.

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

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

The 30-percent credit rate is reduced, but not below 20 percent, by 1 percentage point for each $2,000 (or fraction thereof) of adjusted gross income (AGI) above $10,000. Thus, the credit is never completely phased-out for higher-income individuals.

Interaction with employer-provided dependent care assistance

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

Description of Proposal

The proposal would make several changes to the dependent care tax credit. First, the credit percentage would be increased to 50 percent for taxpayers with an AGI of $30,000 or less. For taxpayers with AGI between $30,001 and $59,000, the credit percentage would be decreased by 1 percent for each $1,000 of AGI, or fraction thereof, in excess of $30,000. The credit percentage would be 20 percent for taxpayers with AGI of $59,001 or greater. Second, 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 child regardless of whether the taxpayer contributed over one-half the cost of maintaining the household. However, in the case of married couple filing separately, the taxpayer claiming the dependent care tax credit would still have to satisfy the present-law household maintenance test to receive the credit. Third, 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.

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

Effective Date

Generally, the proposal would be effective for taxable years beginning after December 31, 1998. The starting point of the phase-down range and the maximum amounts of eligible employment-related expenses would be indexed for inflation for taxable years beginning after December 31, 1999.

Prior Action

The House version of the Taxpayer Relief Act of 1997 would have made two changes relating to the dependent care credit. These changes were not enacted. First, the child tax credit would have been reduced by one-half of the dependent care credit for AGI in excess of $60,000 for married individuals filing a joint return, $33,000 for heads of households and single individuals, and $30,000 for married individuals filing separately. No reduction would have been made with respect to dependents who were physically or mentally incapable of self-care. Second, the sum of the child tax credit and the dependent care credit would have been phased out for taxpayers with modified AGI in excess of certain thresholds. For these purposes, modified AGI would have been computed by increasing the taxpayer's AGI by the amount otherwise excluded from gross income under Code sections 911, 931, and 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). For married individuals filing a joint return, the threshold would have been $110,000. For taxpayers filing as a head of household or a single individual, the threshold would have been $75,000. For married taxpayers filing separate returns, the threshold would have been $55,000.

Analysis

Overview

The proposed expansion of the dependent care tax credit involves several issues. One issue is the government's role in encouraging parents (or "secondary" workers in childless couples) to work in the formal workplace versus in the home. A second issue is the appropriate role of government in providing financial support for child care. A third issue involves the increased complexity added by this proposal and the effect of the phaseout provisions on marginal tax rates. Each of these issues are discussed in further detail below.

Work outside of the home

One of the many factors influencing the decision as to whether the second parent in a two-parent household works outside the home is the tax law. [3] The basic structure of the 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 whose value is formally recognized through the payment of wages. [4] Work in the home, though clearly valuable, bears no taxation. 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. [5] 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 as 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 away, leaving a net wage of less than $10,000. [6] This parent would be better off by staying at home and enjoying the full $10,000 value of home labor without taxation. [7]

Because labor in the home bears no taxation, most economists view the income tax as being biased towards the provision of home labor, resulting in inefficient distribution of labor resources. For ex-

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

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

[5] A neutral position is taken in this analysis as to whether actual parents can provide better care for their own children than can other providers. Thus, since 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 actual parent doing the same work.

[6] 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 will face social security payroll taxes, and may bear 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.

[7] Even with the present lower child care credit, the net wage would still be lower because of the social security taxes and any income taxes for which the taxpayer would be liable.

ample, 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 not feasible for administrative reasons and unfair. The second alternative would be to try to eliminate or reduce the burden of taxation on "secondary" earners when they do enter the formal labor force. This approach has been used in the past through the two-earner deduction (from 1982-1986), which allows a deduction for some portion of the earnings of the lesser-earning spouse.[8] Another approach, and part of present law, is to allow a tax credit for child care expenses, provided both parents (or if unmarried, a single parent) work outside the home. This latter approach is targeted at 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 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 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. If the objective were to further assist all families with children, including those with insufficient income to owe taxes, one would need to make the child credit refundable.

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's bias against work outside of the home. However, the increase in the number of two-parent families where both parents work might suggest that any bias against work outside of the home must have been mitigated by other forces, such as perhaps increased wages available for work outside of the home. Others would argue that the increasing number of two-earner couples with children is not the result of any reduction in the income tax's bias against work outside of the home, but rather reflects economic necessity in many cases.

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

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. 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 tax Code does not adequately account for a family with children's decreased ability to pay taxes.

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 married couples with children in which both parents work are often affected by the so-called marriage penalty.[9] 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.[10]

Thus, in general, the marriage penalty creates an incentive for one of the parents to stay at home. Proposals to eliminate or reduce the marriage penalty that do not also increase the marriage bonus may imply that there will be greater incentives for both parents to work outside of the home. For example, the marriage penalty proposals that would tax the husband and wife separately at the single schedule, thus eliminating the marriage penalty, would imply that the stay-at-home parent would now face a tax liability on any labor income that is lower than he or she would have faced if the couple were taxed under the married joint schedule of present law. Hence, this taxpayer would have a greater incentive to work outside the home.

The appropriate role of government

Another argument against the proposal is that, by giving an increased amount of credit based on money spent for child care, the proposal contributes to a distortion away from other forms of consumption and an incentive to overspend on child care. A counterargument is that there are positive externalities to quality child care, and thus a distortion that encourages additional spending on child care is good for society. However, opponents would counter this argument with a similar argument that the best quality child care will come from the actual parents, and thus if there should be any bias in the provision of child care for reasons of quality it should be a bias towards parents providing their own child care. Such an argument is less tenable, however, for single parents for whom work outside of the home is a necessity. Another response is that, given the assumption that the government should subsidize child care, there are better ways to improve availability and affordability of adequate child care than through the tax code. It is possible that a direct spending initiative would be more efficient and administrable.

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

[10] Married couples with children in which both spouses work and that receive a marriage bonus would also benefit from the dependent care proposal.

Complexity and marginal rate issues

Some argue that the increased number (see the discussion of the employer tax credit for expenses of supporting employee child care in Part I.A.2., below of this pamphlet) and complexity of provisions in the tax code for social purposes (e.g., this proposal) complicates the tax system and undermines the public's confidence in the fairness of the income tax. Others respond that tax fairness should sometimes outweigh simplicity for purposes of the tax Code.

Some argue that the replacement of the maintenance of household test with a residency test 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 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 raise the tax policy issue of complexity. 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 and thus have their marginal tax rates raised by this proposal relative to current law, which phases out a portion of the credit over the income range of $10,000 to $30,000. The increased number of families required to apply a phase-out alone is an increase in complexity. Additionally, the taxpayer's phaseout occurs at a steeper rate 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 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.[11]

2. Employer tax credit for expenses of supporting employee child care

Present Law

Generally, present law does not provide a tax credit to employers for supporting child care or child care resource and referral serv-

[11] 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.

ices.[12] An employer, however, may be able to claim such expenses as deductions for ordinary and necessary business expenses. Alternatively, the taxpayer may be required to capitalize the expenses and claim depreciation deductions over time.

Description of Proposal

Employer tax credit for supporting employee child care

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

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

Employer tax credit for child care resource and referral services

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

Other rules

A taxpayer's total of these credits would be limited to $150,000 per year. Any amounts for which the taxpayer may otherwise claim a tax deduction would be reduced by the amount of these credits. Similarly, if the credits are taken for expenses of acquiring, constructing, rehabilitating, or expanding a facility, the taxpayer's basis in the facility would be reduced by the amount of the credits.

Effective Date

The credits would be effective for taxable years beginning after December 31, 1998.

[12] 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.

Prior Action

The Senate version of the Taxpayer Relief Act of 1997 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. This provision was not included in the final conference agreement of the Taxpayer Relief Act of 1997.

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 for nonprofit child care providers who cannot take advantage of these new tax benefits.

Opponents of the proposal argue that adding complexity to the tax Code can undermine the public's confidence in the fairness of the tax Code, 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.

B. Energy and Environmental Tax Provisions

1. Tax credits

a. Tax credit for energy-efficient building equipment

Present Law

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

A 10-percent 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, and which meet performance and quality standards prescribed by the Secretary of the Treasury (after consultation with the Secretary of the Energy). Public utility property does not qualify for the credit (sec. 48B(a)).

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 would be provided for the purchase of certain types of highly energy-efficient building equipment: fuel cells, electric heat pump water heaters, advanced natural gas and residential size electric heat pumps, and advanced central air conditioners. The credit would equal 20 percent of the purchase price, subject to a cap. The credit would be nonrefundable. For businesses, it would be subject to the limitations on the general business credit and would reduce the basis of the equipment.

To be eligible for the credit, the specific technologies would have to meet the following criteria:

Fuel cells generate electricity and heat using an electrochemical process. To qualify for the credit, fuel cell technologies would be required to have an electricity-only generation efficiency greater than 35 percent. Fuel cells with a minimum generating capacity of 50 kilowatts would be eligible for the credit.

Electric heat pump hot water heaters use electrically powered vapor compression cycles to extract heat from air and deliver it to a hot water storage tank. Qualifying heat pump water heaters would be required to yield an Energy Factor greater than or equal to 1.7 in the standard Department of Energy ("DOE") test procedure.

Electric heat pumps ("EHP") use electrically powered vapor compression cycles to extract heat from air in one space and deliver it to air in another space. EHP technologies with a heating efficiency greater than or equal to 9 HSPF and a cooling efficiency greater than or equal to 15 SEER would qualify for the credit.

Natural gas heat pumps use 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. Qualifying natural gas heat pumps would be those with a coefficient of performance for heating of at least 1.25 and for cooling of at least 0.70.

Central air conditioners would be required to have an efficiency equal to or greater than 15 SEER to qualify for the credit.

Advanced natural gas water heaters use a variety of mechanisms to increase steady state efficiency and reduce standby and vent losses. Only natural gas water heaters with an energy factor of at least 0.80 in DOE test procedures would qualify for the credit.

Effective Date

The credit would generally be available for final purchases from unrelated third parties between December 31, 1999, and before January 1, 2004, for use within the United States. The credit for fuel cells would be available for purchases after December 31, 1999, and before January 1, 2005.

Prior Action

No prior action.

b. Tax credit for purchase of new energy-efficient homes

Present Law

No deductions or credits are provided currently 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. To claim the credit, the taxpayer must use the new home as the taxpayer's principal residence, and the new home must use at least 50 percent less energy for heating, cooling and hot water than the Model Energy Code standard for single family residences. The tax credit would be one percent of the purchase price of the home up to a maximum credit of $2,000 for eligible homes purchased in the five-year period beginning January 1, 1999, and ending December 31, 2003. The credit would be available for an additional two years, i.e., for homes purchased January 1, 2004, through December 31, 2005, with a maximum credit of $1,000.

Effective Date

The credit would generally be available for final homes purchased after December 31, 1998, and before January 1, 2006.

Prior Action

No prior action.

c. Tax credit for high-fuel-economy 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 begins to phase down in 2002 and phases out in 2005.

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.

Description of Proposal

The proposal would provide two temporary tax credits for the purchase of fuel efficient vehicles:

(1) *Credit for vehicles with triple the base fuel economy.*—This credit would be $4,000 for each vehicle that has three times the base fuel economy for its class. The $4,000 credit would be available for purchases of qualifying vehicles after December 31, 2002, and before January 1, 2007. The credit amount would phase down to $3,000 in 2007, $2,000 in 2008, and $1,000 in 2009, and would phase out in 2010.

(2) *Credit for vehicles with twice the base fuel economy.*—This credit would be $3,000 for each vehicle that has twice the base fuel economy for its class. The $3,000 credit would be available for purchases of qualifying vehicles after December 31, 1999, and before January 1, 2004. The credit amount would phase down to $2,000 in 2004, $1,000 in 2005, and would phase out in 2006.

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

Effective Date

The credit would generally be available for vehicles purchased January 1, 1999, and December 31, 2010.

Prior Action

No prior action.

d. Tax credit for combined heat and power ("CHP") systems

Present Law

Combined heat and power ("CHP") systems are used to produce electricity and process heat and/or mechanical power from a single primary energy source. A tax credit is currently not available for investments in CHP systems.

Depreciation allowances for CHP property vary by asset use and capacity. Assets employed in the production of electricity with rated total capacity in excess of 500 kilowatts, or employed in the production of steam with rated total capacity in excess of 12,500 pounds per hour, and used by the taxpayer in an industrial manufacturing process or plant activity (and not ordinarily available for sale to others), have a general cost recovery period of 15 years. Electricity or steam production assets of lesser rated capacity generally are classified with other manufacturing assets and have cost recovery periods of five to ten years. Assets used in the steam power production of electricity for sale, including combustion turbines operated in a combined cycle with a conventional steam unit, have a 20-year recovery period. Other turbines and engines used to produce electricity for sale have a 15-year recovery period. Assets that are structural components of buildings have a recovery period of either 39 years (if nonresidential) or 27.5 years (if residential). For assets with recovery periods of 10 years or less, the 200-percent declining balance method may be used to compute depreciation allowances. The 150-percent declining balance method may be used for assets with recovery periods of 15 or 20 years. The straight-line method must be used for buildings and their structural components.

Description of Proposal

The proposal would establish a 10-percent tax credit for certain CHP systems with an electrical capacity in excess of 50 kilowatts (or with a capacity to produce mechanical power equivalent to 50 kilowatts). Investments in qualified CHP systems that are assigned cost recovery periods of less than 15 years would be eligible for the credit, provided that a 15 year recovery period and 150-percent declining balance method are utilized to calculate depreciation allowances. Property placed in service outside the United States would be ineligible for the credit.

A qualified CHP system would be defined as equipment used in the simultaneous or sequential production of electricity, thermal energy (including heating and cooling and/or mechanical power), and mechanical power. A qualified CHP system would be required to produce at least 20 percent of its total useful energy in the form of both (1) thermal energy, and (2) electric and/or mechanical power. For CHP systems with an electrical capacity of 50 megawatts or less, the total energy efficiency of the system would have to be greater than 60 percent. For larger systems, the total energy efficiency would have to exceed 70 percent. For this purpose, total energy efficiency would be calculated as the sum of the useful electrical, thermal, and mechanical power produced, measured in Btus, divided by the lower heating value of the primary energy supplied. Taxpayers would be required to obtain proper certification by qualified engineers for meeting the energy efficiency and percentage-of-energy tests, pursuant to regulations to be issued by the Secretary of the Treasury.

The credit would be subject to the limitations on the general business credits. The depreciable basis of qualified property for which the credit is taken would be reduced by the amount of the credit. Regulated public utilities claiming the credit would be required to use a normalization method of accounting with respect to the credit. Taxpayers using the credit for CHP systems would not be entitled to any other tax credit for the same equipment.

Effective Date

The credit would apply to investments in CHP systems placed in service after December 31, 1998, but before January 1, 2004.

Prior Action

No prior action.

e. Tax credit for replacement of certain circuit breaker equipment

Present Law

No tax credits are provided currently for the purchase of large power circuit breakers used in the transmission and distribution of electricity.

Description of Proposal

A tax credit would be available for the installation of new power circuit breaker equipment to replace certain older power circuit breakers. The tax credit would be 10 percent of qualified investment. To be eligible for the credit, the replaced power circuit breakers must be dual pressure circuit breakers that contain sulfur hexaflouride ("SF6"), have a capacity of at least 115kV, and have been installed by December 31, 1985. The replaced circuit breaker equipment must be destroyed so as to prevent its further use. The credit would be subject to the limitations on the general business credit. The depreciable basis of qualified property for which the credit is taken would be reduced by the amount of the credit claimed.

Effective Date

The credit would be available for new equipment placed in service in the five year period beginning January 1, 1999, and ending December 31, 2003.

Prior Action

No prior action.

f. Tax credit for certain perfluorocompound ("PFC") and hydroflurocarbon ("HFC") recycling equipment

Present Law

No tax credits are provided currently for the purchase of perfluorocompound ("PFC") and hydrofluorocarbon ("HFC") recycling equipment. Semiconductor manufacturers who install equipment to recover or recycle PFC and HFC gases used in the production of semiconductors may depreciate the cost of that equipment over 5 years.

Description of Proposal

A tax credit would be available for the installation of PFC and HFC recovery/recycling equipment in semiconductor manufacturing plants. The tax credit would be 10 percent of qualified investment. The credit would be subject to the limitations on the general business credit. The depreciable basis of qualified property for which the credit is taken would be reduced by the amount of the credit claimed. Equipment would qualify for the credit only if it recovers at least 99 percent of PFCs and HFCs.

Effective Date

The credit would apply to property placed in service after December 31, 1999, and before January 1, 2004.

Prior Action

No prior action.

g. Tax credit for rooftop solar equipment

Present Law

Nonrefundable business energy tax credits are allowed for 10 percent of the cost of qualified solar and geothermal energy property (sec. 48(a)). Solar energy property that qualifies for the credit includes any equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat.

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).

Description of Proposal

A tax credit would be available for purchasers of rooftop photovoltaic systems and solar water heating systems located on or adjacent to the building for uses other than heating swimming pools. The credit would be equal to 15 percent of qualified investment up to a maximum of $1,000 for solar water heating systems and $2,000 for rooftop photovoltaic systems. This credit would be nonrefundable. For businesses, this credit would be subject to the limitations of the general business credit. The depreciable basis of the qualified property would be reduced by the amount of the credit claimed. Taxpayers would have to choose between the proposed credit and the present business energy credit for each investment.

Effective Date

The proposal would be effective for equipment placed in service after December 31, 1998 and before January 1, 2004 for solar water heating systems, and for equipment placed in service after December 31, 1998 and before January 1, 2006 for rooftop photovoltaic systems.

Prior Action

No prior action.

h. Extend wind and biomass tax credit

Present Law

An income tax credit is allowed for the production of electricity from either qualified wind energy or qualified “closed-loop” biomass facilities (sec. 45). The credit is equal to 1.5 cents (plus adjustments for inflation since 1992) per kilowatt hour of electricity produced from these qualified sources during the 10-year period after the facility is placed in service.

The credit applies to electricity produced by a qualified wind energy facility placed in service after December 31, 1993, and before July 1, 1999, and to electricity produced by a qualified closed-loop biomass facility placed in service after December 31, 1992, and before July 1, 1999. Closed-loop biomass is the use of plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not apply to the use of waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). It also does not apply to taxpayers who use standing timber to produce electricity. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party.

The credit for electricity produced from wind or closed-loop biomass is a component of the general business credit (sec. 38(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. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one taxable year and carried forward 20 taxable years.

Description of Proposal

The proposal would extend for five years the placed in service date for the income tax credit for electricity produced from wind and closed-loop biomass. Thus, the credit would be available for qualifying electricity produced from facilities placed in service before July 1, 2004. As under present law, the credit would be allowable for a period of ten years after the facility is placed in service.

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

A provision to extend this credit for two years (i.e., for facilities placed in service before July 1, 2001), was included in the Senate version of the Taxpayer Relief Act of 1997, but was not included in the final conference agreement. A provision to sunset the credit was included in the House version of the Balanced Budget Act of 1995.

Analysis for a.–h.

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.[13] 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 is said to exist. When negative externalities exist, there will be overconsumption of the good causing the negative externality relative to what would be socially optimal. When positive externalities exist, there will be underconsumption or production of the good producing the positive externality. The reason for the overconsumption or underconsumption 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 wil 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 pollu-

[13] It should be noted that the social cost or benefit includes the cost or benefit to the individual actually doing the consuming or producing.

tion. 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.[14] The basic difference between these two approaches is a question of who 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

Seven of the President's revenue 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.[15] The following general analysis of targeted 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.[16] 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

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[14] It should be noted that 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 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.

[15] Another credit proposal, a production credit for electricity produced from wind or biomass, is discussed below.

[16] Investment in education is often cited as an example where the social return may exceed the private return, i.e., there are positive externalities.

percent would be necessary. Even if the cost of the credit led to tax increases for the third parties, they would 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).[17]

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 may be more appropriate. For example, with respect to the President's proposal to provide a tax credit for the replacement of certain circuit breaker equipment because of the sulfur hexaflouride gas that they can leak, it would likely be impractical to set a tax on any leaking that occurs and to monitor the leaking. The President's proposal to provide a tax credit for their replacement could be the best policy because of its simplicity.[18]

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 gen-

[17] 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* 75, 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* 38, June 1985, pp. 125–40.

[18] The same result could be effected through a direct mandate to replace the equipment, or a sufficiently high tax on the continued use of the old circuit breakers (as opposed to a tax on the leaking of the sulfur hexaflouride gas). This, again, is a question of who should bear the costs of the replacement.

eral credit would subsidize much activity that would have taken place anyway.[19]

Targeted credits like the President's 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.[20] Thus, investment that would take place anyhow is not subsidized, because there presumably is not much of such investment taking place. The presumption behind the targeted tax credits in the President's budget proposals 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 equalize 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. One proposal, the credit for rooftop solar equipment, has 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. 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.

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

[19] 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 States," *Journal of Public Economics*, Vol. 47, No. 2, March 1992.

[20] 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.

to the investments.[21] 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.[22] 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.

Production credit for wind and biomass

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 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

[21] 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.

[22] 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.

be considered an economically inefficient outcome unless there are positive externalities to the production of the good that exceed the value of the credit.[23] 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.

2. Other provisions

a. Tax treatment of parking and transit benefits

Present Law

Under present law, qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income. Qualified transportation fringe benefits include parking, transit passes, and vanpool benefits. In addition, in the case of employer-provided parking, no amount is includible in income of an employee merely because the employer offers the employee a choice between cash and employer-provided parking. Transit passes and vanpool benefits are only excludable if provided in addition to, and not in lieu of, any compensation otherwise payable to an employee. Under present law, up to $175 per month (for 1998) of employer-provided parking and up to $65 per month (for 1998) of employer-provided transit and vanpool benefits are excludable from gross income. These dollar amounts are indexed for inflation.

Description of Proposal

The proposal would permit employers to offer their employees transit and vanpool benefits in lieu of compensation. The proposal would also raise the monthly limit on employer-provided transit and vanpool benefits excludable from gross income to the limit on employer-provided parking benefits ($175). As under present law, this amount would be indexed for inflation.

Effective Date

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

Prior Action

No prior action.

Analysis

The proposal would equalize the tax treatment of employer-provided transit and vanpool benefits with the tax treatment of em-

[23] 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.

ployer-provided parking benefits. This equalization would appear to eliminate the tax disincentives for providing transit and vanpool benefits relative to parking benefits. In addition, it would eliminate possible confusion for employers that inadvertently structure a transit program that offers cash in lieu of parking and other transit benefits. In such cases, the employer may intend the program to qualify for tax exclusion, but it may result in taxation.

On the other hand, some question whether it is appropriate to provide a cash election for any transportation benefits, as this merely allows employees to convert taxable income into nontaxable income.

The equalization of the tax treatment of transit benefits and parking benefits is economically desirable in the sense that it eliminates a distortion that currently favors parking benefits, and hence driving to work, over transit benefits that encourage use of public transportation (and the latter is recognized to be more energy efficient, producing less pollution per passenger-mile). However, the proposal represents further subsidies to transportation in general, and thus encourages more use of transportation over other goods.[24] Such subsidies are only desirable if we believe that, from a social perspective, expenditures on transportation have positive externalities. In general, the opposite view is held, as the burning of fossil fuels in transportation is a major source of pollution. Furthermore, additional use of transportation also causes more congestion, which has a negative impact on all users of the transportation infrastructure. Such subsidies may encourage people to live further from their place of work than they otherwise would, which requires more energy consumption to get to work. Furthermore, such subsidies encourage the use of cars or public transportation, both of which use fossil fuels, over more environmentally friendly forms of transportation such as walking or bicycling to work, or telecommuting from home, which do not benefit from any special tax incentives.

b. Permanent extension of expensing of environmental remediation costs ("brownfields")

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

[24] An alternative proposal would have been to equalize the treatment of parking benefits by putting them on the same footing as transit under current law, rather than the other way around. This would have represented less of a subsidy to transportation in general.

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.*[25] 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[26] (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 deduc-

[25] *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)).

[26] 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.

tion 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.

The provision applies only to eligible expenditures paid or incurred in taxable years ending after August 5, 1997, and before January 1, 2001.

Description of Proposal

The proposal would eliminate the requirement that expenditures must be paid or incurred in taxable years ending before January 1, 2001, 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.

Prior Action

The special expensing for environmental remediation expenditures was enacted as part of the Taxpayer Relief Act of 1997.

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.[27] 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.

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.

C. Retirement Savings Provisions

1. Access to payroll deduction for retirement savings

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 contribution rules.

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 Employer 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 the employer merely withholds amounts from the employee's paycheck and forwards them to the employee's IRA. 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.

[27] 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*, 7 (Cambridge, MA: The MIT Press), 1993.

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 and would be reported as a contributions to an IRA on the employee's W-2. In the event the amounts would not have been deductible had the employee contributed directly to an IRA, the employee would be required to include the amounts in income on the employee's tax return.

Effective Date

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

Prior Action

No prior action.

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 deductions, the proposal is designed to make it more attractive (and more widely utilized) by providing employees with a convenient way to obtain the tax benefit for IRA contributions that will eliminate the need for many employees to report the contributions on their tax returns and enable some employees to use simpler tax forms. The proposal does not increase the present-law benefit of making contributions to an IRA.

It is not clear whether the proposal will have the desired effect. Increased IRA participation may not result because there is no change in the economic incentive to make 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 taxpayer 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. 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, the proposal does not address certain fiduciary issues under the present-law ERISA rules. Without some modification, employers may be unwilling to establish payroll deduction plans out of concern that they will be considered plan fiduciaries.[28]

The exclusion provided by the proposal may be confusing for some employees (e.g., employees who simultaneously participate in a qualified plan and who have AGI in excess of $50,000). They 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.

2. Small business tax credit for retirement plan start-up expenses

Present Law

Under 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, etc.) generally are deductible by the employer as an ordinary and necessary expense in carrying on a trade or business.

Description of Proposal

The proposal would provide a three-year tax credit, in lieu of a deduction, for 50 percent of the administrative and retirement-education expenses for any small business that adopts a new qualified defined benefit or defined contribution plan (including a section 401(k) plan), SIMPLE 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 employers that did not employ, in the preceding year, more than 100 employees with compensation in excess of $5,000, but only if the employer did not have a retirement plan or payroll deduction IRA arrangement during any part of 1997. In order for an employer to get the credit, the plan would have to cover at least two individuals. In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement would have to be made available to all employees of the employer who have worked with the employer for at least three months.

The small business tax credit would be treated as a general business credit and the standard carry forward and backward rules would apply.

Effective Date

The credit would be effective beginning in the year of enactment and would be available only for plans established on or before December 31, 2000. For example, if an eligible employer adopted a

[28] The Administration has indicated that the Department of Labor will address fiduciary issues relating to payroll deduction IRAs.

plan in the year 2000, the credit would be available for the years 2000, 2001, and 2002.

Prior Action

No prior action.

Analysis

Establishing and maintaining a qualified plan involves employer administrative costs both for initial start-up of the plan and for ongoing 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. Thus, for costs incurred or $C, the net, after-tax cost is $C(1–t) where t is the employer's marginal tax rate. The employer's tax rate may be either the applicable corporate tax rate or individual marginal tax rate, depending on the form in which the employer does business (e.g., as a C corporation or a sole proprietor). Under the proposal, a 50-percent credit could be claimed for eligible costs in lieu of the deduction. Thus for qualifying costs, C, the net cost to the employer would be C(1–0.5) or (.5)C. The proposal would reduce the cost of establishing a plan by the difference between the employer's marginal tax rate and 50 percent multiplied by up to $2,000 in the first year or by up to $1,000 in the second or third years. At most the cost reduction would be $700 (the difference between the lowest marginal tax rate of 15 percent and the proposed credit rate of 50 percent multiplied by $2,000) in the first year and $350 for the second and third years. The additional cost saving under the proposal compared to present law could be as little as $208 in the first year and $104 dollars in the second and third years. For a taxpayer in the 39.6-percent marginal income tax bracket.

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.

3. Simplified pension plan for small business ("SMART")

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. 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. Employers are required to make either a matching contribution of up to 3 percent of the employee's compensation or, alternatively, the employer can elect to make a lower percentage contribution on behalf of all eligible employees. 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 made to individual retirement arrangements ("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 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 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).

Employer and employee eligibility and vesting

The SMART Plan could be adopted by an employer who (1) employs 100 or fewer employees who received at least $5,000 in compensation in the prior year, (2) is not a professional service employer (i.e., an employer substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial services, performing arts, or consulting), and (3) has not maintained a defined benefit pension plan or money purchase pension plan within the preceding five years. All employees who have completed two years of service with at least $5,000 in compensation and who are reasonably expected to receive $5,000 in compensation in the current year would participate in the 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. 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 for a year would be $100,000 (indexed for inflation). Each year the employer would be required to contribute an amount 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. If the investment returns exceed the 5 percent assumption, the employee would be entitled to the larger account balance. 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 where 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 benefits under qualified plans. 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 matching 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. Vendors and employers would have the option of using their own documents instead of the models.

Coordination with IRA deduction rules.—SMART Plans would be treated as qualified plans for purposes of the IRA deduction phaseout 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 1998.

Prior Action

A similar proposal (H.R. 1656) was introduced in the House in 1997.

Analysis

Under present law, small businesses have many options available for providing retirement benefits for their employees, including establishing 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 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 $130,000 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. It also may be that the costs of contributing to a plan are too high for small employers. Providing small business employers with an additional option for providing retirement benefits for their employees, the SMART Plan may provide greater benefits for employees while reducing the costs of establishing and maintaining a retirement plan. However, there is an issue concerning which employees will actually benefit from participating in a SMART Plan. Because the SMART Plan benefits are based on a formula that takes into account a participant's age and years of service with the employer who established the SMART Plan, those older employees with long service records will receive the greatest benefits. In many cases, the older employees with the longest service records will be the higher paid employees. Generally, younger employees with shorter service records would receive a greater benefit under a defined contribution plan, SIMPLE or SEP.

4. Faster vesting for employer matching contributions

Present Law

Under present law, a participant's employer-provided benefits under a qualified plan must either be fully vested after the participant has completed 5 years of service, or must become vested in increments of 20 percent for each year beginning after 3 years of service, with full vesting after the participant completes 7 years of service. 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. Employer matching contributions on behalf of a participant under a section 401(k) plan are generally subject to these vesting rules. However, employer matching contributions that are treated as elective contributions for purposes of the actual deferral percentage test under section 401(k) ("qualified matching contributions") must be fully vested immediately.

Description of Proposal

Under the proposal, employer matching contributions under 401(k) plans (or other qualified plans) would be required either to be fully vested after an employee has completed 3 years of service, or to become vested in increments of 20 percent for each year beginning after the employee has completed 2 years of service, with full vesting after the employee has completed 6 years of service.

Qualified matching contributions used to satisfy the 401(k) actual deferral percentage test would continue to be fully vested immediately, as under present law.

Effective Date

The proposal would be effective for plan years beginning after December 31, 1998, with an (unspecified) extended effective date for plans maintained pursuant to a collective bargaining agreement.

Prior Action

No prior action.

Analysis

The popularity and importance of 401(k) plans has grown substantially over the years. Employers often choose to contribute to 401(k) plans by matching the salary reduction contributions made by employees. The general justification for accelerating the vesting of employer matching 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 matching 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 matching contributions may reduce overall retirement savings by making plans more expensive for some employers. Because matching contributions that are forfeited are used by some employers to reduce the contributions of the employer in subsequent years, these employers may find that the shorter vesting period increases their plan costs. This could cause employers to eliminate or reduce the matching contribution. 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 or to reduce training to balance against whatever costs accelerated vesting may create.

5. Pension "right to know" provisions

Present Law

Spouse's right to know distribution information

In general, a qualified pension plan is required to provide automatic survivor benefits for married participants. In the case of a married participant who commences distribution of retirement benefits, the benefit must be distributed in the form of a qualified joint and survivor annuity. A qualified joint and survivor annuity distributes the retirement benefit over the life of the participant and continues to pay at least one-half of the benefit amount to the surviving spouse following the participant's death. In the case of a married participant who dies prior to the commencement of retirement benefits, the surviving spouse must be provided with a qualified preretirement survivor annuity. A qualified preretirement survivor annuity provides the surviving spouse with a benefit that is not less than what would have been paid under the survivor portion of the qualified joint and survivor annuity. Certain defined contribution plans, (such as profit sharing and 401(k) plans) are not required to provide these survivor annuities provided certain conditions are satisfied, including that the spouse be the beneficiary of the participant's entire account balance.

Plans subject to the survivor annuity requirements may permit participants to waive the right to receive these annuities provided certain conditions are satisfied. In general, these conditions include (1) providing the participant with a written explanation of the terms and conditions of the survivor annuity, (2) the right to make, and the effect of, a waiver of the annuity, (3) the rights of the spouse to waive the survivor annuity, and (4) 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.

Election periods and right to know employer contribution formula

Under present law, there are certain nondiscrimination tests that 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 a specified percentage. The ACP test is similar but it tests the average contribution percentages 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. If the employees are provided a specified matching contribution (or a specified nonelective contribution), the employer can avoid all ADP and ACP testing of employee elective contributions and employer matching contributions. There are similar safe-harbor designs under the SIMPLE plan and the SIMPLE 401(k) plan. Under the SIMPLE plans, employees must be provided annual 60-day election periods and notification tied to those election periods. Unlike the SIMPLE plans, for 401(k) plans using the safe harbor designs there are no specific requirements that prescribe the length and frequency of the election period or that tie the timing of the notice describing employee rights and obligations under the plan.

Description of Proposal

Spouse's right to know distribution information

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

Election periods and right to know employer contribution formula

The proposal would require employers who use one of the safe harbor designs to avoid ADP and ACP testing to provide notice and contribution opportunities comparable to those provided under SIMPLE plans. Thus, employees would have to be offered an opportunity to elect to make contributions (or modify a prior election) during a 60-day period before the beginning of each year and a 60-day period when they first become eligible. In addition, the present law requirement that employers provide employees with notice of their rights to make contributions and notice of the safe harbor contributions formula the employer is currently using (in order to notify employees of their rights and obligations) would be modified to require the notice within a reasonable period of time before the 60-day periods begin rather than before the beginning of the year.

Effective Date

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

Prior Action

No prior action.

Analysis

The pension right to know proposals would add two new plan administration requirements. In one case, additional information must be provided to spouses of plan participants and in the other case employees must be provided specified notice and election periods when an employer chooses to use the 401(k) safe harbors. In both cases, it can be argued that the requirements are necessary so that the individuals affected understand their rights and have the opportunity to make informed decisions regarding their benefit entitlements. On the other hand, the proposals may add to the costs of sponsoring a plan.

6. Simplified method for improving benefits of nonhighly compensated employees under the safe harbor for 401(k) 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 contribution or a specified 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 would have to make nonelective contributions of at least three percent of compensation for each nonhighly compensated employee eligible to participate in the plan. Alternatively, under the other safe harbor, the employer would have to make a 100 percent matching contribution on an employee's elective contributions up to the first 3 percent of compensation and a matching contribution of at least 50 percent on the employee's elective contributions up to the next 2 percent of compensation.

Description of Proposal

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

Effective Date

The proposal would be effective for years beginning after December 31, 1998, when the 401(k) designed-based safe harbors become effective.

Prior Action

No prior action.

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 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.

7. 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 years beginning after December 31, 1998.

Prior Action

No prior action.

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.

8. Simplify 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 $130,000 (for 1998) 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.

Description of Proposal

Under the proposal, the 100-percent-of-compensation limit on defined benefit plan benefits would not apply to multiemployer plans. In addition, certain survivor and disability benefits payable under multiemployer plans would be exempt from the adjustments for early commencement of benefits and for participation and service of less than 10 years.

Effective Date

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

Prior Action

The proposal was included in the Administration's 1995 Pension Simplification Proposal,[29] in the Small Business Job Protection Act of 1996 as passed by the Senate, and in the Taxpayer Relief Act of 1997 as passed by the Senate.

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 not compensation. In addition, it is argued that 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.

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 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 is not appropriate, it is not clear why only participants in multiemployer plans should receive the benefit of a higher limit.

9. Simplify 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 150 percent of current liability. The 150 percent of

[29] See Department of the Treasury, Department of Labor, *General Explanation of the Administration's Pension Simplification Proposal* (September 1995).

current liability limit is scheduled to increase gradually, beginning in 1999, 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 years beginning after December 31, 1998.

Prior Action

The proposal was included in the Administration's 1995 Pension Simplification Proposal.[30]

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 was increased in 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.

Others argue that the proposal should be extended to all collectively bargained plans (i.e., including single-employer plans).

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[30] *Ibid.*

10. Eliminate partial termination rules for multiemployer plans

Present Law

Under present law, tax-qualified plans are required to provide that plan benefits become 100 percent vested (to the extent funded) upon the termination or partial termination of a plan. Whether a partial termination has occurred in a particular situation is generally based on all the facts and circumstances. Situations that can result in a partial termination include, for example, the exclusion from the plan of a group of employees previously covered under the plan due to a plan amendment or termination of employment by the employer. In addition, if a defined benefit plan stops or reduces future benefit accruals under the plan, a partial termination of the plan is deemed to occur if, as a result of the cessation or reduction in accruals a potential reversion to the employer or employers maintaining the plan is created or increased. If no such reversion is created or increased, a partial termination is not deemed to occur; however, a partial termination may be found to have taken place under the generally applicable rule.

Description of Proposal

The requirement that plan participants must be 100-percent vested upon partial termination of a plan would be repealed with respect to multiemployer plans.

Effective Date

The proposal would be effective with respect to partial terminations that begin after December 31, 1998.

Prior Action

The proposal was included in the Administration's 1995 Pension Simplification Proposal and in the Taxpayer Relief Act of 1997 as passed by the Senate.[31]

Analysis

The partial termination rules help to protect the benefits of plan participants in circumstances that do not give rise to a complete termination. In some cases, the partial termination rules prevent avoidance of the rule requiring vesting upon complete termination.

Proponents of the proposal argue that the partial termination rules are not necessary to protect multiemployer plan participants in the case of terminations due to reductions in force, because the multiemployer plan structure itself provides protections. That is, participation in the plan is not tied to employment with a particular employer, so that an individual who terminates employment with one employer may continue participation in the plan if the individual is employed by an employer participating in the plan.

Others question whether the plan structure will protect participants in the same manner as the partial termination rules. There

[31] *Ibid.*

is no assurance that an individual will continue participation in the plan after an event that would give rise to a partial termination. In addition, others argue that the multiemployer plan structure provides no special protection if the partial termination is due to a plan amendment regarding eligibility or due to cessation or reduction of accruals under a defined benefit pension plan.

D. Education Tax Provisions

1. Tax credits for holders of qualified school modernization bonds and qualified zone academy 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

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

The Treasury Department will set the credit rate each month 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 in a given month also 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. Such present value will be determined using as a discount rate the average annual interest rate of tax-exempt obligations with a term of 10 years or more issued during the month.

"Qualified zone academy bonds" are 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.

A school is a "qualified zone academy" if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community (including empowerment zones designated or authorized to be designated[32]), 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.

A total of $400 million of "qualified zone academy bonds" may be issued in each of 1998 and 1999. The $400 million aggregate bond cap will be allocated each year to the States according to their respective populations of individuals below the poverty line.[33] Each State, in turn, will allocate the credit to qualified zone academies within such State. A State may carry over any unused allocation into subsequent years.

Description of Proposal

Qualified zone academy bonds

The proposal would increase the aggregate bond cap for qualified zone academy bonds for 1999 from $400 million to $1.4 billion. In addition, the proposal would authorize the issuance of an additional $1.4 billion of qualified zone academy bonds for 2000. As under present law, the aggregate bond cap would be allocated to the States according to their respective populations of individuals below the poverty line, and States could carry over unused allocations into subsequent years.

The proposal also would expand the list of permissible uses of proceeds of qualified zone academy bonds to include new school construction. Moreover, the proposal would set the maximum term of qualified zone academy bonds at 15 years.

Qualified school modernization bonds

Under the proposal, State and local governments would be able to issue "qualified school modernization bonds" to fund the construction or rehabilitation of public schools. Similar to the tax benefits available to holders of qualified zone academy bonds, the holders of qualified school modernization bonds would receive annual Federal income tax credits in lieu of interest payments. Because the proposed credits would compensate the holder for lending money, such credits would be treated as payments of interest for Federal income tax purposes and, accordingly, would be included in the holder's gross income. As with qualified zone academy bonds, the "credit rate" for qualified school modernization bonds would be set by the Secretary of the Treasury so that, on average, such

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[32] Pursuant to the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), the Secretaries of the Department of Housing and Urban Development (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994 (sec. 1391). Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations (sec. 1392). The Code provides special tax incentives for certain business activities conducted in empowerment zones and enterprise communities (secs. 1394, 1396, and 1397A). In addition, the Taxpayer Relief Act of 1997 provides for the designation of 22 additional empowerment zones (secs. 1391(b)(2) and 1391(g)).

[33] See Rev. Proc. 98–9, which sets forth the maximum face amount of qualified zone academy bonds that may be issued for each State during 1998; IRS Proposed Rules (REG–119449–97), which provides guidance to holders and issuers of qualified zone academy bonds.

bonds would be issued without interest, discount, or premium. The maximum term of the bonds would be 15 years.

In contrast to qualified zone academy bonds, any person (and not only financial institutions) holding a qualified school modernization bond would be able to claim a tax credit under the proposal. Information returns would be required to be provided to the holders of qualified school modernization bonds and to the IRS with respect to the tax credits related to such bonds.

A total of $9.7 billion of qualified school modernization bonds could be issued in each of 1999 and 2000, to be allocated among the States. Half of this annual $9.7 billion cap would be allocated among the 100 school districts with the largest number of low-income children.[34] The remaining half of the annual cap would be divided among the States and Puerto Rico in proportion to their shares of Federal assistance under the Basic Grant Formula (contained in Title I of the Elementary and Secondary Education Act of 1965), adjusted for amounts allocated to the 100 school districts with the largest number of low-income children.[35] A State, possession, or eligible school district would be permitted to carry forward any unused portion of its allocation until September 30, 2003.

Under the proposal, a bond would be treated as a qualified school modernization bond only if the following three requirements are satisfied: (1) the Department of Education approves the construction plan of the State or eligible school district, which plan must (a) demonstrate that a comprehensive survey has been undertaken of the construction and renovation needs in the jurisdiction, and (b) describe how the jurisdiction will assure that bond proceeds are used as proposed; (2) the State or local governmental entity issuing the bond receives an allocation for the bond from the State educational agency or eligible school district; and (3) at least 95 percent of the bond proceeds must be used to construct or rehabilitate public school facilities.[36] In contrast to qualified zone academy bonds, the proposed qualified school modernization bonds would not be subject to a requirement that private businesses contribute a specified amount of goods or services to the local school district.

Effective Date

The provisions regarding qualified school modernization bonds would be effective for such bonds issued in 1999 and 2000 (and such bonds issued prior to September 30, 2003, with respect to unused allocations carried forward from 1999 or 2000). The provisions regarding qualified zone academy bonds would be effective for such

[34] The cap would be allocated among the 100 districts based on the amounts of Federal assistance each district receives 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.

[35] A small portion of the total cap would be set aside for each possession (other than Puerto Rico) based on its share of the total U.S. poverty population. The relative shares of assistance provided under the Basic Grant Formula would be determined by the Secretary of the Treasury based on the most recent data available from the Department of Education on November 1 of the year prior to the year for which the allocation of authority to issue qualified school modernization bonds is made.

[36] In determining whether this third requirement is satisfied, taxpayers may rely on principles used to determine satisfaction of similar requirements with respect to tax-exempt obligations.

bonds issued in 1999 and 2000 (and such bonds issued thereafter with respect to unused allocations).

Prior Action

The credit for certain holders of qualified zone academy bonds (sec. 1397E) was enacted as part of the Taxpayer Relief Act of 1997.

Analysis

The President's 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 State and local governments. This would enable the State and local governments to spend the savings on other government functions or to reduce taxes.[37] In this event, the stated objective of the proposals would not be achieved. If the subsidy is successful at encouraging new investment, the quality of education could be improved.

To be eligible for the qualified zone academy bonds, State and local governments also must obtain private business contributions to the qualified zone academy in amounts equal to at least 10 percent of the bond proceeds. Such a requirement further lowers the costs to State and local governments of a successful zone academy bond issue, relative to the amount of funds that are made available for the qualified zone academy. However, the requirement also makes it more difficult to obtain the subsidy from the Federal Government, as private support needs to be obtained. The requirement may make it more likely that a successful bond issue will represent new, incremental investment in qualified zone academies. On the other hand, it is not certain that this would be the case, since private businesses already could donate to schools if they were so motivated. It is possible that the federal subsidy could be viewed as a "matching grant", motivating more private giving. However, it would remain possible that State and local governments could receive additional private contributions and obtain the Federal subsidy and yet not invest any more funds in public education than they would have otherwise. The proposed school modernization bonds do not carry the requirement that private financing also be found.

Though called a tax credit, the Federal subsidy for the zone academy bonds and the proposed school modernization bonds is equivalent to the Federal Government directly paying the interest on a

[37] 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.

taxable bond issue on behalf of the State or local government that benefits from the bond proceeds.[38] 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 zone academy bonds and the proposed school modernization 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 the zone academy bonds and the proposed school modernization bonds, the $100 credit also has to be claimed as income. Claiming an additional $100 in income, though no income is actually realized, 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 as previously. The Federal 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 and local government would also be in the same situation in both cases.

The proposed tax credit arrangement to subsidize public school investment, as opposed to the equivalent direct interest payment by the Federal Government on behalf of the State or locality, raises some questions of administrative efficiencies and tax complexity. 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, additional risk is imposed on the investor relative to a Federal agreement to directly make the interest payments to the bondholders on behalf of the State or locality that issues the bond. For these reasons, and the fact that the bonds will be less liquid than comparable Federal obligations,[39] the Treasury Department has decided that the zone academy bonds under the proposal will pay a credit rate that is 110

[38] 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.

[39] There is also more risk that the principal will not be repaid, since investors consider the credit risk of States and localities to be greater than that of the Federal Government.

percent of the long-term applicable Federal rate (AFR).[40] Since the Federal Government must ultimately determine the eligibility of the bonds for the credit, it would appear that an otherwise equivalent direct spending program where the Federal Government promises upfront to pay the interest would remove some information costs to the bondholder as well as the risk of buying a bond that could ultimately be deemed to not qualify for the credit. The bonds would then presumably bear a lower interest rate, which would reduce the effective costs of the program to the Federal Government. Additionally, the direct payment of interest would involve less complexity in administering the income tax, as the interest could simply be reported as any other taxable interest. Finally, the tax credit implies that non-taxable entities could not take advantage of the bonds to assist school investment. In the case of a direct payment of interest, non-profits would be able to take advantage of the bonds.

2. Exclusion for employer-provided educational assistance

Present Law

Under present law (Code sec. 127), an employee's gross income and wages do not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts are paid or incurred pursuant to an educational assistance program that meets certain requirements. This exclusion is limited to $5,250 of educational assistance with respect to an individual during a calendar year. In the absence of the exclusion, educational assistance is excludable from income only if it is related to the employee's current job. The exclusion applies with respect to undergraduate courses beginning before June 1, 2000. The exclusion does not apply to graduate level courses beginning after June 30, 1996.

Description of Proposal

The proposal would expand the exclusion for employer-paid educational assistance to graduate education, and extend the exclusion (as applied to both graduate and undergraduate education) through May 2001.

Effective Date

The proposal to extend the exclusion for undergraduate courses would be effective for courses beginning before June 1, 2001. The exclusion with respect to graduate-level courses would be effective for courses beginning after June 30, 1998 and before June 1, 2001.

Prior Action

A similar proposal to extend the exclusion to graduate-level courses was included in the President's fiscal year 1997 budget proposal and in the 1997 Senate bill.

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[40] 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. That rate has not yet been established.

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. Employer-provided educational assistance benefits may serve as a substitute for cash wages (or other types of fringe benefits) in the overall employment compensation package. Because of their favorable tax treatment, benefits received in this form are less costly than cash wages in terms of the after-tax cost of compensation to the employee.

Present-law section 127 serves to subsidize the provision of education and 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 overconsumption of education.[41]

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, 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. Proponents argue that the exclusion is primarily useful to non-highly 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

[41] For a broader discussion of social and private benefits from education and an analysis of subsidies to education, see Joint Committee on Taxation, *Analysis of Proposed Tax Incentives for Higher Education* (JCS–3–97), March 4, 1997, pp.19–23.

be higher-paid workers.[42] 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.[43]

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, while 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 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 IRS, who may come to different conclusions based on the same facts. The exclusion eliminates the need to make this determination.

The exclusion for employer-provided education has always been enacted on a temporary basis. It has been extended frequently, and often retroactively. The past experience of allowing the exclusion to expire and subsequently retroactively extending it has created burdens for employers and employees. Employees may have difficulty planning for their educational goals if they do not know whether their tax bills will increase. Employers have administrative problems determining the appropriate way to report and withhold on educational benefits each time the exclusion expires before it is extended. Providing greater certainty by further extending the exclusion may reduce administrative burdens and complexity, as well as enable individuals to better plan for their educational costs.

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

Present Law

Code section 108(f)

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

[42] See, for example, Coopers & Lybrand, "Section 127 Employee Educational Assistance: Who Benefits? At What Cost?," June 1989, p. 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, p. 9.

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

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 outstanding student loans [44] 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.[45] 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).[46] The Direct Loan Program

[44] A technical correction is required to clarify that gross income does not include amounts from the forgiveness of loans made by educational organizations and certain tax-exempt organizations to refinance any existing student loan (and not just loans made by educational organizations). A provision to this effect is included in Title VI (sec. 604(e)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

[45] A technical correction is required to clarify that refinancing loans made by educational organizations and certain tax-exempt organizations must be made pursuant to a program of the refinancing organization (e.g., school or private foundation) that requires the student to fulfill a public service work requirement. A provision to this effect is included in Title VI (sec. 604(e)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

[46] 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.

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.[47] 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.[48] Generally, a borrower's monthly loan payment is capped at 20 percent of discretionary income (AGI minus the poverty level adjusted for family size).[49] If the loan is not repaid in full at the 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 would be expanded to cover forgiveness of direct student loans made through the William D. Ford Federal Direct Loan Program where 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, 1998.

Prior Action

The proposal was included in the President's fiscal year 1998 budget proposal, as well as in the House and Senate versions of the Taxpayer Relief Act of 1997. The proposal was, however, dropped in conference.

Analysis

There are three types of expenditures incurred by students in connection with their education: (1) direct payment of tuition; (2) payment via implicit transfers received from governments or pri-

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

[48] 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.

[49] 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 capitalized.

vate 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 treatment that is the equivalent of expensing 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 under the present-law income tax.[50]

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 includable in taxable income. Economically, a subsequent forgiveness of the loan converts the original loan into a scholarship. Thus, as noted above, exempting a scholarship or forgiving a loan is equivalent to permitting a deduction for tuition paid.

While section 117 generally excludes scholarships from income to the extent it is used for qualified tuition and related expenses regardless of the recipient's income level, 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).[51] 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 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, expanding section 108(f) to cover forgiveness of Federal Direct Loans for which the income-contingent repayment option is elected does not appear to be consistent with the conceptual framework of 108(f). There is no explicit or implicit public service

[50] 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.

[51] 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.

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.[52] 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, thus, will have the unpaid amount of their loans discharged at the end of the 25-year period.[53] In this regard, it is important to note that the primary revenue effects associated with this provision would not commence until 2019–25 years after the program originated in 1994.

E. Extend Certain Expiring Tax Provisions

1. Extend the work opportunity tax credit

Present Law

The work opportunity tax credit ("WOTC") is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit generally is equal to a percentage of qualified wages. The credit percentage is 25 percent for employment of at least 120 hours but less than 400 hours and 40 percent for employment of 400 hours or more. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer. For a vocational rehabilitation referral, however, the period begins on the day the individual begins work for the employer on or after the beginning of the individual's vocational rehabilitation plan as under prior law.

Generally, no more than $6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is $2,400. With respect to qualified summer youth employees, the maximum credit is 40 percent of up to $3,000 of qualified first-year wages, for a maximum credit of $1,200. The credit expires for wages paid to, or incurred with respect to, qualified individuals who begin work for the employer after June 30, 1998.

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

Description of Proposal

The proposal would extend the WOTC for 22 months (through April 30, 2000).

Effective Date

The proposal would be effective for wages paid to, or incurred with respect to, qualified individuals who begin work for the employer after June 30, 1998 and before May 1, 2000.

[52] 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.

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

Prior Action

The Taxpayer Relief Act of 1997 provided for several modifications to the WOTC and extended the credit for wages paid to, or incurred with respect to, qualified individuals who begin work for the employer before July 1, 1998.

Analysis

Overview

The WOTC is intended to increase the employment and earnings of targeted group members. The credit is made available to employers as an incentive to hire members of the targeted groups. To the extent the value of the credit is passed on from employers to employees, the wages of target group employees will be higher than they would be in the absence of the credit.[54]

The basic rationale for the WOTC is that employers will not hire certain individuals without a subsidy because either the individuals are stigmatized (e.g., convicted felons) or the current productivity of the individuals is below the prevailing wage rate. Where particular groups of individuals suffer reduced evaluations of work potential due to membership in one of the targeted groups, the credit may provide employers with a monetary offset for the lower perceived work potential. In these cases, employers may be encouraged to hire individuals from the targeted groups, and then make an evaluation of the individual's work potential in the context of the work environment, rather than from the job application. Where the current productivity of individuals is currently below the prevailing wage rate, on-the-job-training may provide individuals with skills that will enhance their productivity. In these situations, the WOTC provides employers with a monetary incentive to bear the costs of training members of targeted groups and providing them with job-related skills which may increase the chances of these individuals being hired in unsubsidized jobs. Both situations encourage employment of members of the targeted groups, and may act to increase wages for those hired as a result of the credit.

As discussed below, the evidence is mixed on whether the rationales for the credit are supported by economic data. The information presented is intended to provide a structured way to determine if employers and employees respond to the existence of the credit in the desired manner.

Efficiency of the credit

The credit provides employers with a subsidy for hiring members of targeted groups. For example, assume that a worker eligible for the credit is paid an hourly wage of w and works 2,000 hours during the year. The worker is eligible for the full credit (40 percent of the first $6,000 of wages), and the firm will receive a $2,400 credit against its income taxes and reduce its deduction for wages by $2,400. Assuming the firm faces the full 34-percent corporate income tax rate, the cost of hiring the credit-eligible worker is lower

[54] For individuals with productivity to employers lower than the minimum wage, the credit may result in these individuals being hired and paid the minimum wage. For these cases, it would be clear that the credit resulted in the worker receiving a higher wage than would have been received in the absence of the credit (e.g., zero).

than the cost of hiring a credit-ineligible worker for 2,000 hours at the same hourly wage w by $2{,}400(1-.34)$ = $1,584.[55] This $1,584 amount would be constant for all workers unless the wage (w) changed in response to whether or not the individual was a member of a targeted group. If the wage rate does not change in response to credit eligibility, the WOTC subsidy is larger in percentage terms for lower wage workers. If w rises in response to the credit, it is uncertain how much of the subsidy remains with the employer, and therefore the size of the WOTC subsidy to employers is uncertain.

To the extent the WOTC subsidy flows through to the workers eligible for the credit in the form of higher wages, the incentive for eligible individuals to enter the paid labor market may increase. Since many members of the targeted groups receive governmental assistance (e.g., Temporary Assistance for Needy Families or food stamps), and these benefits are phased out as income increases, these individuals potentially face a very high marginal tax rate on additional earnings. Increased wages resulting from the WOTC may be viewed as a partial offset to these high marginal tax rates. In addition, it may be the case that even if the credit has little effect on observed wages, credit-eligible individuals may have increased earnings due to increased employment.

The structure of the WOTC (the 40-percent credit rate for the first $6,000 of qualified wages) appears to lend itself to the potential of employers churning employees who are eligible for the credit. This could be accomplished by firing employees after they earn $6,000 in wages and replacing them with other WOTC-eligible employees. If training costs are high relative to the size of the credit, it may not be in the interest of an employer to churn such employees in order to maximize the amount of credit claimed. Empirical research in this area has not found an explicit connection between employee turnover and utilization of WOTC's predecessor, the Targeted Jobs Tax Credit ("TJTC").[56]

Job creation

The number of jobs created by the WOTC is certainly less than the number of certifications. To the extent employers substitute WOTC-eligible individuals for other potential workers, there is no net increase in jobs created. This could be viewed as merely a shift in employment opportunities from one group to another. However, this substitution of credit-eligible workers for others may not be socially undesirable. For example, it might be considered an acceptable trade-off for a targeted group member to displace a secondary earner from a well-to-do family (e.g., a spouse or student working part-time).

In addition, windfall gains to employers or employees may accrue when the WOTC is received for workers that the firm would have hired even in the absence of the credit. When windfall gains are received, no additional employment has been generated by the

[55] The after-tax cost of hiring this credit eligible worker would be $((2{,}000)(w)-2{,}400)(1-.34)$ dollars. This example does not include the costs to the employer for payroll taxes (e.g., Social security, Medicare and unemployment taxes) and any applicable fringe benefits.

[56] See, for example, Macro Systems, Inc., *Final Report of the Effect of the Targeted Jobs Tax Credit Program on Employers*, U.S. Department of Labor, 1986.

credit. Empirical research on the employment gains from the TJTC has indicated that only a small portion of the TJTC-eligible population found employment because of the program. One study indicates that net new job creation was between 5 and 30 percent of the total certifications. This finding is consistent with some additional employment as a result of the TJTC program, but with considerable uncertainty as to the exact magnitude.[57]

A necessary condition for the credit to be an effective employment incentive is that firms incorporate WOTC eligibility into their hiring decisions. This could be done by determining credit eligibility for each potential employee or by making a concerted effort to hire individuals from segments of the population likely to include members of targeted groups. Studies examining this issue through the TJTC found that some employers made such efforts, while other employers did little to determine eligibility for the TJTC prior to the decision to hire an individual.[58] In these latter cases, the TJTC provided a cash benefit to the firm, without affecting the decision to hire a particular worker.

2. Extend the welfare-to-work tax credit

Present Law

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

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

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

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

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[57] Macro Systems, Inc., *Impact Study of the Implementation and Use of the Targeted Jobs Tax Credit: Overview and Summary*, U.S. Department of Labor, 1986.

[58] For example, see U.S. General Accounting Office, *Targeted Jobs Tax Credit: Employer Actions to Recruit, Hire, and Retain Eligible Workers Vary* (GAO–HRD 91–33), February 1991.

Description of Proposal

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

Effective Date

The proposal would be effective for wages paid to or incurred with respect to, qualified individuals who begin work for an employer after April 30, 1998 and before May 1, 2000.

Prior Action

The welfare-to-work tax credit was proposed in the President's fiscal year 1998 budget proposal and enacted in the Taxpayer Relief Act of 1997.

Analysis

Proponents argue that an extension of the welfare-to-work tax credit will encourage employers to hire, invest in training, and provide certain benefits and more permanent employment, to longer term welfare recipients. Opponents argue that tax credits to employers for hiring certain classes of individuals do not increase overall employment and may disadvantage other deserving job applicants. There are also concerns about the efficiency of tax credits as an incentive to potential employees to enter the job market as well as an incentive for employers to retain such employees after they no longer qualify for the tax credit (e.g., replacing an employee whose wages no longer qualify for the tax credit with another employee whose wages do qualify). For a more detailed discussion of these issues, refer to the analysis section of the extension of the work opportunity tax credit in Part I. E.1., above, of this pamphlet.

3. Extend the research tax credit

Present Law

General rule

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit is scheduled to expire and generally will not apply to amounts paid or incurred after June 30, 1998.[59]

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

[59] A special termination rule applies under section 41(h)(1) for taxpayers that elected to be subject to the alternative incremental research credit regime for their first taxable year beginning after June 30, 1996, and before July 1, 1997.

computation is commonly referred to as the "university basic research credit" (see sec. 41(e)).

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984–1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.[60]

In computing the credit, a taxpayer's base amount may not be less than 50 percent of its current-year qualified research expenditures.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer (sec. 41(f)(1)). Special rules apply for computing the credit when a major portion of a business changes hands, under which qualified research expenditures and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage (sec. 41(f)(3)).

Alternative incremental research credit regime

Taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1 percent (i.e., the base amount equals 1 percent of the taxpayer's average gross receipts for the four preceding

[60] The Small Business Job Protection Act of 1996 expanded the definition of "start-up firms" under section 41(c)(3)(B)(I) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983.

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

years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 2.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of 2 percent. A credit rate of 2.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2 percent. An election to be subject to this alternative incremental credit regime 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 unless revoked with the consent of the Secretary of the Treasury.

Eligible expenditures

Qualified research expenditures eligible for the research tax credit consist of: (1) "in-house" expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called "contract research expenses").[61]

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 (described below) but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors (sec. 41(d)(3)). In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control (sec. 41(d)(4)).

Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

[61] Under a special rule enacted as part of the Small Business Job Protection Act of 1996, 75 percent of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

Relation to deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized. However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year. Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

Description of Proposal

The research tax credit would be extended for twelve months—i.e., for the period July 1, 1998, through June 30, 1999.

Effective Date

The proposal would be effective for qualified research expenditures paid or incurred during the period July 1, 1998, through June 30, 1999.

Prior Action

The research tax credit initially was enacted in the Economic Recovery Tax Act of 1981 as a credit equal to 25 percent of the excess of qualified research expenses incurred in the current taxable year over the average of qualified research expenses incurred in the prior three taxable years. The research tax credit was modified in the Tax Reform Act of 1986, which (1) extended the credit through December 31, 1988, (2) reduced the credit rate to 20 percent, (3) tightened the definition of qualified research expenses eligible for the credit, and (4) enacted the separate, university basic research credit.

The Technical and Miscellaneous Revenue Act of 1988 ("1988 Act") extended the research tax credit for one additional year, through December 31, 1989. The 1988 Act also reduced the deduction allowed under section 174 (or any other section) for qualified research expenses by an amount equal to 50 percent of the research tax credit determined for the year.

The Omnibus Budget Reconciliation Act of 1989 ("1989 Act") effectively extended the research credit for nine months (by prorating qualified expenses incurred before January 1, 1991). The 1989 Act also modified the method for calculating a taxpayer's base amount (i.e., by substituting the present-law method which uses a fixed-base percentage for the prior-law moving base which was calculated by reference to the taxpayer's average research expenses incurred in the preceding three taxable years). The 1989 Act further reduced the deduction allowed under section 174 (or any other section) for qualified research expenses by an amount equal to 100 percent of the research tax credit determined for the year.

The Omnibus Budget Reconciliation Act of 1990 extended the research tax credit through December 31, 1991 (and repealed the special rule to prorate qualified expenses incurred before January 1, 1991).

The Tax Extension Act of 1991 extended the research tax credit for six months (i.e., for qualified expenses incurred through June 30, 1992).

The Omnibus Budget Reconciliation Act of 1993 ("1993 Act") extended the research tax credit for three years—i.e., retroactively from July 1, 1992 through June 30, 1995. The 1993 Act also provided a special rule for start-up firms, so that the fixed-base ratio of such firms eventually will be computed by reference to their actual research experience (see footnote 60 *supra*).

Although the research tax credit expired during the period July 1, 1995, through June 30, 1996, the Small Business Job Protection Act of 1996 ("1996 Act") extended the credit for the period July 1, 1996, through May 31, 1997 (with a special 11-month extension for taxpayers that elect to be subject to the alternative incremental research credit regime). In addition, the 1996 Act expanded the definition of "start-up firms" under section 41(c)(3)(B)(I), enacted a special rule for certain research consortia payments under section 41(b)(3)(C), and provided that taxpayers may elect an alternative research credit regime (under which the taxpayer is assigned a three-tiered fixed-base percentage that is lower than the fixed-base percentage otherwise applicable and the credit rate likewise is reduced) for the taxpayer's first taxable year beginning after June 30, 1996, and before July 1, 1997.

The Taxpayer Relief Act of 1997 ("1997 Act") extended the research credit for 13 months—i.e., generally for the period June 1, 1997, through June 30, 1998. The 1997 Act also provided that taxpayers are permitted to elect the alternative incremental research credit regime for any taxable year beginning after June 30, 1996 (and such election will apply to that taxable year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury).

Analysis

Overview

Technological development is an important component of economic growth. However, while an individual business may find it profitable to undertake some research, it may not find it profitable to invest in research as much as it otherwise might because it is difficult to capture the full benefits from the research and prevent such benefits from being used by competitors. In general, businesses acting in their own self-interest will not necessarily invest in research to the extent that would be consistent with the best interests of the overall economy. This is because costly scientific and technological advances made by one firm are cheaply copied by its competitors. Research is one of the areas where there is a consensus among economists that government intervention in the marketplace can improve overall economic efficiency.[62] However, this does not mean that increased tax benefits or more government spending for research always will improve economic efficiency. It is possible

[62] This conclusion does not depend upon whether the basic tax regime is an income tax or a consumption tax.

to decrease economic efficiency by spending too much on research. It is difficult to determine whether, at the present levels of government subsidies for research, further government spending on research or additional tax benefits for research would increase or decrease overall economic efficiency. There is some evidence that the current level of research undertaken in the United States, and worldwide, is too little to maximize society's well-being.[63]

If it is believed that too little research is being undertaken, a tax subsidy is one method of offsetting the private-market bias against research, so that research projects undertaken approach the optimal level. Among the other policies employed by the Federal Government to increase the aggregate level of research activities are direct spending and grants, favorable anti-trust rules, and patent protection. The effect of tax policy on research activity is largely uncertain because there is relatively little evidence about the responsiveness of research to changes in taxes and other factors affecting its price. To the extent that research activities are responsive to the price of research activities, the research and experimentation tax credit should increase research activities beyond what they otherwise would be. However, the present-law treatment of research expenditures does create certain complexities and compliance costs.

The scope of present-law tax expenditures on research activities

The tax expenditure related to the research and experimentation tax credit is estimated to be $1.6 billion for 1998. The related tax expenditure for expensing of research and development expenditures is estimated to be $2.6 billion for 1998 growing to $3.4 billion for 2002.[64] As noted above, the Federal Government also directly subsidizes research activities. For example, in fiscal 1997 the National Science Foundation made $2.2 billion in grants, subsidies, and contributions to research activities and the Department of Defense financed $2.1 billion in advanced technology development.[65]

Tables 1 and 2 present data for 1993 on those industries that utilized the research tax credit and the distribution of the credit claimants by firm size. Three quarters of the research tax credits claimed are claimed by taxpayers whose primary activity is manufacturing. Nearly two- thirds of the credits claimed are claimed by large firms (assets of $500 million or more). Nevertheless, as Table 2 documents, a large number of small firms are engaged in research and are able to claim the research tax credit.

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[63] See Zvi Griliches, "The Search for R&D Spillovers," National Bureau of Economic Research, Working Paper No. 3768, 1991 and M. Ishaq Nadiri, "Innovations and Technological Spillovers," National Bureau of Economic Research, Working Paper No. 4423, 1993. These papers suggest that the rate of return to privately funded research expenditures is high compared to that in physical capital and the social rate of return exceeds the private rate of return.

[64] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1998–2002* (JCS–22–97), December 15, 1997, p.18.

[65] Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1999, Appendix*, pp. 996 and 275.

Table 1.—Percentage Distribution of Firms Claiming Research Tax Credit and of Amount of Credit Claimed by Sector, 1993

Sector	Number of firms (percent)	Credit claimed (percent)
Agriculture, Forestry and Fishing	([1])	([1])
Mining	([1])	([1])
Construction	0.7	0.4
Manufacturing	58.0	75.2
Transportation, Communication, and Public Utilities	1.4	8.1
Wholesale and Retail Trade	9.1	2.6
Finance, Insurance, and Real Estate	1.5	1.3
Services	28.3	12.0

[1] Data undisclosed to protect taxpayer confidentiality.

Source: Joint Committee on Taxation (JCT) calculations from Internal Revenue Service, *Statistics of Income* data.

Table 2.—Percentage Distribution of Firms Claiming Research Tax Credit and of Amount of Credit Claimed by Firm Size, 1993

Asset size (dollars)	Number of firms (percent)	Credit claimed (percent)
≤0	0.6	0.2
1—100,000	13.4	0.4
100,000—250,000	6.0	0.5
250,000—500,000	10.2	0.9
500,000—1 million	14.6	1.4
1 million—10 million	32.7	7.9
10 million—50 million	12.2	8.5
50 million—100 million	2.8	4.2
100 million—250 million	2.4	5.0
250 million—500 million	1.4	6.0
500 million and over	3.7	64.9

Source: JCT calculations from Internal Revenue Service, *Statistics of Income* data.

Incremental tax credits

For a tax credit to be effective in increasing a taxpayer's research expenditures it is not necessary to provide that credit for all the taxpayer's research expenditures. By limiting the credit to expenditures above a base amount, incremental tax credits attempt to target the tax incentives where they will have the most effect on taxpayer behavior.

Suppose, for example, a taxpayer is considering two potential research projects: Project A will generate cash flow with a present value of $105 and Project B will generate cash flow with present value of $95. Suppose that the cost of investing in each of these projects is $100. Without any tax incentives, the taxpayer will find it profitable to invest in Project A and will not invest in Project B.

Consider now the situation where a 10-percent "flat credit" applies to all research expenditures incurred. In the case of Project A, the credit effectively reduces the cost to $90. This increases profitability, but does not change behavior with respect to that project, since it would have been undertaken in any event. However, because the cost of Project B also is reduced to $90, this previously neglected project (with a present value of $95) would now be profitable. Thus, the tax credit would affect behavior only with respect to this marginal project.

Incremental credits attempt not to reward projects which would have been undertaken in any event and to target incentives to marginal projects. To the extent this is possible, incremental credits have the potential to be far more effective per dollar of revenue cost than flat credits in inducing taxpayers to increase qualified expenditures.[66] Unfortunately, it is nearly impossible as a practical matter to determine which particular projects would be undertaken without a credit and to provide credits only to other projects. In practice, almost all incremental credit proposals rely on some measure of the taxpayer's previous experience as a proxy for a taxpayer's total qualified expenditures in the absence of a credit. This is referred to as the credit's "base amount." Tax credits are provided only for amounts above this base amount.

Since a taxpayer's calculated base amount is only an approximation of what would have been spent in the absence of a credit, in practice, the credit may be less effective per dollar of revenue cost than it otherwise might be in increasing expenditures. If the calculated base amount is too low, the credit is awarded to projects that would have been undertaken even in the absence of a credit. If, on the other hand, the calculated base amount is too high, then there is no incentive for projects that actually are on the margin.

Nevertheless, the incentive effects of incremental credits per dollar of revenue loss can be many times larger than those of a flat credit. However, in comparing a flat credit to an incremental credit, there are other factors that also deserve consideration. A flat credit generally has lower administrative and compliance costs than does an incremental credit. Probably more important, however, is the potential misallocation of resources and unfair competition that could result as firms with qualified expenditures determined to be above their base amount receive credit dollars, while other firms with qualified expenditures considered below their base amount receive no credit.

The responsiveness of research expenditures to tax incentives

Like any other commodity, the amount of research expenditures that a firm wishes to incur generally is expected to respond positively to a reduction in the price paid by the firm. Economists often refer to this responsiveness in terms of "price elasticity," which is measured as the ratio of the percentage change in quantity to a percentage change in price. For example, if demand for a product

[66] In the example above, if an incremental credit were properly targeted, the Government could spend the same $20 in credit dollars and induce the taxpayer to undertake a marginal project so long as its expected cash flow exceeded $80.

increases by five percent as a result of a 10-percent decline in price paid by the purchaser, that commodity is said to have a price elasticity of demand of 0.5.[67] One way of reducing the price paid by a buyer for a commodity is to grant a tax credit upon purchase. A tax credit of 10 percent (if it is refundable or immediately usable by the taxpayer against current tax liability) is equivalent to a 10-percent price reduction. If the commodity granted a 10-percent tax credit has an elasticity of 0.5, the amount consumed will increase by five percent. Thus, if a flat research tax credit were provided at a 10-percent rate, and research expenditures had a price elasticity of 0.5, the credit would increase aggregate research spending by five percent.[68]

Despite the central role of the measurement of the price elasticity of research activities, there is little empirical evidence on this subject. What evidence exists generally indicates that the price elasticity for research is substantially less than one. For example, one survey of the literature reached the following conclusion:

> In summary, most of the models have estimated long-run price elasticities of demand for R&D on the order of −0.2 and −0.5. . . . However, all of the measurements are prone to aggregation problems and measurement errors in explanatory variables.[69]

Although most analysts agree that there is substantial uncertainty in these estimates, the general consensus when assumptions are made with respect to research expenditures is that the price elasticity of research is less than 1.0 and may be less than 0.5.[70]

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[67] For simplicity, this analysis assumes that the product in question can be supplied at the same cost despite any increase in demand (i.e., the supply is perfectly elastic). This assumption may not be valid, particularly over short periods of time, and particularly when the commodity—such as research scientists and engineers—is in short supply.

[68] It is important to note that not all research expenditures need be subject to a price reduction to have this effect. Only the expenditures which would not have been undertaken otherwise—so called marginal research expenditures—need be subject to the credit to have a positive incentive effect.

[69] Charles River Associates, *An Assessment of Options for Restructuring the R&D Tax Credit to Reduce Dilution of its Marginal Incentive* (final report prepared for the National Science Foundation), February, 1985, p. G–14.

[70] In a 1983 study, the Treasury Department used an elasticity of .92 as its upper range estimate of the price elasticity of R&D, but noted that the author of the unpublished study from which this estimate was taken conceded that the estimate might be biased upward. See, Department of the Treasury, *The Impact of Section 861–8 Regulation on Research and Development*, p. 23. As stated in the text, although there is uncertainty, most analysts believe the elasticity is considerable smaller. For example, the General Accounting Office summarizes: "These studies, the best available evidence, indicate that spending on R&E is not very responsive to price reductions. Most of the elasticity estimates fall in the range of −0.2 and −0.5. . . . Since it is commonly recognized that all of the estimates are subject to error, we used a range of elasticity estimates to compute a range of estimates of the credit's impact." See, *The Research Tax Credit Has Stimulated Some Additional Research Spending* (GAO/GGD–89–114), September 1989, p. 23. Similarly, Edwin Mansfield concludes: "While our knowledge of the price elasticity of demand for R&D is far from adequate, the best available estimates suggest that it is rather low, perhaps about 0.3." See, "The R&D Tax Credit and Other Technology Policy Issues," *American Economic Review*, Vol. 76, no. 2, May 1986, p. 191. More recent empirical analyses have estimated higher elasticity estimates. One recent empirical analysis of the research credit has estimated a short-run price elasticity of 0.8 and a long-run price elasticity of 2.0. The author of this study notes that the long-run estimate should be viewed with caution for several technical reasons. In addition, the data utilized for the study cover the period 1980 through 1991, containing only two years under the revised credit structure. This makes it empirically difficult to distinguish short-run and long-run effects, particularly as it may take firms some time to fully appreciate the incentive structure of the revised credit. See, Bronwyn H. Hall, "R&D Tax Policy During the 1980s: Success or Failure?" in James M. Poterba (ed.), *Tax Policy and the Economy*, 7, pp. 1–35 (Cambridge: The MIT Press, 1993). Another recent study examined the post-1986 growth of research expenditures by 40 U.S.-based multinationals and found price elasticities between 1.2 and 1.8. However, including an additional 76 firms, that had initially been excluded because they had been involved in merger activity, the estimated elasticities fell by half. See,

Apparently there have been no specific studies of the effectiveness of the university basic research tax credit.

Other issues related to the research and experimentation credit

Perhaps the greatest criticism of the research and experimentation tax credit among taxpayers regards its temporary nature. Research projects frequently span years. If a taxpayer considers an incremental research project, the lack of certainty regarding the availability of future credits increases the financial risk of the expenditure. A credit of longer duration may more successfully induce additional research than would a temporary credit, even if the temporary credit is periodically renewed.

An incremental credit does not provide an incentive for all firms undertaking qualified research expenditures. Many firms have current-year qualified expenditures below the base amount. These firms receive no tax credit and have an effective rate of credit of zero. Although there is no revenue cost associated with firms with qualified expenditures below base, there may be a distortion in the allocation of resources as a result of these uneven incentives.

If a firm has no current tax liability, or if the firm is subject to the alternative minimum tax (AMT) or the general business credit limitation, the research credit must be carried forward for use against future-year tax liabilities. The inability to use a tax credit immediately reduces its value according to the length of time between when it actually is earned and the time it actually is used to reduce tax liability.[71]

Under present law, firms with research expenditures substantially in excess of their base amount may be subject to the 50-percent limitation. In general, although these firms receive the largest amount of credit when measured as a percentage of their *total* qualified research expenditures, their marginal effective rate of credit is exactly one half of the statutory credit rate of 20 percent (i.e., firms on the base limitation effectively are governed by a 10-percent credit rate).

Although the statutory rate of the research credit is currently 20 percent, it is likely that the average marginal effective rate may be substantially below 20 percent. Reasonable assumptions about the frequency that firms are subject to various limitations discussed above yields estimates of an average effective rate of credit between 25 and 40 percent below the statutory rate i.e., between 12 and 15 percent.[72]

James R. Hines, Jr., "On the Sensitivity of R&D to Delicate Tax Changes: The Behavior of U.S. Multinationals in the 1980s" in Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod (eds.), *Studies in International Taxation*, (Chicago: University of Chicago Press 1993). Also see M. Ishaq Nadiri and Theofanis P. Mamuneas, "R&D Tax Incentives and Manufacturing-Sector R&D Expenditures," in James M. Poterba, editor, *Borderline Case: International Tax Policy, Corporate Research and Development, and Investment*, (Washington, D.C.: National Academy Press), 1997. While their study concludes that one dollar of research tax credit produces 95 cents of research, they note that time series empirical work is clouded by poor measures of the price deflators used to convert nominal research expenditures to real expenditures.

[71] As with any tax credit that is carried forward, its full incentive effect could be restored, absent other limitations, by allowing the credit to accumulate interest that is paid by the Treasury to the taxpayer when the credit ultimately is utilized.

[72] For a more complete discussion of this point see Joint Committee on Taxation, *Description and Analysis of Tax Provisions Expiring in 1992* (JCS–2–92), January 27, 1992, pp. 65–66.

Since sales growth over a long time frame will rarely track research growth, it can be expected that over time each firm's base will "drift" from the firm's actual current qualified research expenditures. Therefore, increasingly over time there will be a larger number of firms either substantially above or below their calculated base. This could gradually create an undesirable situation where many firms receive no credit and have no reasonable prospect of ever receiving a credit, while other firms receive large credits (despite the 50-percent base limitation). Thus, over time, it can be expected that, for those firms eligible for the credit, the average marginal effective rate of credit will decline while the revenue cost to the Federal Government increases.

Administrative and compliance burdens also result from the present-law research tax credit. The General Accounting Office ("GAO") has testified that the research tax credit is difficult for the IRS to administer. The GAO reports that the IRS view is that it is "required to make difficult technical judgments in audits concerning whether research was directed to produce truly innovative products or processes." While the IRS employs engineers in such audits, the companies engaged in the research typically employ personnel with greater technical expertise and, as would be expected, personnel with greater expertise regarding the intended application of the specific research conducted by the company under audit. Such audits create a burden for both the IRS and taxpayers. The credit generally requires taxpayers to maintain records more detailed than those necessary to support the deduction of research expenses under section 174.[73]

4. Extend the deduction provided for contributions of appreciated stock to private foundations

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization.[74] However, in the case of a charitable contribution of short-term gain, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.[75]

[73] Natwar M. Gandhi, Associate Director Tax Policy and Administration Issues, General Government Division, U.S. General Accounting Office, "Testimony before the Subcommittee on Taxation and Internal Revenue Service Oversight," Committee on Finance, United States Senate, April 3, 1995.

[74] The amount of the deduction allowable for a 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 (secs. 170(b) and 170(e)).

[75] As part of the Omnibus Budget Reconciliation Act of 1993, Congress eliminated the treatment of contributions of appreciated property (real, personal, and intangible) as a tax preference for alternative minimum tax (AMT) purposes. Thus, if a taxpayer makes a gift to charity of property (other than short-term gain, inventory, or other ordinary income property, or gifts to private foundations) that is real property, intangible property, or tangible personal property the use of which is related to the donee's tax-exempt purpose, the taxpayer is allowed to claim the same fair-market-value deduction for both regular tax and AMT purposes (subject to present-law percentage limitations).

In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property. However, under a special rule contained in section 170(e)(5), taxpayers are allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation prior to June 30, 1998. Qualified appreciated stock is defined as publicly traded stock which is capital gain property. The fair-market-value deduction for qualified appreciated stock donations applies only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10 percent of the outstanding stock of that corporation. For this purpose, an individual is treated as making all contributions that were made by any member of the individual's family.

Description of Proposal

The proposal would extend the the special rule contained in section 170(e)(5) for one year—for contributions of qualified appreciated stock made to private foundations during the period July 1, 1998, through June 30, 1999.

Effective Date

The proposal would be effective for contributions of qualified appreciated stock to private foundations made during the period July 1, 1998, through June 30, 1999.

Prior Action

The special rule contained in section 170(e)(5), which was originally enacted in 1984, expired January 1, 1995. The Small Business Job Protection Act of 1996 reinstated the rule for 11 months—for contributions of qualified appreciated stock made to private foundations during the period July 1, 1996, through May 31, 1997. The Taxpayer Relief Act of 1997 extended the special rule for the period June 1, 1997, through June 30, 1998.

Analysis

Any tax deduction or credit reduces the price of an activity that receives the tax incentive. For example, for a taxpayer 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. With gifts of appreciated property, if a fair market value deduction is allowed (while the accrued appreciation is not included in income), the price of giving $100 worth of appreciated property is as low as $40.40.[76]

[76] This assumes that the taxpayer is in the highest statutory rate bracket and the property has a basis of zero and is computed as follows: $100 minus $20 (tax avoided from non-recognition of built-in capital gain) minus $39.60 (tax saved from deduction for fair market value). This "price of giving" figure assumes that the taxpayer would sell the appreciated property (and pay tax on the built-in gain) in the same year of the donation if the property were not given to charity. However, a higher "price of giving" would be derived if it is assumed that, had the taxpayer

Continued

In principle, a lower price of giving should result in more charitable giving. The amount of charitable giving that results from lowering the price of giving determines the efficiency of the tax deductions. If taxpayers do not increase their charitable giving significantly in response to a charitable contribution deduction, the revenue lost to the government because of the tax incentive may exceed the benefits of additional contributions that flow to charitable organizations as a result of the deduction.

Economists have not reached a consensus as to whether the deduction for charitable donations is efficient in the sense that the cost to the government in lost revenue is more than offset by additional funds flowing to charitable organizations. The economics literature generally does not specifically address gifts of appreciated property. Moreover, these studies do not include the possibility of the substitutability between lifetime giving and gifts made at death. Substantial tax savings are available to owners of appreciated property if they bequeath such property to qualified charitable organizations. Even if the general rule for donating appreciated property discourages current giving, such giving may not be lost permanently to charitable organizations, but merely may be converted into gifts at death. However, if a policy goal is to speed the donation of such gifts, there may be additional benefits to inducing gifts prior to death.

The aggregate data on charitable donations also present a mixed picture of the effect of tax deductions on gifts of appreciated property. Although gifts of appreciated property substantially declined after enactment of the Tax Reform Act of 1986, the total value of gifts to charity has continued to grow since that time, despite the fact that the reduction in marginal tax rates should have reduced the incentive to give. Thus, to the extent that gifts of appreciated property have declined, the decline has been largely offset by increases in cash gifts.

There are, however, a number of limitations on charitable contributions contained in the Internal Revenue Code. For instance, a taxpayer's deduction for a taxable year for gifts of appreciated property to public charities cannot exceed 30 percent of the taxpayer's adjusted gross income (20 percent if the donee is a private foundation).

There is another dimension to efficiency. Receipt of gifts of cash by charitable organizations is more efficient, because a cash gift permits the donee to avoid the transaction costs involved should it wish to convert the appreciated property to cash. Moreover, gifts of appreciated property instead of cash create administrative costs. Cash donations do not require appraisals, generally increase taxpayer compliance, and reduce the burden on the IRS of monitoring the accuracy of valuation of gifts of appreciated property.

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not donated the property, he would have retained the asset until death (and obtained a step-up in basis) or obtained benefits of deferral of tax by selling the asset in a later year.

F. Miscellaneous Tax Provisions

1. Increase low-income housing tax credit per capita cap

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 generally has a present value of 70 percent (new construction) or 30 percent (existing housing and most housing also receiving other Federal subsidies) of qualified costs.

Generally, the tax credits available for projects in the first year of the 10-year period are subject to annual per-State limitations of $1.25 per capita. Credits that remain unallocated by States after prescribed periods are reallocated to other States through a "national pool." The $1.25 per capita cap was set in 1986 with the inception of the tax credit.

Description of Proposal

The $1.25 per capita cap would be increased to $1.75 per capita.

Effective Date

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

Prior Action

The low-income housing tax credit was enacted as part of the Tax Reform Act of 1986. It was extended several times, and was made permanent by the Omnibus Budget Reconciliation Act of 1993. The House version of the Balanced Budget Act of 1995 would have repealed the low-income housing tax credit after 1997.

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.[77] 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.[78] 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

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

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

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.[79] The benefit of the subsidy will accrue primarily to the property owners because of the higher rents.

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 consum-

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

ers 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 3, below, presents data from a survey of State credit allocating agencies.

Table 3.—Allocation of the Low-Income Housing Credit, 1987–1995

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	206.4	65.0
1991 [1]	497.3	400.6	80.6
1992 [1]	476.8	332.7	70.0
1993 [1]	546.4	322.7	70.0
1994 [1]	523.7	424.7	77.7
1995 [1]	432.6	410.9	95.0

[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 (1996).

Table 3 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 fiscal year 1998 tax expenditure resulting from the low-income credit will total $3.2 billion.[80] This estimate would include revenue lost to the Federal Government from buildings placed in service in the 10 years prior to 1998. Table 1 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.[81] 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 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

[80] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1998-2002* (JCS-22-97), December 15, 1997, p. 21.

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

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.

Increasing State credit allocations

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 38.1 percent price inflation between 1986 and the third quarter of 1997. Had the per capita credit allocation been indexed for inflation, using this index, the value of the credit today would be approximately $1.73.[82] 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.

2. Extend and modify Puerto Rico 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 ten-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.

[82] Most Code provisions are indexed to the Consumer Price Index ("CPI"). Over this same period, cumulative inflation as measured by the CPI was approximately 47 percent. Indexing the $1.25 to the CPI would have produced a value of approximately $1.84 today.

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 eliminate the December 31, 2005 termination date with respect to such credit. Second, the proposal would eliminate the income cap with respect to such credit. Third, 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. The proposal would not modify the credit computed under the economic activity limit with respect to operations in possessions other than Puerto Rico. The 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, 1998.

Prior Action

The proposal (with an effective date of one year earlier) was included in the President's fiscal year 1998 budget proposal.

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 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 have just 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 1996, the unemployment rate averaged 14 percent in Puerto Rico. By comparison, the United States's unemployment rate averaged 5.4 percent in 1996 and the State with the highest average unemployment rate, New Mexico, averaged 8.1 percent unemployment.[83] 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.[84] In 1996, per capita GDP in Puerto Rico was $8,104 while per capita GDP for the United States was $28,784.[85] It has been these, or comparable, facts that have motivated efforts to encourage economic development in 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 cir-

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[83] The unemployment rate in the District of Columbia averaged 8.5 percent in 1996. Source: Bureau of the Census, U.S. Department of Commerce, *Statistical Abstract of the United States,* 1997.

[84] *Ibid.* 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 Census of Population, Social and Economic Characteristics, Puerto Rico,* p. 42.

[85] *Ibid.*

cumstances 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, would eliminate the present-law cap on the economic activity credit, and would make the economic activity credit permanent. 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.[86] 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 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

[86] 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.

are left to the private sector rather than being made by government officials.

3. Specialized small business investment companies

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[87] 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 their stock for the exclusion.

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 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 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.

Finally, the 50-percent exclusion for gain on the sale of qualifying small business stock would be increased to 60 percent where the corporation was an SSBIC (or involving the sale in a pass-through entity holding an interest in an SSBIC).

Effective Date

The proposal would be effective for sales after date of enactment.

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[87] 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.

Prior Action

No prior action.

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, market values indicate sectors of the economy where investment funds are most needed. Artificially diverting investment funds in one direction or another results in certain investments that offer a lower rate of return being funded in lieu of certain other 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 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 such businesses is not the result of inefficiency of the capital market, an important social goal can be achieved 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.

4. Accelerate and expand incentives available to two new empowerment zones

Present Law

Designated zones and communities

Zones and communities designated under OBRA 1993

Pursuant to the Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993"), the Secretaries of the Department of Housing and Urban Development (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994. As required by law, six empowerment zones are located in urban areas and three empowerment zones are located in rural areas.[88] Of the enterprise communities, 65 are located in urban areas and 30 are located in rural areas (sec. 1391). Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations (sec. 1392).

The following tax incentives are available for certain businesses located in empowerment zones: (1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the zone; (2) an additional $20,000 of section 179 expensing for "qualified zone property" placed in service by an "enterprise zone business" (accordingly, certain businesses operating in empowerment zones are allowed up to $38,500 of expensing for 1998); (3) special tax-exempt financing for certain zone facilities (described in more detail below); and (4) the so-called "brownfields" tax incentive, which allows taxpayers to expense (rather than capitalize) certain environmental remediation expenditures.[89]

The 95 enterprise communities are eligible for the special tax-exempt financing benefits and "brownfields" tax incentive, but not the other tax incentives (i.e., the wage credit and additional sec. 179 expensing) available in the empowerment zones. In addition to

[88] The six designated urban empowerment zones are located in New York City, Chicago, Atlanta, Detroit, Baltimore, and Philadelphia-Camden (New Jersey). The three designated rural empowerment zones are located in 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).

[89] The environmental remediation expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site, generally meaning any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance. Targeted areas include: (1) empowerment zones and enterprise communities as designated under OBRA 1993 and the 1997 Act (including any supplemental empowerment zone designated on December 21, 1994); (2) sites announced before February 1997, as being 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. The "brownfields" provision (enacted in the Taxpayer Relief Act of 1997) applies to eligible expenditures incurred in taxable years ending after August 5, 1997, and before January 1, 2001.

The President's budget proposal would make the brownfields incentive permanent (See Part I.B.2.b., above).

these tax incentives, OBRA 1993 provided that Federal grants would be made to designated empowerment zones and enterprise communities.

The tax incentives (other than the "brownfields" incentive) for empowerment zones and enterprise communities generally will be available during the period that the designation remains in effect, i.e., the 10–year period of 1995 through 2004.

Additional zones designated under 1997 Act

Two additional urban zones with same tax incentives as previously designated empowerment zones.—Pursuant to the Taxpayer Relief Act of 1997 ("1997 Act"), the Secretary of HUD designated two additional empowerment zones located in Cleveland and Los Angeles (thereby increasing to eight the total number of empowerment zones located in urban areas) with respect to which apply the same tax incentives (i.e., the wage credit, additional expensing, special tax-exempt financing, and brownfields incentive) as are available within the empowerment zones authorized by OBRA 1993.[90] The two additional empowerment zones located in Cleveland and Los Angeles were subject to the same eligibility criteria under section 1392 that applied to the original six urban empowerment zones.[91]

The two additional empowerment zones located in Cleveland and Los Angeles were designated by the Secretary of HUD on January 31, 1997. However, a special rule provides that the designations of these two additional empowerment zones will not take effect until January 1, 2000 (and generally will remain in effect for 10 years).

20 additional urban and rural empowerment zones.—The 1997 Act also authorizes the Secretaries of HUD and Agriculture to designate an additional 20 empowerment zones (no more than 15 in urban areas and no more than five in rural areas).[92] With respect to these additional empowerment zones, the present-law eligibility criteria are expanded slightly in comparison to the eligibility criteria provided for by OBRA 1993. First, the general square mileage limitations (i.e., 20 square miles for urban areas and 1,000 square miles for rural areas) are expanded to allow the empowerment zones to include an additional 2,000 acres. This additional acreage, which could be developed for commercial or industrial purposes, is not subject to the poverty rate criteria and may be divided among up to three noncontiguous parcels. In addition, the general requirement that at least half of the nominated area consist of census tracts with poverty rates of 35 percent or more does not apply to the 20 additional empowerment zones. However, under present-law section 1392(a)(4), at least 90 percent of the census tracts within a nominated area must have a poverty rate of 25 percent or more, and the remaining census tracts must have a poverty rate of 20

[90] The wage credit available in the two new urban empowerment zones is modified slightly to provide that the credit rate will be 20 percent for calendar years 2000–2004, 15 percent for calendar year 2005, 10 percent for calendar year 2006, and 5 percent for calendar 2007. No wage credit will be available in the two new urban empowerment zones after 2007.

[91] In order to permit designation of these two additional empowerment zones, the 1997 Act increased the aggregate population cap applicable to urban empowerment zones from 750,000 to a cap of one million aggregate population for the eight urban empowerment zones.

[92] In contrast to OBRA 1993, areas located within Indian reservations are eligible for designation as one of the additional 20 empowerment zones under the 1997 Act.

percent or more.[93] For this purpose, census tracts with populations under 2,000 are treated as satisfying the 25-percent poverty rate criteria if (1) at least 75 percent of the tract was zoned for commercial or industrial use, and (2) the tract is contiguous to one or more other tracts that actually have a poverty rate of 25 percent or more.[94]

Within the 20 additional empowerment zones, qualified "enterprise zone businesses" are eligible to receive up to $20,000 of additional section 179 expensing[95] and to utilize special tax-exempt financing benefits. The "brownfields" tax incentive (described above) also is available within all designated empowerment zones. However, businesses within the 20 additional empowerment zones are *not* eligible to receive the present-law wage credit available within the 11 other designated empowerment zones (i.e., the wage credit is available only within in the nine zones designated under OBRA 1993 and the two urban zones designated under the 1997 Act that are eligible for the same tax incentives as are available in the nine zones designated under OBRA 1993).

The 20 additional empowerment zones are required to be designated before 1999, and the designations generally will remain in effect for 10 years.[96]

Definition of "qualified zone property"

Present-law section 1397C defines "qualified zone property" as depreciable tangible property (including buildings), provided that: (1) the property is acquired by the taxpayer (from an unrelated party) after the zone or community designation took effect; (2) the original use of the property in the zone or community commences with the taxpayer; and (3) substantially all of the use of the property is in the zone or community and is in the active conduct of a qualified business by the taxpayer in the zone or community. In the case of property which is substantially renovated by the taxpayer, however, the property need not be acquired by the taxpayer after zone or community designation or originally used by the taxpayer within the zone or community if, during any 24-month period after zone or community designation, the additions to the taxpayer's basis in the property exceed 100 percent of the taxpayer's basis in the property at the beginning of the period, or $5,000 (whichever is greater).

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[93] In lieu of the poverty criteria, outmigration may be taken into account in designating one rural empowerment zone.

[94] A special rule enacted as part of the 1997 Act modifies the present-law empowerment zone and enterprise community designation criteria so that any zones or communities designated in the future in the States of Alaska or Hawaii will not be subject to the general size limitations, nor will such zones or communities be subject to the general poverty-rate criteria. Instead, nominated areas in either State will be eligible for designation as an empowerment zone or enterprise community if, for each census tract or block group within such area, at least 20 percent of the families have incomes which are 50 percent or less of the State-wide median family income. Such zones and communities will be subject to the population limitations under present-law section 1392(a)(1).

[95] However, the additional section 179 expensing is *not* available within the additional 2,000 acres allowed to be included under the 1997 Act within an empowerment zone.

[96] In addition, the 1997 Act also provides for special tax incentives (some of which are modeled after the empowerment zone tax incentives) for the District of Columbia.

Definition of "enterprise zone business"

Present-law section 1397B defines the term "enterprise zone business" as a corporation or partnership (or proprietorship) if for the taxable year: (1) every trade or business of the corporation or partnership is the active conduct of a qualified business within an empowerment zone or enterprise community[97]; (2) at least 50 percent[98] of the total gross income is derived from the active conduct of a "qualified business" within a zone or community; (3) a substantial portion of the business's tangible property is used within a zone or community; (4) a substantial portion of the business's intangible property is used in the active conduct of such business; (5) a substantial portion of the services performed by employees are performed within a zone or community; (6) at least 35 percent of the employees are residents of the zone or community; and (7) less than five percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business.

A "qualified business" is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license.[99] In addition, the leasing of real property that is located within the empowerment zone or community to others is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses.[100] The rental of tangible personal property to others is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone or enterprise community.

Tax-exempt financing rules

Tax-exempt private activity bonds may be issued to finance certain facilities in empowerment zones and enterprise communities. These bonds, along with most private activity bonds, are subject to an annual private activity bond State volume cap equal to $50 per resident of each State, or (if greater) $150 million per State. However, a special rule (enacted in the 1997 Act) provides that certain "new empowerment zone facility bonds" issued for qualified enterprise zone businesses in the 20 additional empowerment zones are not subject to the State private activity bond volume caps or the special limits on issue size generally applicable to qualified enterprise zone facility bonds under section 1394(c).[101]

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[97] A qualified proprietorship is *not* required to meet the requirement that the sole trade or business of the proprietor is the active conduct of a qualified business within the empowerment zone or enterprise community.

[98] The 1997 Act reduced this threshold from 80 percent (as enacted in OBRA 1993) to 50 percent.

[99] Also, a qualified business does not include certain facilities described in section 144(c)(6)(B)(e.g., massage parlor, hot tub facility, or liquor store) or certain large farms.

[100] The 1997 Act provides that the lessor of property may rely on a lessee's certification that such lessee is an enterprise zone business.

[101] The maximum amount of "new empowerment zone facility bonds" that can be issued is limited to $60 million per rual zone, $130 million per urban zone with a population of less than 100,000, and $230 million per urban zone with a population of 100,000 or more. "New empower-

Continued

Qualified enterprise zone facility bonds are bonds 95 percent or more of the net proceeds of which are used to finance (1) "qualified zone property" (as defined above[102]) the principal user of which is an "enterprise zone business" (also defined above[103]), or (2) functionally related and subordinate land located in the empowerment zone or enterprise community.[104] These bonds may only be issued while an empowerment zone or enterprise community designation is in effect.

The aggregate face amount of all qualified enterprise zone bonds for each qualified enterprise zone business may not exceed $3 million per zone or community. In addition, total qualified enterprise zone bond financing for each principal user of these bonds may not exceed $20 million for all zones and communities.

Description of Proposal

The proposal would accelerate from January 1, 2000, to January 1, 1999, the effective date for designation of the two additional empowerment zones located in Cleveland and Los Angeles with respect to which will apply the same tax incentives as are available within the nine empowerment zones authorized by OBRA 1993. Under the proposal, the wage credit would be available in these two empowerment zones for 10 years. The credit rate for the wage credit would be 20 percent for calendar years 1999–2005, 15 percent for calendar year 2006, 10 percent for calendar year 2007, and 5 percent for calendar year 2008.

Effective Date

The proposal would be effective on January 1, 1999.

Prior Action

OBRA 1993 authorized the designation of nine empowerment zones and 95 enterprise communities. The Secretaries of HUD and the Department of Agriculture designated such empowerment zones and enterprise communities on December 21, 1994, and such

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ment zone facility bonds" may not be issued with respect to the two urban empowerment zones to be designated under the 1997 Act within which will apply the same tax incentives as apply to the empowerment zones authorized by OBRA 1993.

[102] A special rule (enacted in the 1997 Act) relaxes the rehabilitation requirement for financing existing property with qualified enterprise zone facility bonds. In the case of property which is substantially renovated by the taxpayer, the property need not be acquired by the taxpayer after zone or community designation and need not be originally used by the taxpayer within the zone if, during any 24-month period after zone or community designation, the additions to the taxpayer's basis in the property exceed 15 percent of the taxpayer's basis at the beginning of the period, or $5,000 (whichever is greater).

[103] For purposes of the tax-exempt financing rules, an "enterprise zone business" also includes a business located in a zone or community which would qualify as an enterprise zone business if it were separately incorporated.

A special rule (enacted in the 1997 Act) waives the requirements of an enterprise zone business (other than the requirement that at least 35 percent of the business' employees be residents of the zone or community) for all years after a prescribed testing period equal to the first three taxable years after the startup period.

[104] A special rule (enacted in the 1997 Act) waives until the end of a "startup period" the requirement that 95 percent or more of the proceeds of bond issue be used by a qualified enterprise zone business. With respect to each property, the startup period would end at the beginning of the first taxable year beginning more than two years after the later of (1) the date of the bond issue financing such property, or (2) the date the property was placed in service (but in no event more than three years after the date of bond issuance). This waiver is available only if, at the beginning of the startup period, there is a reasonable expectation that the use by a qualified enterprise zone business will be satisfied at the end of the startup period and the business makes bona fide efforts to satisfy the enterprise zone business definition.

designations generally will remain in effect through December 31, 2004.

The 1997 Act authorized the designation of two additional empowerment zones, with respect to which will apply the same tax incentives as are available within the empowerment zones authorized by OBRA 1993. Pursuant to this authorization, areas located in Cleveland and Los Angeles were designated as empowerment zones on January 31, 1998, but such designations will not take effect until January 1, 2000. The 1997 Act also authorizes the designation of an additional 20 empowerment zones (with different eligibility criteria and tax incentives compared to the empowerment zones designated under OBRA 1993). These additional 20 empowerment zones have not yet been designated.

Analysis

Pursuant to the 1997 Act, areas located in Cleveland and Los Angeles have been designated as empowerment zones. With respect to these areas, the Administration's proposal would permit qualifying businesses to claim wage credits, expense additional capital investments under section 179, to benefit from special tax-exempt financing, and to expense certain environmental remediation expenses for expenses incurred during the 10-year period 1999 through 2008, rather than the 10-year period 2000 through 2009.[105] The proposal does not change materially any of the tax benefits (other than adding two more years during which the wage credit will be available), but rather the time period for which such tax benefits may be claimed. However, by changing the time period for which tax benefits may be claimed, the value of those benefits may be altered for taxpayers in different situations.

The tax benefits for empowerment zones are designed to facilitate community economic renewal by encouraging existing businesses to remain and expand in the designated empowerment zone, by encouraging new businesses to locate within the empowerment zone, and by encouraging the employment of zone residents within the zone. By accelerating the availability of tax benefits, existing businesses located within the empowerment zone will be able to claim tax benefits almost immediately. The reduction in capital costs or employment costs may enable certain existing businesses which might otherwise have closed or moved from the zone to remain profitable in their current location. Because present law delays the tax benefits for Cleveland and Los Angeles, the present value of the entire 10-year stream of potential tax benefits is reduced. Such a reduction may mean that certain existing businesses will find it more profitable to operate elsewhere. Similarly, because the empowerment zones located in Cleveland and Los Angeles were designated on January 31, 1998, community leaders could advertise that Federal tax benefits will be available in the future to businesses that relocate to within the zone. However, a business that is currently considering a relocation would find it less attractive to have to wait until the year 2000 to claim the promised tax benefits

[105] Expensing of qualified environmental remediation expenditures within the zones may be claimed only through 2000 under present law. In a separate proposal, the President's budget would make permanent the expensing of qualified environmental remediation expenditures. (See Part I.B.2.b., above.)

than to be able to begin claiming the tax benefits in 1999. By accelerating the period during which tax benefits may be claimed, certain businesses will find the tax benefits more attractive, and this could induce such businesses to remain, locate, or expand within the zone.

On the other hand, by accelerating the period during which tax benefits may be claimed, certain businesses may find the tax benefits less attractive. Many investment plans, whether they be for expansion of an existing business within the zone, the relocation of a business to within the zone, or the creation of a new business, require substantial lead time before investment expenses are incurred or employees are hired. For example, commencement of operations for a qualifying business may take one year or more between the initial planning decisions, the procurement of necessary permits, and the placement in service of business property. In such a case, by accelerating the period during which a business may claim additional expensing under section 179 to the years 1999 through 2008 rather than the years 2000 through 2009, a business considering an investment to commence operations in 2002 may find that, under the proposal, it may claim additional expensing for only seven years, rather than eight years under present law. If the subsidy offered by the additional expensing under section 179 is critical to the decision to invest in this business, the loss of one year's worth of subsidy could affect investment decisions.[106] More generally, community leaders could find it advantageous to have the lead time provided under present law to coordinate State and local redevelopment efforts with those that will be forthcoming from the private sector in response to future availability of Federal tax benefits.

5. 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

Under the proposal, up to $2,000 of certain severance payments would be excludable from the income of the recipient. 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 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 $125,000.

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[106] Because the proposal would add two years during which the wage credit would be available within the Cleveland and Los Angeles empowerment zones, all businesses that relocate to such zones prior to January 1, 2009, would be better off under the proposal than under present law with respect to the wage credit, despite the proposed one-year acceleration of the effective date of the designation of such zones.

Effective Date

The proposal would be effective for severance pay received in taxable years beginning after December 31, 1998, and before January 1, 2004.

Prior Action

No prior action.

Analysis

The proposals 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 determine the breadth and impact of the proposal. 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 $125,000 cap is exceeded.

It is also not entirely 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.

The stated rationale for the proposal is that the tax on severance payments places an additional burden on displaced workers, especially if the worker is separated from service because of a reduction in work force, in which case it may be difficult for the worker to find new, comparable employment. Some would agree that it is appropriate to provide tax relief for individuals in such circumstances. However, others would argue that the proposal does not provide relief for all persons in similar circumstances. For example, some would 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 would 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 would 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 are less than $125,000, 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. It is unclear in those cases how the individual would correct the error, e.g., would the individual file an amended return?

G. Simplification Provisions

1. 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 ($68,400 for OASDI taxes in 1998 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, 1998.

Prior Action

The proposal was included in the Administration's 1997 simplification proposals.[107] A similar proposal was also included in the Taxpayer Relief Act of 1997, as passed by the House. However, that provision would also 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 provision would also have provided that the optional method could not be elected retroactively on an amended return.

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.

2. Statutory hedging and other rules to ensure business property is treated as ordinary property

Present Law

Capital gain treatment applies to gain on the sale or exchange of a capital asset. Capital assets include property other than (1) stock in trade or other types of assets includible in inventory, (2) property used in a trade or business that is real property or property subject to depreciation, (3) accounts or notes receivable acquired in the ordinary course of a trade or business, or (4) certain copyrights (or similar property) and U.S. government publications. Gain or loss on such assets generally is treated as ordinary, rather than capital, gain or loss. Certain other Code sections also treat gains or losses as ordinary, such as the gains or losses of a securi-

[107] See Department of the Treasury, *Taxpayer Bill of Rights 3 and Tax Simplification Proposals* (April 1997).

ties or commodities trader or dealer that are subject to "mark-to-market" accounting (sec. 475). Other Code sections treat certain assets as giving rise to capital gain or loss.

Under case law in a number of Federal courts prior to 1988, business hedges generally were treated as giving rise to ordinary, rather than capital, gain or loss. In 1988, the U.S. Supreme Court rejected this interpretation in *Arkansas Best* v. *Commissioner,* 485 U.S. 212 (1988), which, relying on the statutory definition of a capital asset described above, held that a loss realized on a sale of stock was capital even though the stock was purchased for a business, rather than an investment, purpose.

In 1993, the Department of the Treasury issued temporary regulations, which were finalized in 1994, that require ordinary character treatment for most business hedges and provide timing rules requiring that gains or losses on hedging transactions be taken into account in a manner that matches the income or loss from the hedged item or items. The regulations apply to hedges that meet a standard of "risk reduction" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred) by the taxpayer and that meet certain identification and other requirements (Treas. reg. sec. 1.1221–2).

Under the straddle rules, when a taxpayer realizes a loss on one offsetting position in actively-traded personal property, the taxpayer generally can deduct this loss only to the extent the loss exceeds the unrecognized gain in the other positions in the straddle (sec. 1092). 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 such stock or substantially identical stock or securities 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.

Description of Proposal

The proposal would add three categories to the list of assets gain or loss on which is treated as ordinary (sec. 1221). The new categories would be: (1) derivative contracts entered into by derivative dealers; (2) supplies of a type regularly used by the taxpayer in the provision of services or the production of ordinary property; and (3) hedging transactions.

In defining a hedging transaction, the proposal would generally codify the approach taken by the Treasury regulations, but would modify the rules to some extent. The "risk reduction" standard of the regulations would be broadened to one of "risk management" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred). As under the Treasury regulations, the transaction would have to be identified as a hedge of specified property. If a transaction was improperly identified as a hedging transaction, losses would retain their usual character (i.e., usually capital), but gains would be ordinary. If a hedging transaction was not identified (and there was no reasonable basis for that failure), gains would be ordinary but losses would retain their non-hedging character. The proposal would provide an exclusive list of assets the gains and losses which would receive ordinary character treatment; other rationales for ordinary treatment generally would not be allowed. The Treasury Department would be given authority to apply these rules to related parties.

As under current Treasury regulations, the proposal would require that the timing of income, gain, deduction or loss from hedging transactions must reasonably match the income, gain, deduction or loss from the items being hedged. In addition, under the proposal, taxpayers could, to the extent provided in Treasury regulations, elect the application of these timing rules for certain transactions that would otherwise be subject to loss deferral under the straddle rules. The proposal would repeal the exception from the straddle rules for stock. Finally, the Treasury Department would be given the authority to treat the offsetting positions in a straddle on an integrated basis.

Effective Date

The proposal would be generally effective after the date of enactment. The identification requirements for hedging transactions would be effective 60 days after the date of enactment. The Treasury would be given the authority to issue regulations applying treatment similar to that provided in the proposal to transactions entered into prior to the effective date.

Prior Action

A similar proposal was included in the President's tax simplification proposals released in April 1997.

Analysis

The proposal's additions to the list of assets that give rise to ordinary gain and loss would to some extent be a clarification of present law. Hedging transactions have long been treated as ordinary under the case law and, more recently, under Treasury regulations. Gains on derivative contracts referencing interest rates, equity or foreign currencies recognized by a dealer in such contracts are treated as ordinary under the "mark-to-market" rules (sec. 475(c)(2) and (d)(3)). One addition the proposal would make to the ordinary list would be gains on commodities derivative contracts recognized by a dealer in such contracts. Some would argue that this addition is justifiable in order to eliminate the disparity between commodities derivatives dealers and dealers in other derivative contracts, whose gains are treated as ordinary as described above. The other addition that the proposal would make to the list of ordinary assets is supplies used in the provision of services or the production of ordinary property. An example would be a sale of excess jet fuel by an airline, which is treated as giving rise to capital gain under present law. Advocates of this addition would argue that such supplies are so closely related to the taxpayer's business that ordinary character should apply. Indeed, if the fuel were used rather than sold by the airline, it would give rise to an ordinary deduction. In addition, hedges of such items generally are treated as ordinary in character under present law, giving rise to a potential character mismatch, e.g. ordinary gain on the hedging transaction with a capital loss on the fuel sale that cannot be used to offset it (Treas. reg. sec. 1.1221–2(c)(5)(ii)). However, opponents would argue that not all business-related income is ordinary in character and, thus, that the proposal would only create other disparities. For example, under present law, a special regime applies to gains and losses from property used in a trade or business that is either real property or depreciable property held for more than one year (sec. 1231). The effect of these rules generally is to treat a taxpayer's net amount of gain in any year from these items as long-term capital gain, but any net losses as ordinary losses.

The proposal with respect to the definition of hedging transactions is largely a codification of the current Treasury regulations, with the expansion of the regulations' definition of hedging transactions to cover transactions that involve "risk management". As noted above, the Treasury regulations were issued in response to the U.S. Supreme Court's decision in *Arkansas Best,* which narrowed the definition of hedging allowed by some Federal courts and resulted in confusion in the business community as to what types of business hedges would receive tax hedging treatment. The regulations adopted a more expansive standard than *Arkansas Best,* with the result that more types of business hedging practices can now be treated as hedges for character and timing purposes, and the regulations have generally been well received by the business community. Thus, codifying the regulations would serve to validate the Treasury regulations, as well as to assure businesses that the current regime for hedges will be available for some time. They would also prevent taxpayers from taking aggressive positions that transactions that are not described in the proposal qualify as hedges.

The principal change that the proposal would make in the hedging definition is the replacement of the regulations' requirement that a hedging transaction result in "risk reduction" with respect to the hedged item with a broader "risk management" standard. This is a change that is arguably not within the Treasury's authority to adopt by regulations. The parameters of the "risk management" standard are not clear in the proposal, yielding the possibility that the proposal could result in essentially speculative transactions obtaining the favorable character and timing benefits of hedging transactions. However, advocates of the proposal would point to some common types of business hedging transactions that arguably do not meet a "risk reduction" standard. One example frequently cited is a fixed-rate debt instrument hedged with a floating rate hedging instrument. A fixed-rate debt instrument bears little interest-rate risk, and thus the transaction would arguably not meet the "risk reduction" standard (cf. Treas. reg. sec. 1.1221–2(c)(1)(ii)(B)). However, businesses frequently enter into transactions hedging such instruments in order to obtain the benefits of floating interest rates, and such transactions should meet a "risk management" standard. There have been also reports of tax controversies over the present law "risk reduction" standard that should be reduced by the proposal. Finally, advocates of the proposal would point out that the expansiveness of the "risk management" standard would be limited by identification requirement of the present Treasury regulations that would be codified by the proposal. Under that requirement, in order to obtain hedging character and timing treatment, the taxpayer must identify the hedging position in its own records on the day that the position is acquired and must identify the specific property or liabilities being hedged within 35 days thereafter (Treas. reg. sec. 1.1221–2(e)). Despite the potential overbreadth of the "risk management" standard, these identification requirements limit the ability of taxpayers to utilize the hedging rules for essentially speculative transactions.

The proposal would generally codify the Treasury regulations' timing rules for hedges, with the advantages of codification described above, but would also allow taxpayers to elect such treatment for non-hedging transactions that are subject to the straddle rules. Like any election, this one would be made only by taxpayers who predict that it would result in a tax savings. Moreover, by adding the election, the proposal adds complexity to the already complicated rules for timing of straddle income. The proposal is not clear as to the priority of the new election and the elections already available under the straddle rules (Treas. reg. sec. 1092(b)–3T and 4T) and thus may grant multiple elective tax treatments for the same transaction. However, advocates of the proposal would argue that treatment of some transactions under the straddle rules is too severe. For example, a small loss can be deferred even where large amounts of gain have been recognized on the offsetting position because there is also some unrecognized gain. However, opponents of the proposal would argue that such problems call for a revision, and hopefully a simplification, of the straddle rules, not for a new elective treatment. On the other hand, the hedge timing rules, which the proposal would allow taxpayers to elect, account for income in an economic manner—the timing of gains and losses on the hedging transaction must reasonably match those from the items being hedged. Advocates of the proposal would also point to the identification requirement, which would require taxpayers to elect hedge accounting for a transaction at the time it is entered into and to follow that treatment whether or not it proves advantageous. However, the portion of the proposal that would, in addition to the above rules, grant the Treasury Department authority to adopt integration treatment for the positions of a straddle is unclear in scope and should be clarified.

The repeal of the limited exception from the straddle rules for stock is arguably consistent with the policy of those rules, which 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 would also point out that offsetting stock positions are fully subject to the constructive sale rules added by the Taxpayer Relief Act of 1997 (sec. 1259), which have more onerous results than loss deferral under the straddle rules. However, because stock is widely held, the repeal of the stock exception would subject many more taxpayers to the complicated straddle rules. It must also be pointed out that proposed Treasury regulations would severely limit the stock exception even if the proposal is not adopted (Prop. Treas. reg. sec. 1.1092(d)–2).

Finally, the proposal would grant the Treasury Department regulatory authority to apply the proposal to transactions entered into prior to the date of enactment. It is difficult to assess whether it is appropriate to apply rules in a retroactive manner without knowing what these rules will be. As an alternative, where Congress intends that the provisions of the proposal will not change present law, a "no inference" statement could be made in the legislative history. However, this approach would leave ambiguity in the law.

3. Clarify rules relating to certain disclaimers

Present Law

Historically, 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 that provide that, where 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 is not currently effective for Federal tax purposes other than transfer taxes (e.g., it is not effective for 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.

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.

Prior Action

The proposal was included in the House version of the Taxpayer Relief Act of 1997.

Analysis

Under present law, a State-law disclaimer can be a qualified disclaimer even (1) where it is only a partial disclaimer of the property interest, or (2) where the disclaimant spouse retains an interest in the property. In contrast, it is currently unclear whether a transfer-type disclaimer 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.

4. 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").[108] 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 ac-

[108] A controlled foreign corporation in which the taxpayer owns at least 10% 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.

cumulated 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, specifically including rules to disregard both pre-acquisition earnings and profits and foreign taxes, in appropriate circumstances.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

Prior Action

The proposal would modify the effective date of a provision included in the Taxpayer Relief Act of 1997 (the "1997 Act").

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.

5. 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 (sec. 851(a)).

In addition, to qualify as a RIC, a corporation must elect such status and must satisfy certain tests (sec. 851(b)). 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 includible 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 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 dividends paid by a RIC in taxable years beginning after December 31, 1998.

Prior Action

No prior action.

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.

H. Taxpayers' Rights Provisions

1. Suspend collection by levy during refund suit

Present Law

Levy is the IRS's administrative authority to seize a taxpayer's property to pay the taxpayer's tax liability. The IRS is entitled to seize a taxpayer's property by levy if the Federal tax lien has attached to such property. The Federal tax lien arises automatically where (1) a tax assessment has been made; (2) the taxpayer has been given notice of the the assessment stating the amount and demanding payment; and (3) the taxpayer has failed to pay the amount assessed within ten days after the notice and demand. The IRS is prohibited from making a tax assessment (and thus prohibited from collecting payment) with respect to a tax liability while it is being contested in Tax Court.[109] However, under present law, the IRS is permitted to assess and collect tax liabilities during the

[109] Code section 6213(a).

pendency of a refund suit relating to such tax liabilities, under the circumstances described below.

Generally, full payment of the tax at issue is a prerequisite to a refund suit.[110] However, if the tax is divisible (such as employment taxes or the trust fund penalty under Code section 6672), the taxpayer need only pay the tax for the applicable period before filing a refund claim. Most divisible taxes are not within the Tax Court's jurisdiction; accordingly, the taxpayer has no pre- payment forum for contesting such taxes. In the case of divisible taxes, it is possible that the taxpayer could be properly under the refund jurisdiction of the district court or the U.S. Court of Federal Claims and still be subject to collection by levy with respect to the entire amount of the tax at issue. The IRS's policy is generally to exercise forbearance with respect to collection while the refund suit is pending, so long as the interests of the Government are adequately protected (e.g., by the filing of a notice of Federal tax lien) and collection is not in jeopardy.[111] Any refunds due the taxpayer may be credited to the unpaid portion of the liability pending the outcome of the suit.

Description of Proposal

This proposal would require the IRS to withhold collection by levy of liabilities that are the subject of a refund suit during the pendency of the litigation. This would only apply when refund suits can be brought without the full payment of the tax, *i.e.,* in the case of divisible taxes. Collection by levy would be withheld unless jeopardy exists or the taxpayer waives the suspension of collection in writing. This proposal would not affect the IRS's ability to collect other assessments that are not the subject of the refund suit, to offset refunds, or to file a notice of Federal tax lien. The statute of limitations on collection would be stayed for the period during which the IRS is prohibited from collecting by levy.

Effective Date

The proposal would be effective for refund suits brought with respect to tax years beginning after December 31, 1998.

Prior Action

No prior action.

Analysis

The decision in a refund suit with respect to divisible taxes generally determines the liability for all such tax liability of the taxpayer, not merely for the amounts at issue in the suit. It may be appropriate that taxpayers who are litigating a refund action over divisible taxes should be protected from collection of the full assessed amount, until a determination of the liability is made, provided that the IRS's ultimate ability to collect the amount determined by the court to be properly due is preserved.

[110] *Flora* v. *United States,* 357 U.S. 63 (1958), aff'd on reh'g, 362 U.S. 145 (1960).

[111] See, *e.g.,* Internal Revenue Manual ("IRM") 563(13).2 (May 5, 1993) (setting forth criteria for withholding collection of trust fund penalties at the taxpayer's request).

2. Suspend collection by levy while offer-in-compromise is pending

Present Law

Section 7122 of the Code permits the IRS to compromise a taxpayer's tax liability. In general, this occurs when a taxpayer submits an offer-in-compromise to the IRS. An offer-in-compromise is a proposal to settle unpaid tax accounts for less than the full amount of the balance due. They may be submitted for all types of taxes, as well as interest and penalties, arising under the Internal Revenue Code. Pursuant to the IRM, collection normally is withheld during the period an offer is pending, "unless it is determined that the offer is a delaying tactic and collection is in jeopardy."[112]

Description of Proposal

The proposal would prohibit the IRS from collecting a tax liability by levy (1) during any period that a taxpayer's offer-in-compromise for that liability is being processed, (2) during the 30 days following rejection of an offer, and (3) during any period in which an appeal of the rejection of an offer is being considered. Return of an offer-in-compromise as unprocessable would be considered a rejection for this purpose. Taxpayers whose offers are either rejected or returned as unprocessable and who made good faith revisions of their offers and resubmitted them within 30 days of the rejection or return would be eligible for a continuous period of relief from collection by levy. This prohibition on collection by levy would not apply if the IRS determines that collection is in jeopardy or that the offer was submitted solely to delay collection. The proposal would not require the IRS to stop any levy action that was initiated, or withdraw any lien that was filed, before the taxpayer submitted an offer in compromise to the IRS. The proposal would provide that the statute of limitations on collection would be tolled for the period during which collection by levy is barred.

Effective Date

The proposal would be effective with respect to taxes assessed on or after 60 days after the date of enactment.

Prior Action

No prior action.

Analysis

The proposal may increase taxpayers' perception of fairness in the tax system, in that the proposal will generally prohibit IRS from utilizing strong collection measures at the same time the taxpayer is attempting to resolve the issue with the IRS.

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[112] IRM 57(10)5.1(3) (Sept. 22, 1994).

3. Suspend collection to permit resolution of disputes as to liability

Present Law

In general, before assessment of a tax deficiency, the IRS must give notice of such deficiency to the taxpayer, which provides the taxpayer an opportunity to contest the deficiency in Tax Court (secs. 6212 and 6213). The notice of deficiency must be mailed to the taxpayer's last known address (sec. 6212(b)). If the taxpayer fails to file a petition in Tax Court within 90 days (150 days if the notice is addressed outside the United States), the IRS may then assess the deficiency (sec. 6213(c)). Once the 90 (or 150) day period has expired, so has the taxpayer's only opportunity to seek pre-payment judicial determination of the taxpayer's liability. Under present law, once a valid assessment is made, the IRS is not required to suspend collection if the taxpayer claims not to owe the taxes.

The taxpayer has one final opportunity to argue doubt as to liability. Section 7122 of the Code permits the IRS to compromise a taxpayer's tax liability. In general, this occurs when a taxpayer submits an offer-in-compromise to the IRS, proposing to settle unpaid tax accounts for less than the full amount of the assessed balance due.[113] The regulations provide that doubt as to liability may be grounds for the IRS's accepting the taxpayer's offer-in-compromise. The Code and regulations do not preclude collection of a tax liability while an offer-in-compromise with respect to that liability is pending. The regulations provide that collection may be deferred while an offer-in-compromise is pending, unless the interests of the United States are jeopardized.[114] The Internal Revenue Manual directs employees to advise taxpayers that "collection normally will be withheld unless it is determined that the offer is a delaying tactic and collection is in jeopardy."[115] Collection is ordinarily barred, pursuant to the parties" agreement, if an offer-in-compromise is accepted.

Description of Proposal

This proposal would permit an individual taxpayer to request that collection be suspended temporarily with regard to an income tax liability that is assessed based upon a statutory notice of deficiency that the taxpayer failed to receive or to which the taxpayer failed to respond. The IRS would suspend collection for a 60-day period, during which the taxpayer may dispute the merits of the underlying assessment. The 60-day period would be extended in appropriate cases where progress is being made in resolving the liability. Collection by refund offset and jeopardy levies would be exempted. The statute of limitations on collection would be stayed while the taxpayer's claim is pending. The proposal also would not affect the IRS's ability to file a notice of Federal tax lien.

[113] Treas. Reg. sec. 301.7122–1(a).
[114] Treas. Reg. sec. 301.7122–1(d)(2).
[115] IRM 57(10)5.1(3) (Sept. 22, 1994).

Effective Date

The proposal would be effective for taxes assessed with respect to taxable years beginning after December 31, 1998.

Prior Action

No prior action.

Analysis

This proposal may ease the burden on taxpayers with a colorable dispute as to liability who were unable to have a hearing in Tax Court because they failed to receive or respond to a proper statutory notice of deficiency. Proponents of the proposal argue that if such a taxpayer is making a legitimate effort to resolve a tax liability through an offer-in-compromise, and the interests of the United States are adequately protected, it would be appropriate to preclude enforced collection of the liability. In conjunction with the proposal to suspend collection by levy while an offer-in-compromise is pending, this proposal would restrict IRS collection measures while the taxpayer is attempting to resolve the issue with the IRS.

4. Require district counsel approval of certain third-party collection activities

Present Law

The Code authorizes the IRS to levy upon all non-exempt property and rights to property belonging to the taxpayer (sec. 6331(a)). In some cases, property belonging to the taxpayer may be nominally held in a name other than the taxpayer's. For example, if a corporation would be treated as the alter ego of an individual taxpayer under common law principles, the IRS may treat the corporation's assets as those of the taxpayer and can properly take administrative collection action against those assets. Similarly, it is sometimes possible to show that property held in the name of a third party individual is being held in a nominal or representative capacity for a taxpayer (such as, for example, in the case of a fraudulent conveyance). In such situations, IRS policy is to require written advice by District Counsel as to the need for a supplemental assessment, a new notice and demand, and the language to be incorporated in the notices of lien and levy on such property. However, District Counsel approval is not presently required before a notice of Federal tax lien can be filed in connection with property held by a nominee, transferee, or alter ego of the taxpayer, or before the seizure of property to which a Federal tax lien attaches but which is presently neither owned by the taxpayer nor titled in the name of the taxpayer.

Description of Proposal

The proposal would require IRS District Counsel approval before a notice of Federal tax lien can be filed or levy is made in connection with property held by a nominee, transferee, or alter ego of the taxpayer. District Counsel approval would be required before the IRS seizes property encumbered by a Federal tax lien if the property is presently neither owned nor titled in the name of the taxpayer. The only exception would be in jeopardy situations. If District Counsel's approval was not obtained, the property-owner would be entitled to obtain release of the lien or levy, and, if the IRS failed to make such release, to appeal first to the Collections Appeals process and then to the U.S. District Court.

Effective Date

The proposal would be effective with respect to taxes assessed after the date of enactment.

Prior Action

No prior action.

Analysis

The determination of whether property held in the hands of a third party belongs to the taxpayer often involves difficult legal issues. It may be argued that District Counsel review of these issues before the IRS takes collection action against such property will insure that third party property seizures are legally sound, thus improving the public's perception of the IRS.

5. Require additional approval of levies on certain assets

Present Law

In general, the IRS may collect taxes by levy on the property and rights to property of the taxpayer. A number of statutory restrictions apply. One of these is that a levy is allowed on a taxpayer's principal residence only if a District Director or Assistant District Director of the IRS personally approve in writing of the levy (except in cases of jeopardy).

Description of Proposal

The proposal would expand these approval requirements to also apply to levies on non-governmental pensions and on the cash value of life insurance policies. The proposal would also provide for administrative and judicial remedies if appropriate approval were not obtained.

Effective Date

The proposal would be effective with respect to taxes assessed after the date of enactment.

Prior Action

No prior action.

Analysis

Taxpayers may find it beneficial to have these approval requirements extended to these additional items, in that doing so will help ensure more careful consideration of the appropriateness of the levy in the taxpayer's situation.

6. Require district counsel review of jeopardy and termination assessments and jeopardy levies

Present Law

The Code provides special procedures that allow the IRS to make jeopardy assessments or termination assessments in certain extraordinary circumstances, such as if the taxpayer is leaving or removing property from the United States (sec. 6851), or if assessment or collection would be jeopardized by delay (secs. 6861 and 6862). In jeopardy situations, a levy may also be made without the 30 days' notice of intent to levy that is ordinarily required by section 6331(d)(2). The Code and regulations do not presently require District Counsel to review jeopardy assessments, termination assessments, or jeopardy levies, although the Internal Revenue Manual does require District Counsel review before such actions and it is current practice to make such a review.[116] The IRS bears the burden of proof with respect to the reasonableness of a jeopardy or termination assessment or a jeopardy levy (sec. 7429(g)).

Description of Proposal

The proposal would require IRS District Counsel review and approval before the IRS could make a jeopardy assessment, a termination assessment, or a jeopardy levy. If District Counsel's approval was not obtained, the taxpayer would be entitled to obtain abatement of the assessment or release of the levy, and, if the IRS failed to offer such relief, to appeal first to the Collections Appeals process and then to the U.S. District Court.

Effective Date

The proposal would be effective with respect to taxes assessed after the date of enactment.

Prior Action

No prior action.

Analysis

Seizure of property without the notice periods generally required by the Code is a serious matter that should not be undertaken without adequate safeguards for the property rights of the taxpayer. Determination of whether a jeopardy situation exists justifying immediate collection often involves difficult legal issues. District Counsel review prior to collection action may help protect taxpayers' property rights.

7. Require management approval of sales of perishable goods

Present Law

If the IRS seizes property that (1) is liable to perish, (2) is liable to become greatly reduced in price or value by keeping, or (3) can-

[116] IRM (CCDM) (34)(12)25.

not be kept without great expense, special rules apply (sec. 6336). First, the IRS must appraise the value of the property. Next, the IRS must give the owner the opportunity to pay (or give bond for) the appraised amount. If the owner does so, the property must be returned to the owner. If the owner does not do so, the IRS conducts a public sale of the property as soon as practicable. The IRS Manual ("IRM")[117] permits IRS district directors to delegate the authority to approve a sale to group managers.

Description of Proposal

The proposal would require approval by the IRS district director or assistant district director before the sale of perishable goods. If these provisions are not followed, taxpayers could sue for civil damages for unauthorized collection actions (sec. 7433). Taxpayers would be permitted to waive the requirement of approval.[118] The proposal would also clarify what a perishable good is.[119]

Effective Date

The proposal would be effective with respect to taxes assessed after the date of enactment.

Prior Action

No prior action.

Analysis

Taxpayers may find it beneficial to have these approval requirements applied to sales of perishable goods, in that doing so will help ensure more careful consideration of the appropriateness of all elements of the sale.

8. Codify certain fair debt collection practices

Present Law

The Fair Debt Collection Practices Act[120] provides a number of rules relating to debt collection practices. Among these are restrictions on communication with the consumer, such as a general prohibition on telephone calls outside the hours of 8:00 a.m. to 9:00 p.m. local time,[121] and prohibitions on harassing or abusing the consumer.[122] In general, these provisions do not apply to the Federal Government.[123] These provisions relating to communication with the consumer and prohibiting harassing or abusing the consumer have been applied to the IRS through the appropriations process.[124]

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[117] IRM Part V, chapter 5600, 56(14)5.

[118] It is anticipated that owners would consider doing so when time is of the essence and an immediate sale was in the owner's best interests.

[119] The proposal does not specifiy the natue of the clarification.

[120] 15 U.S.C. 1692.

[121] 15 U.S.C. 1692c.(a).

[122] 15 U.S.C. 1692d.

[123] 15 U.S.C. 1692a.(6)(c).

[124] Section 104 of the Fiscal Year 1998 Treasury Department Appropriations Act.

Description of Proposal

The proposal would make the restrictions relating to communication with the consumer and the prohibitions on harassing or abusing the consumer applicable to the IRS by incorporating these provisions into the Internal Revenue Code.

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

The 1998 Treasury Department Appropriations Act requires that the IRS follow these restrictions.

Analysis

Placing these restrictions in the Code may improve the general awareness of these restrictions and emphasize their importance.

9. Payment of taxes

Present Law

The Code provides that it is lawful for the Secretary to accept checks or money orders as payment for taxes, to the extent and under the conditions provided in regulations prescribed by the Secretary (sec. 6311). Those regulations [125] state that checks or money orders should be made payable to the Internal Revenue Service.

Description of Proposal

The proposal would require the Secretary or his delegate to establish such rules, regulations, and procedures as are necessary to allow payment of taxes by check or money order to be made payable to the United States Treasury.

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

The proposal is contained in section 374 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997.

Analysis

The proponents believe that it is more appropriate that checks be made payable to the United States Treasury rather than the Internal Revenue Service. They argue that it may improve the public's perception of the IRS by raising awareness that the IRS is merely the collector of revenue for the Federal Government.

[125] Treas. Reg. Sec. 301.6311–1(a)(1).

10. Procedures relating to extensions of statute of limitations by agreement

Present Law

The statute of limitations within which the IRS may assess additional taxes is generally three years from the date a return is filed (sec. 6501).[126] Prior to the expiration of the statute of limitations, both the taxpayer and the IRS may agree in writing to extend the statute, using Form 872 or 872–A. An extension may be for either a specified period or an indefinite period. The statute of limitations within which a tax may be collected after assessment is 10 years after assessment (sec. 6502). Prior to the expiration of the statute of limitations, both the taxpayer and the IRS may agree in writing to extend the statute, using Form 900.

Description of Proposal

The proposal would require that, on each occasion on which the taxpayer is requested by the IRS to extend the statute of limitations, the IRS must notify the taxpayer of the taxpayer's right to refuse to extend the statute of limitations or to limit the extension to particular issues.

Effective Date

The proposal would apply to requests to extend the statute of limitations made after the date of enactment.

Prior Action

The proposal is contained in section 345 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997.

Analysis

The proponents believe that taxpayers should be fully informed of their rights with respect to the statute of limitations.

11. Offers-in-compromise

Present Law

Section 7122 of the Code permits the IRS to compromise a taxpayer's tax liability. In general, this occurs when a taxpayer submits an offer-in-compromise to the IRS. An offer-in- compromise is a proposal to settle unpaid tax accounts for less than the full amount of the assessed balance due. An offer-in-compromise may be submitted for all types of taxes, as well as interest and penalties, arising under the Internal Revenue Code.

Taxpayers submit an offer-in-compromise on Form 656. There are two bases on which an offer can be made. The first is doubt as to the liability for the amount owed. The second is doubt as to the taxpayer's ability fully to pay the amount owed. An application

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[126] For this purpose, a return filed before the due date is considered to be filed on the due date.

can be made on either or both of these grounds. Taxpayers are required to submit background information to the IRS substantiating their application. If they are applying on the basis of doubt as to the taxpayer's ability fully to pay the amount owed, the taxpayer must complete a financial disclosure form enumerating assets and liabilities.

As part of an offer-in-compromise made on the basis of doubt as to ability fully to pay, taxpayers must agree to comply with all provisions of the Internal Revenue Code relating to filing returns and paying taxes for five years from the date the IRS accepts the offer. Failure to observe this requirement permits the IRS to begin immediate collection actions for the original amount of the liability.

Description of Proposal

The proposal would require the IRS to develop and publish schedules of national and local allowances designed to provide taxpayers entering into an offer-in-compromise with adequate means to provide for basic living expenses.

Effective Date

The materials required by this provision would be required to be published as soon as practicable, but no later than 180 days after the date of enactment.

Prior Action

The proposal is contained in section 346 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997. (That section of the House bill also contains additional provisions relating to offers-in-compromise.)

Analysis

In determining whether there is doubt as to the taxpayer's ability fully to pay the amount owed, the proponents believe that the Secretary should take into consideration a taxpayer's need to provide for the basic living expenses of his or her family, based on the cost of living in the taxpayer's locality.

12. Ensure availability of installment agreements

Present Law

Section 6159 of the Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed. An installment agreement does not reduce the amount of taxes, interest, or penalties owed; it does, however, provide for a longer period during which payments may be made during which other IRS enforcement actions (such as levies or seizures) are held in abeyance. Many taxpayers can request an installment agreement by filing form 9465. This form is relatively simple and does not require the submission of detailed financial statements. The IRS in most instances readily approves these requests if the amounts involved are not large (in general, below $10,000) and if the taxpayer has filed tax returns on time in the past. Some taxpayers are required to submit background information to the IRS substantiating their application. If the request for an installment agreement is approved by the IRS, a user fee of $43 is charged.[127] This user fee is in addition to the tax, interest, and penalties that are owed.

Description of Proposal

The proposal would require the Secretary to enter an installment agreement, at the taxpayer's option, if:

(1) the liability is $10,000 or less;

(2) within the previous 5 years, the taxpayer has not failed to file or to pay, nor entered an installment agreement under this provision;

(3) if requested by the Secretary, the taxpayer submits financial statements that demonstrate an inability to pay the tax due in full;

(4) the installment agreement provides for full payment of the liability within 3 years, with installment payments made by direct debit of the taxpayer's bank account;

(5) the taxpayer extends the statute of limitations on collection during the term of the agreement; and (6) the taxpayer agrees to continue to comply with the tax laws and the terms of the agreement for the period (up to 3 years) that the agreement is in place.

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

Several elements of the proposal essentially codify current IRS Manual provisions relating to installment agreements.

Analysis

Taxpayers may consider it helpful to have statutory assurance of their right to an installment agreement.

13. Increase superpriority dollar limits

Present Law

The Federal tax lien attaches to all property and rights in property of the taxpayer, if the taxpayer fails to pay the assessed tax liability after notice and demand (sec. 6321). However, the Federal tax lien is not valid as to certain "superpriority" interests as defined in section 6323(b).

Two of these interests are limited by a specific dollar amount. Under section 6323(b)(4), purchasers of personal property at a casual sale are presently protected against a Federal tax lien attached to such property to the extent the sale is for less than $250. Section 6323(b)(7) provides protection to mechanic's lienors with respect to

[127] This user fee is imposed pursuant to 31 U.S.C. 9701. See T.D. 8589 (February 14, 1995).

the repairs or improvements made to owner- occupied personal residences, but only to the extent that the contract for repair or improvement is for not more than $1,000.

In addition, a superpriority is granted under section 6323(b)(10) to banks and building and loan associations which make passbook loans to their customers, provided that those institutions retain the passbooks in their possession until the loan is completely paid off.

Description of Proposal

The proposal would increase the dollar limit in section 6323(b)(4) for purchasers at a casual sale from $250 to $1,000, and it would increase the dollar limit in section 6323(b)(7) from $1,000 to $5,000 for mechanics lienors providing home improvement work for owner-occupied personal residences. The proposal would index these amounts for inflation. The proposal also would clarify section 6323(b)(10) to reflect present banking practices, where a passbook-type loan may be made even though an actual passbook is not used.

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

No prior action.

Analysis

The dollar limits on the superpriority amounts have not been increased for decades and do not reflect present prices or values. Similarly, the passbook loan requirement does not reflect present banking practices, in which an actual passbook is not used.. If the policy behind the creation of superpriority interests is still valid, then increasing the limits would be appropriate, as the protection provided by present law is not effective because it is so limited.

14. Permit personal delivery of section 6672(b) notices

Present Law

Any person who is required to collect, truthfully account for, and pay over any tax imposed by the Internal Revenue Code who willfully fails to do so is liable for a penalty equal to the amount of the tax (Sec. 6672(a)). Before the IRS may assess any such "100 percent penalty," it must mail a written preliminary notice informing the person of the proposed penalty to that person's last known address. The mailing of such notice must precede any notice and demand for payment of the penalty by at least 60 days. The statute of limitations shall not expire before the date 90 days after the date in which the notice was mailed. These restrictions do not apply if the Secretary finds the collection of the penalty is in jeopardy.

Description of Proposal

The proposal would permit personal delivery, as an alternative to delivery by mail, of a preliminary notice that the IRS intends to assess a 100 percent penalty.

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

The requirement that such preliminary notices be mailed to the person's last known address was added in 1996 by the Taxpayer Bill of Rights 2 (P.L. 104–168).

Analysis

A penalty under section 6672 may be assessed where a "responsible person" willfully fails to remit Federal income tax withholding, social security and health insurance taxes. A "responsible person" includes the employer and certain employees of the employer who have control over the use of corporate funds. An individual identified by the IRS as a responsible person is permitted an administrative appeal on the question of responsibility.

At the time Congress added the requirement that the preliminary notice of intention to assess a penalty under section 6672 be mailed, it was concerned that some employees may not be fully aware of their personal liability under section 6672 and believed that the IRS could make additional efforts to assist the public in understanding its responsibilities.[128]

The IRS and the Treasury Department have expressed concern that the requirement that preliminary notices be mailed leads to unnecessary disputes over whether the notice was properly addressed or received. The IRS and the Treasury Department have also suggested that if the preliminary notice could be personally delivered it could afford an additional opportunity to resolve disputes in these cases at an earlier stage.

In requiring the preliminary notice to be mailed, Congress insured that the person to whom the notice was addressed would have an opportunity to consider the issue of personal liability for the penalty before being required to respond. Personal delivery should not change this, since the 60–day waiting period between the mailing or personal delivery of the notice and the assessment of any penalty would continue to apply.

15. Allow taxpayers to quash all third-party summonses

Present Law

When the IRS issues a summons to a "third-party record keeper" relating to the business transactions or affairs of a taxpayer, section 7609 requires that notice of the summons be given to the taxpayer within three days by certified or registered mail. The taxpayer is thereafter given up to 23 days to begin a court proceeding

[128] See Joint Committee on Taxation, *General Explanation of Tax Legislation Encated in the 104th Congress* (JCS–12–96), December 18, 1996, pp. 38–39.

to quash the summons. If the taxpayer does so, third-party record keepers are prohibited from complying with the summons until the court rules on the taxpayer's petition to quash, but the statute of limitations for assessment and collection with respect to the taxpayer is stayed during the pendency of such a proceeding. Third-party record keepers are generally persons who hold financial information about the taxpayer, such as banks, brokers, attorneys, and accountants.

Description of Proposal

The proposal would generally expand the current "third-party record keeper" procedures to apply to all summonses issued to persons other than the taxpayer. Thus, the taxpayer whose liability is being investigated would receive notice of the summons and would be entitled to bring an action in the appropriate U.S. District Court to quash the summons, although (as under the current third-party record keeper provision) the statute of limitations on assessment and collection would be stayed pending the litigation, and certain kinds of summonses specified under current law would not be subject to these requirements.

Effective Date

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

Prior Action

No prior action.

Analysis

A taxpayer should have notice when the IRS utilizes its summons power to gather information in an effort to determine the taxpayer's liability. A taxpayer should be able to challenge all such efforts where appropriate, and not just those situations where the IRS is attempting to recover records related to the taxpayer from a specially-defined third party. Allowing a taxpayer to challenge all third party summons will also eliminate unnecessary disputes between taxpayers, third parties and the IRS as to whether a summonsed third party is a record keeper.

16. Disclosure of criteria for examination selection

Present Law

The IRS examines Federal tax returns to determine the correct liability of taxpayers. The IRS selects returns to be audited in a number of ways, such as through a computerized classification system (known as the discriminant function ("DIF") system).

Description of Proposal

The proposal would require that IRS add to Publication 1 ("Your Rights as a Taxpayer") a statement which sets forth in simple and nontechnical terms the criteria and procedures for selecting taxpayers for examination. The statement must not include any information the disclosure of which would be detrimental to law enforcement. The statement must specify the general procedures used by the IRS, including whether taxpayers are selected for examination on the basis of information in the media or from informants. Drafts of the statement or proposed revisions to the statement would be required to be submitted to the House Committee on Ways and Means, the Senate Committee on Finance, and the Joint Committee on Taxation.

Effective Date

The addition to Publication 1 would be required to be made not later than 180 days after the date of enactment.

Prior Action

The proposal is contained in section 353 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997.

Analysis

The proponents believe that it is important that taxpayers understand the reasons they may be selected for examination.

17. Threat of audit prohibited to coerce tip reporting alternative commitment agreements

Present Law

Restaurants may enter into Tip Reporting Alternative Commitment ("TRAC") agreements. A restaurant entering into a TRAC agreement is obligated to educate its employees on their tip reporting obligations, to institute formal tip reporting procedures, to fulfill all filing and record keeping requirements, and to pay and deposit taxes. In return, the IRS agrees to base the restaurant's liability for employment taxes solely on reported tips and any unreported tips discovered during an IRS audit of an employee.

Description of Proposal

The proposal would require the IRS to instruct its employees that they may not threaten to audit any taxpayer in an attempt to coerce the taxpayer to enter into a TRAC agreement.

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

The proposal is contained in section 349 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997.

Analysis

The proponents believe that it is inappropriate for the Secretary to use the threat of an IRS audit to induce participation in voluntary programs.

18. Permit service of summonses by mail

Present Law

Section 7603 requires that a summons shall be served "by an attested copy delivered in hand to the person to whom it is directed or left at his last and usual place of abode." By contrast, if a third-party recordkeeper summons is served, section 7609 permits the IRS to give the taxpayer notice of the summons via certified or registered mail. Moreover, Rule 4 of the Federal Rules of Civil Procedure permits service of process by mail even in summons enforcement proceedings.

Description of Proposal

The proposal would permit the IRS the option to serve all summonses in person or by mail.

Effective Date

The provision would be effective for summonses served after the date of enactment.

Prior Action

No prior action.

Analysis

The proposal would conform the general service of summons procedures to the procedures applicable to third party recordkeeper summonses and to the service of process requirements of the Federal Rules of Civil Procedure.

Many IRS summonses are used to obtain financial data from large corporate financial institutions, such as banks and brokers. Under present law, IRS officials must appear personally and serve the summons on an officer of the corporation designated to receive service of process. This unnecessarily disruptive intrusion could be avoided were the mails used as an option.

19. Civil damages for violation of certain bankruptcy procedures

Present Law

A taxpayer may sue the United States for up to $1 million of civil damages caused by an officer or employee of the IRS who recklessly or intentionally disregards provisions of the Internal Revenue Code or Treasury regulations in connection with the collection of Federal tax with respect to the taxpayer.

Description of Proposal

The proposal would provide for up to $1 million in civil damages caused by an officer or employee of the IRS who willfully disregards provisions of the Bankruptcy Code relating to automatic stays or discharges. No person is entitled to seek civil damages in a court of law unless he first exhausts his administrative remedies.

Effective Date

The proposal would be effective with respect to actions of officers or employees of the IRS occurring after the date of enactment.

Prior Action

No prior action.

Analysis

The proponents believe that taxpayers should also be able to recover economic damages they incur as a result of a willful violation by an officer or employee of the IRS of these provisions of the Bankruptcy Code.

20. Increase in size of cases permitted on small case calendar in the Tax Court

Present Law

Taxpayers may choose to contest many tax disputes in the Tax Court. Special small case procedures apply to disputes involving $10,000 or less, if the taxpayer chooses to utilize these procedures (and the Tax Court concurs).

Description of Proposal

The proposal would increase the cap for small case treatment from $10,000 to $25,000.

Effective Date

The proposal would apply to proceedings commenced after the date of enactment.

Prior Action

The proposal is contained in section 313 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997.

Analysis

The proponents believe that use of the small case procedures should be expanded.

21. Suspension of statute of limitations on filing refund claims during periods of disability

Present Law

In general, a taxpayer must file a refund claim within three years of the filing of the return or within two years of the payment of the tax, whichever period expires later (if no return is filed, the two-year limit applies) (sec. 6511(a)). A refund claim that is not filed within these time periods is rejected as untimely.

There is no explicit statutory rule providing for equitable tolling of the statute of limitations. Several courts have considered whether equitable tolling implicitly exists. The First, Third, Fourth, and Eleventh Circuits have rejected equitable tolling with respect to tax refund claims. The Ninth Circuit has permitted equitable tolling. However, the U.S. Supreme Court has reversed the Ninth Circuit in *U.S.* v. *Brockamp* [129], holding that Congress did not intend the equitable tolling doctrine to apply to the statutory limitations of section 6511 on the filing of tax refund claims.

Description of Proposal

The proposal would permit equitable tolling of the statute of limitations for refund claims of an individual taxpayer during any period of the individual's life in which he or she is unable to manage his or her financial affairs by reason of a medically determinable physical or mental impairment that can be expected to result in death or to last for a continuous period of not less than 12 months. Proof of the existence of the impairment must be furnished in the form and manner required by the Secretary. Tolling would not apply during periods in which the taxpayer's spouse or another person is authorized to act on the taxpayer's behalf in financial matters.

Effective Date

The proposal would apply to taxable years ending after the date of enactment.

Prior Action

The proposal (with a different effective date) is contained in section 322 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997.

Analysis

The proponents believe that, in cases of severe disability, equitable tolling should be considered in the application of the statutory limitations on the filing of tax refund claims.

[129] 117 S. Ct. 849 (1997), reversing 67 F. 3d 260 and 70 F. 3d 120.

22. Notice of deficiency to specify deadlines for filing Tax Court petition

Present Law

Taxpayers must file a petition with the Tax Court within 90 days after the deficiency notice is mailed (150 days if the person is outside the United States) (sec. 6213). If the petition is not filed within that time period, the Tax Court does not have jurisdiction to consider the petition.

Description of Proposal

The proposal would require that the IRS include on each deficiency notice the date determined by the IRS as the last day on which the taxpayer may file a petition with the Tax Court. The last day on which a taxpayer who is outside the United States may file a petition with the Tax Court would be shown as an alternative. The proposal would provide that a petition filed with the Tax Court by this date shall be treated as timely filed.

Effective Date

The proposal would apply to notices mailed after December 31, 1998.

Prior Action

The proposal is contained in section 347 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997.

Analysis

Proponents of the proposal believe that taxpayers should receive assistance in determining the time period within which they must file a petition in the Tax Court and that taxpayers should be able to rely on the computation of that period by the IRS. Computation of the time period may be difficult for some taxpayers and the consequences of missing the filing deadline are severe (loss of the ability to litigate in a prepayment forum).

23. Allow actions for refund with respect to certain estates which have elected the installment method of payment

Present Law

In general, the U.S. Court of Federal Claims and the U.S. district courts have jurisdiction over suits for the refund of taxes, as long as full payment of the assessed tax liability has been made. *Flora* v. *United States,* 357 U.S. 63 (1958), aff'd on reh'g, 362 U.S. 145 (1960). Under Code section 6166, if certain conditions are met, the executor of a decedent's estate may elect to pay the estate tax attributable to certain closely-held businesses over a 14-year period. Courts have held that U.S. district courts and the U.S. Court of Federal Claims do not have jurisdiction over claims for refunds by taxpayers deferring estate tax payments pursuant to section 6166 unless the entire estate tax liability has been paid (i.e., timely payment of the installments due prior to the bringing of an action is not sufficient to invoke jurisdiction). See, e.g., *Rocovich* v. *United States*, 933 F.2d 991 (Fed. Cir. 1991), *Abruzzo* v. *United States*, 24 Ct. Cl. 668 (1991). A provision in the Taxpayer Relief Act of 1997, however, provides limited authority to the U.S. Tax Court to provide declaratory judgments regarding initial or continuing eligibility for deferral under section 6166.

Description of Proposal

The proposal would grant the U.S. Court of Federal Claims and the U.S. district courts jurisdiction to determine the correct amount of estate tax liability (or refund) in actions brought by taxpayers deferring estate tax payments under section 6166, as long certain conditions are met. In order to qualify for the proposal, the estate must have made an election pursuant to section 6166, fully paid each installment of principal and/or interest due before the date the suit is filed (as long as one or more installments are not yet due), and no portion of the payments due may have been accelerated. The proposal further would provide that once a final judgment has been entered by a district court or the U.S. Court of Federal Claims, the IRS would not be permitted to collect any amount disallowed by the court, and any amounts paid by the taxpayer in excess of the amount the court finds to be currently due and payable would be refunded to the taxpayer. Lastly, the proposal would provide that the two-year statute of limitations for filing a refund action would be suspended during the pendency of any action brought by a taxpayer pursuant to section 7479 for a declaratory judgment as to an estate's eligibility for section 6166.

Effective Date

The proposal would be effective for claims for refunds filed after the date of enactment.

Prior Action

The proposal is contained in H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997.

Analysis

Present-law section 6166 allows taxpayers to defer payment of estate taxes attributable to certain closely-held businesses, and pay such taxes over a 14-year period. Section 6166 was enacted to address the liquidity problems of estates holding farms and closely held businesses, so that such businesses need not be liquidated in order to pay estate taxes. Where an installment election has been made under 6166, taxpayers may have limited access to judicial review of the amount of estate tax liability before the entire estate tax liability has been paid. If a dispute arises as to the amount of estate taxes due with respect to the closely-held business, taxpayers may be required to pay the full amount of estate taxes the IRS asserts as being owed for the full 14-year period in order to obtain judicial review of the IRS determination, which could cause the potential liquidation of the assets and frustrate the purpose behind the installment provisions of section 6166. In addition, where installment payments are being made over a 14-year period, the two-year statute of limitations for filing refund claims could operate to bar refunds with respect to payments made more than two years prior to the date the refund action is filed.

The proposal is intended to equalize access to the courts between taxpayers who are required to pay their full estate tax liability at one time with those taxpayers who are deferring payments under section 6166, as long as such taxpayers are current with respect to their installment payments. To ensure that taxpayers deferring payments under 6166 are not provided with greater access to the courts than taxpayers who have not made such an election, and to ensure that the proposal would operate as intended, possible modifications to the Administration proposal have been suggested. Under these proposed modifications, in order to commence suit: (1) the estate must have paid all non-6166-related estate taxes due (in addition to any 6166 installments due before the date the suit is filed), (2) there must be no suits for declaratory judgment pursuant to section 7479 pending, (3) there must be no outstanding deficiency notices against the estate, and (4) the taxpayer must continue to make any installment payments that come due while the lawsuit is pending.

24. Expansion of authority to award costs and certain fees

Present Law

Any person who substantially prevails in any action by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding. In general, only an individual whose net worth does not exceed $2 million is eligible for an award, and only a corporation or partnership whose net worth does not exceed $7 million is eligible for an award.

Reasonable litigation costs include reasonable fees paid or incurred for the services of attorneys, except that the attorney's fees will not be reimbursed at a rate in excess of $110 per hour (indexed for inflation) unless the court determines that a special factor, such as the limited availability of qualified attorneys for the proceeding, justifies a higher rate. Awards of reasonable litigation costs and reasonable administrative costs cannot exceed amounts paid or incurred.

Once a taxpayer has substantially prevailed over the IRS in a tax dispute, the IRS has the burden of proof to establish that it was substantially justified in maintaining its position against the taxpayer. A rebuttable presumption exists that provides that the position of the United States is not considered to be substantially justified if the IRS did not follow in the administrative proceeding (1) its published regulations, revenue rulings, revenue procedures, information releases, notices, or announcements, or (2) a private letter ruling, determination letter, or technical advice memorandum issued to the taxpayer.

Description of Proposal

The proposal would permit the award of attorney's fees (in amounts up to the statutory limit determined to be appropriate) to specified persons who represent for no more than a nominal fee a taxpayer who is a prevailing party.

Effective Date

The proposal would apply to costs incurred and services performed after the date of enactment.

Prior Action

The proposal is contained in section 311 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997. (That section of the House bill also contains additional provisions relating to attorney's fees.)

Analysis

The proponents believe that the pro bono publicum representation of taxpayers should be encouraged and the value of the legal services rendered in these situations should be recognized. Where the IRS takes positions that are not substantially justified, it should not be relieved of its obligation to bear reasonable administrative and litigation costs because representation was provided the taxpayer on a pro bono basis.

25. Expansion of authority to issue taxpayer assistance orders

Present Law

Taxpayers can request that the Taxpayer Advocate in the Internal Revenue Service ("IRS") issue a taxpayer assistance order ("TAO") if they are suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered (sec. 7811). A TAO may require the IRS to release property of the taxpayer that has been levied upon, or to cease any action, take any action as permitted by law, or refrain from taking any action with respect to the taxpayer.

Description of Proposal

The proposal would provide that in determining whether to issue a TAO, the Taxpayer Advocate shall consider, among others, the following four factors: (1) whether there is an immediate threat of adverse action; (2) whether there has been an unreasonable delay in resolving the taxpayer's account problems; (3) whether the taxpayer will have to pay significant costs (including fees for professional representation) if relief is not granted; and (4) whether the taxpayer will suffer irreparable injury, or a long-term adverse impact, if relief is not granted.

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

A substantially similar proposal is contained in section 342 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997.

Analysis

The proponents believe that these factors should generally be considered by the Taxpayer Advocate in determining whether a taxpayer assistance order should be issued.

26. Provide new remedy for third parties who claim that the IRS has filed an erroneous lien

Present Law

Prior to 1995, the provisions governing jurisdiction over refund suits had generally been interpreted to apply only if an action was brought by the taxpayer against whom tax was assessed. Remedies for third parties from whom tax was collected (rather than assessed) were found in other provisions of the Internal Revenue Code. The Supreme Court held in *Williams* v. *United States*, 115 S.Ct. 1611 (1995), however, that a third party who paid another person's tax under protest to remove a lien on the third party's property could bring a refund suit, because she had no other adequate administrative or judicial remedy. In *Williams*, the IRS had filed a nominee lien against property that was owned by the taxpayer's former spouse and that was under a contract for sale. In order to complete the sale, the former spouse paid the amount of the lien under protest, and then sued in district court to recover the amount paid. The Supreme Court held that parties who are forced to pay another's tax under duress could bring a refund suit, because no other judicial remedy was adequate.

Description of Proposal

The proposal would create an administrative procedure similar to the wrongful levy remedy for third parties in section 7426. Under this procedure, a record owner of property against which a Federal tax lien had been filed could obtain a certificate of discharge of property from the lien as a matter of right. The third party would be required to apply to the Secretary of the Treasury for such a certificate and either to deposit cash or to furnish a bond sufficient to protect the lien interest of the United States. Although the Secretary would determine the amount of the bond necessary to protect the Government's lien interest, if this procedure was followed the Secretary would have no discretion to refuse to issue a certificate of discharge, thus curing the defect in this remedy that the Supreme Court found in *Williams*. A certificate of discharge of property from a lien issued pursuant to the procedure would enable the record owner to sell the property free and clear of the Federal tax lien in all circumstances. The proposal also would authorize the refund of all or part of the amount deposited, plus interest at the same rate that would be made on an overpayment of tax by the taxpayer, or the release of all or part of the bond, if the Secretary otherwise satisfies the tax liability or determines that the United States does not have a lien interest or has a lesser lien interest than the amount initially determined.

The proposal would also establish a judicial cause of action for third parties challenging a lien that is similar to the wrongful levy remedy in section 7426. The period within which such an action must be commenced would be a short period (120 days) to ensure an early resolution of the parties' interests. The statute of limitations on collecting from the taxpayer would be stayed while a third party challenged a lien in court under these procedures. Upon conclusion of the litigation, the IRS would be authorized to apply the deposit or bond to the assessed liability and to refund to the third party any amount in excess of the liability, plus interest, or to release the bond. Actions to quiet title under 28 U.S.C. §2410 would still be available to persons who did not seek the expedited review permitted under the new statutory procedure.

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

No prior action.

Analysis

The *Williams* decision left many important questions unresolved, such as: which class of third parties have standing; what administrative procedure is required before litigation; the applicable statutes of limitations; the IRS's authority to pay interest on such a refund; and how to prevent expiration of the collection period on the taxpayer while the third party from whom the tax was collected challenges the IRS. In order to avoid prolonged uncertainty in this area, it may be appropriate to resolve these questions by statute rather than through litigation.

27. Allow civil damages for unauthorized collection actions by persons other than the taxpayer

Present Law

A taxpayer may sue the United States for up to $1 million of civil damages caused by an officer or employee of the IRS who recklessly or intentionally disregards provisions of the Internal Revenue Code or Treasury regulations in connection with the collection of Federal tax with respect to the taxpayer.

Description of Proposal

The proposal would provide that persons other than the taxpayer may sue for civil damages for unauthorized collection actions.

Effective Date

The proposal would be effective with respect to action of officers or employees of the IRS occurring after the date of enactment.

Analysis

Proponents argue that anyone should be able to recover economic damages they incur as a result of unauthorized collection actions.

28. Suspend collection in certain joint liability cases

Present Law

In general, spouses who file a joint tax return are each fully responsible for the full tax liability. However, both spouses need not join in contesting such liability in the Tax Court. Thus, it is possible for one spouse to file a petition in Tax Court while the other spouse does not. The IRS may not assess the tax liability or take collection action against the spouse who has filed the petition in Tax Court, until the Tax Court decision is final (sec. 6213(a)). However, there are no provisions in the Code or the regulations that prohibit administrative collection action against a nonpetitioning spouse during the pendency of the Tax Court. In general, the IRS is authorized to assess and commence collection action against the nonpetitioning spouse after the expiration of the 90 (or 150) day period in section 6213(c). The IRS's policy is generally to forbear from administrative collection until the Tax Court renders its decision on the liability.[130]

Under certain circumstances, collection action may be appropriate even during the pendency of the Tax Court action. Collection is appropriate if the amount of the assessment is not being contested in the Tax Court, such as when the petitioning spouse is seeking relief solely as an innocent spouse. Collection may also be appropriate when the interests of the IRS are likely to be jeopardized by forbearance, such as when the nonpetitioning spouse intends to file a bankruptcy petition or leave the United States.

Description of Proposal

When a married couple's joint return is the subject of a Tax Court proceeding, the proposal would require the IRS to withhold collection by levy against a nonpetitioning spouse during the pendency of a Tax Court proceeding involving the other spouse. This would treat the nonpetitioning spouse the same as the petitioning spouse in most situations. Certain exceptions would be provided, including in jeopardy situations, when the taxpayer waives this protection (*i.e.*, agrees to the collection action), or for some other, limited but automatic kinds of collection activity, such as automatic refund offset, filing of protective notices of Federal tax lien, or in certain other circumstances. The statute of limitations on assessment and collection would be stayed for the period during which collection is barred. In general, if there is a final decision that reduces the proposed assessment against the petitioning spouse, the assessment against the nonpetitioning spouse would likewise be re-

[130] IRS Policy Statement P–5–16.

duced. The proposal would not affect the IRS's ability to collect other liabilities or assessments that are not the subject of the Tax Court proceeding.

Effective Date

The proposal would be effective for taxes assessed with respect to taxable years beginning after December 31, 1998.

Prior Action

No prior action.

Analysis

A nonpetitioning spouse should generally receive the same protection against IRS collection action as the spouse who has filed a petition in Tax Court contesting a proposed deficiency. The stay of collection protects nonpetitioning taxpayers from premature deprivation of their property, before the adjudication of the joint and several liability. This proposal generally complements the proposal on innocent spouse relief.

29. Explanation of joint and several liability

Present Law

In general, spouses who file a joint tax return are each fully responsible for the accuracy of the tax return and for the full liability. This is true even though only one spouse may have earned the wages or income which is shown on the return. This is "joint and several" liability. Spouses who wish to avoid joint and several liability may file as a married person filing separately. Special rules apply in the case of innocent spouses pursuant to section 6013(e).

Description of Proposal

The proposal would require that, no later than 180 days after the date of enactment, the IRS must establish procedures clearly to alert married taxpayers of their joint and several liability on all appropriate tax publications and instructions.

Effective Date

The proposal would require that the procedures be established as soon as practicable, but no later than 180 days after the date of enactment.

Prior Action

The proposal is contained in section 351 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997.

Analysis

The proposal would assist married taxpayers need in clearly understanding the legal implications of signing a joint return; it is appropriate for the IRS to provide the information necessary for that understanding.

30. Innocent spouse relief

Present Law

Spouses who file a joint tax return are each fully responsible for the accuracy of the return and for the full tax liability. This is true even though only one spouse may have earned the wages or income which is shown on the return. This is "joint and several" liability. A spouse who wishes to avoid joint liability may file as a "married person filing separately.'

Relief from liability for tax, interest and penalties is available for "innocent spouses" in certain limited circumstances. To qualify for such relief, the innocent spouse must establish: (1) that a joint return was made; (2) that an understatement of tax, which exceeds the greater of $500 or a specified percentage of the innocent spouse's adjusted gross income for the preadjustment (most recent) year, is attributable to a grossly erroneous item [131] of the other spouse; (3) that in signing the return, the innocent spouse did not know, and had no reason to know, that there was an understatement of tax; and (4) that taking into account all the facts and circumstances, it is inequitable to hold the innocent spouse liable for the deficiency in tax. The specified percentage of adjusted gross income is 10 percent if adjusted gross income is $20,000 or less. Otherwise, the specified percentage is 25 percent.

It is unclear under present law whether a court may grant partial innocent spouse relief. The Ninth Circuit Court of Appeals in *Wiksell* v. *Commissioner* [132] has allowed partial innocent spouse relief where the spouse did not know, and had no reason to know, the magnitude of the understatement of tax, even though the spouse knew that the return may have included some understatement.

The proper forum for contesting a denial by the Secretary of innocent spouse relief is determined by whether an underpayment is asserted or the taxpayer is seeking a refund of overpaid taxes. Accordingly, the Tax Court may not have jurisdiction to review all denials of innocent spouse relief.

No form is currently provided to assist taxpayers in applying for innocent spouse relief.

Description of Proposal

The proposal generally would make innocent spouse status easier to obtain. The proposal would eliminate all of the understatement thresholds and requires only that the understatement of tax be attributable to an erroneous (and not just a grossly erroneous) item of the other spouse. The proposal would also make parallel the innocent spouse rules applicable in community property States and common law States.

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[131] Grossly erroneous items include items of gross income that are omitted from reported income and claims of deductions, credits, or basis in an amount for which there is no basis in fact or lwa (Code sec. 6013(e)(2)).

[132] 90 F.3d 1459 (9th Cir. 1997).

The proposal would provide that the Tax Court has jurisdiction to review any denial (or failure to rule) by the Secretary regarding an application for innocent spouse relief. The Tax Court may order refunds as appropriate where it determines the spouse qualifies for relief and an overpayment exists as a result of the innocent spouse qualifying for such relief. The taxpayer must file his or her petition for review with the Tax Court during the 90-day period that begins on the earlier of (1) 6 months after the date the taxpayer filed his or her claim for innocent spouse relief with the Secretary or (2) the date a notice denying innocent spouse relief was mailed by the Secretary. Except for termination and jeopardy assessments (secs. 6851, 6861), the Secretary would not be permitted to levy or proceed in court to collect any tax from a taxpayer claiming innocent spouse status with regard to such tax until the expiration of the 90–day period in which such taxpayer may petition the Tax Court or, if the Tax Court considers such petition, before the decision of the Tax Court has become final. The running of the statute of limitations would be suspended in such situations with respect to the spouse claiming innocent spouse status.

The proposal would also require the Secretary of the Treasury to develop a separate form with instructions for taxpayers to use in applying for innocent spouse relief within 180 days from the date of enactment.

Effective Date

The proposal would be effective for understatements with respect to taxable years beginning after the date of enactment. An innocent spouse seeking relief under this proposal must claim innocent spouse status with regard to any assessment not later than two years after the date of such assessment.

Prior Action

A similar proposal is contained in section 321 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997.

Analysis

The proponents are concerned that the innocent spouse provisions of present law are inadequate. The proponents believe it is inappropriate to limit innocent spouse relief only to the most egregious cases where the understatement is large and the tax position taken is grossly erroneous. The proponents also believe that all taxpayers should have access to the Tax Court in resolving disputes concerning their status as an innocent spouse. Finally, the proponents believe that taxpayers need to be better informed of their right to apply for innocent spouse relief in appropriate cases and that the IRS is the best source of that information.

31. Elimination of interest differential on overlapping periods of interest on income tax overpayments and underpayments

Present Law

A taxpayer that underpays its taxes is required to pay interest on the underpayment at a rate equal to the Federal short-term interest rate plus three percentage points. A special "hot interest" rate equal to the Federal short-term interest rate plus five percentage points applies in the case of certain large corporate underpayments.

A taxpayer that overpays its taxes receives interest on the overpayment at a rate equal to the Federal short-term interest rate plus two percentage points. In the case of corporate overpayments in excess of $10,000, this is reduced to the Federal short-term interest rate plus one-half of a percentage point.

If a taxpayer has an underpayment of tax from one year and an overpayment of tax from a different year that are outstanding at the same time, the IRS will typically offset the overpayment against the underpayment and apply the appropriate interest to the resulting net underpayment or overpayment. However, if either the underpayment or overpayment have been satisfied, the IRS will not typically offset the two amounts, but rather will assess or credit interest on the full underpayment or overpayment at the underpayment or overpayment rate. This has the effect of assessing the underpayment at the higher underpayment rate and crediting the overpayment at the lower overpayment rate. This results in the taxpayer being assessed a net interest charge, even if the amounts of the overpayment and underpayment are the same.

The Secretary has the authority to credit the amount of any overpayment against any liability under the Code (sec. 6402). Congress has previously directed the Internal Revenue Service to consider procedures for "netting" overpayments and underpayments and, to the extent a portion of tax due is satisfied by a credit of an overpayment, not impose interest. [133]

Description of Proposal

The proposal would establish a net interest rate of zero on equivalent amounts of overpayment and underpayment of income tax that exist for any period, provided that the taxpayer reasonably identifies and establishes an appropriate situation for netting before the statute of limitations for filing a claim for refund for any of the periods involved has expired. Each overpayment and underpayment is to be considered only once in determining whether equivalent amounts of overpayment and underpayment exist. The special rules that increase the interest rate paid on large corporate underpayments and decrease the interest rate received on cor-

[133] Pursuant to TBOR2 (1996), the Secretary conducted a study of the manner in which the IRS has implemented the netting of interest on overpaymetns and underpayments and the policy and administrative implications of global netting. The legislative history to the General Agreement on Trade and Tariffs (GATT) (1994) stated that the Secretary should implement the most comprehensive crediting procedures that are consistent with sound administrative practice, and should do so as rapidly as is practicable. A similar statment was included in the Conference Report to the Omnibus Budget Reconciliation Act of 1990.

porate underpayments in excess of $10,000 would not prevent the application of the net zero rate. The proposal would apply to income taxes.

Effective Date

The proposal would apply prospectively, to periods of overlapping mutual indebtedness that occur after the date of enactment.

Prior Action

A similar proposal is contained in section 331 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997.

Analysis

The proponents believe that taxpayers should be charged interest only on the amount they actually owe, taking into account overpayments and underpayments from all open years.

32. Archive of records of the IRS

Present Law

The IRS is obligated to transfer agency records to the National Archives and Records Administration ("NARA") for retention or disposal. The IRS is also obligated to protect confidential taxpayer records from disclosure. These two obligations have created conflict between NARA and the IRS. Under present law, the IRS determines whether records contain taxpayer information. Once the IRS has made that determination, NARA is not permitted to examine those records. NARA has expressed concern that the IRS may be using the disclosure prohibition to improperly conceal agency records with historical significance.

IRS obligation to archive records

The IRS, like all other Federal agencies, must create, maintain, and preserve agency records in accordance with section 3101 of title 44 of the United States Code. NARA is the Government agency responsible for overseeing the management of the records of the Federal government.[134] Federal agencies are required to deposit significant and historical records with NARA.[135] The head of each Federal agency must also establish safeguards against the removal or loss of records.[136]

Authority of NARA

NARA is authorized, under the Federal Records Act, to establish standards for the selective retention of records of continuing value.[137] NARA has the statutory authority to inspect records management practices of Federal agencies and to make recommendations for improvement.[138] The head of each Federal agency must

[134] 44 U.S.C. sec. 2904
[135] 5 U.S.C. sec. 552a(b)(6),
[136] 44 U.S.C. sec. 3105.
[137] 44 U.S.C. sec. 2905.
[138] 44 U.S.C. sec. 2904(c)(7).

submit to NARA a list of records to be destroyed and a schedule for such destruction.[139] NARA examines the list to determine if any of the records on the list have sufficient administrative, legal research, or other value to warrant their continued preservation. In many cases, the description of the record on the list is sufficient for NARA to make the determination. For example, NARA does not need to inspect Presidential tax returns to determine that they have historical value and should be retained. In some cases, NARA may find it helpful to examine a particular record. NARA has general authority to inspect records solely for the purpose of making recommendations for the improvement of records management practices.[140] However, tax returns and return information can only be disclosed under the authority provided in section 6103 of the Internal Revenue Code. There is no exception to the disclosure prohibition for records management inspection by NARA.[141]

NARA is also responsible for the custody, use and withdrawal of records transferred to it.[142] Statutory provisions that restrict public access to the records in the hands of the agency from which the records were transferred also apply to NARA. Thus, if a confidential record, such as a Presidential tax return, is transferred to NARA for archival storage, NARA is not permitted to disclose it. In general, the application of such restrictions to records in the hands of NARA expire after the records have been in existence for 30 years.[143] The issue of whether the specific disclosure prohibition of section 6103 takes precedence over the general 30-year expiration of restrictions generally applicable to records in the hands of NARA has not been addressed by a court, but an informal advisory opinion from the Office of Legal Counsel of the Attorney General concluded that the 30–year expiration provision would not reach records subject to section 6103.[144]

Confidentiality requirements

The IRS must preserve the confidentiality of taxpayer information contained in Federal income tax returns. Such information may not be disclosed except as authorized under Code section 6103. Section 6103 was substantially revised in 1976 to address Congress' concern that tax information was being used by Federal agencies in pursuit of objectives unrelated to administration and enforcement of the tax laws. Congress believed that the widespread use of tax information by agencies other than the IRS could adversely affect the willingness of taxpayers to comply voluntarily with the tax laws and could undermine the country's self-assessment tax system.[145] Section 6103 does not authorize the disclosure of confidential return information to NARA.

Section 6103 restricts the disclosure of returns and return information only. Return means any tax or information return, declaration of estimated tax, or claim for refund, including schedules and

[139] 44 U.S.C. sec. 3303.
[140] 44 U.S.C. 2906.
[141] *American Friends Service Committee* v. *Webster*, 720 F.wd 29 (D.C. Cir. 1983).
[142] 44 U.S.C. sec. 2108.
[143] 44 U.S.C. sec. 2108.
[144] Department of Justice, Office of Legal Counsel, Memorandum to Richard K. Willard, Assistant Attorney General (Civil Division) (February 27, 1986).
[145] S. Rept. 94–938, p. 317 (1976).

attachments thereto, filed with the IRS. Return information includes the taxpayer's name; nature and source or amount of income; and whether the taxpayer's return is under investigation. Section 6103(b)(2) provides that "nothing in any other provision of law shall be construed to require the disclosure of standards used or to be used for the selection of returns for examination, or data used or to be used for determining such standards, if the Secretary determines that such disclosure will seriously impair assessment, collection, or enforcement under the internal revenue laws." Section 6103 does not restrict the disclosure of other records required to be maintained by the IRS, such as records documenting agency policy, programs and activities, and agency histories. Such records are required to be made available to the public under the Freedom of Information Act ("FOIA").[146]

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431).

Description of Proposal

The proposal would provide an exception to the disclosure rules to require IRS to disclose IRS records to officers or employees of NARA, upon written request from the Archivist, for purposes of the appraisal of such records for destruction or retention. The present-law prohibitions on and penalties for disclosure of tax information would generally apply to NARA.

Effective Date

The proposal would be effective for requests made by the Archivist after the date of enactment.

Prior Action

The proposal is contained in section 373 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997.

Analysis

The proponents believe that it is appropriate to permit disclosure to NARA for purposes of scheduling records for destruction or retention, while at the same time preserving the confidentiality of taxpayer information in those documents.

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[146] FOIA does not require disclosure of records of information that would frustrate law enforcement efforts. 5 U.S.C. sec. 552(b)(7).

33. Clarification of authority of Secretary relating to the making of elections

Present Law

Except as otherwise provided, elections provided by the Code are to be made in such manner as the Secretary shall by regulations or forms prescribe.

Description of Proposal

The proposal would clarify that, except as otherwise provided, the Secretary may prescribe the manner of making of any election by any reasonable means.

Effective Date

The proposal would be effective as of the date of enactment.

Prior Action

The proposal is contained in section 375 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997.

Analysis

The proposal would eliminate any confusion over the type of guidance in which the Secretary may prescribe the manner of making any election.

34. Grant IRS broad authority to enter into cooperative agreements with State tax authorities

Present Law

The IRS is generally not authorized to provide services to non-Federal agencies even if the cost is reimbursed (62 Comp. Gen. 323,335 (1983)).

Most taxpayers reside in States with an income tax and, therefore, must file both Federal and State income tax returns each year. Each return is separately prepared, with the State return often requiring information taken directly from the Federal return.

Description of Proposal

The proposal would provide that the IRS is authorized to enter into cooperative agreements with State tax authorities to enhance joint tax administration. These agreements may include (1) joint filing of Federal and State income tax returns, (2) joint processing of these returns, and (3) joint collection of taxes (other than Federal income taxes).

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

The proposal was included in the Tax Simplification and Technical Corrections Act of 1993 (H.R. 3419), as passed by the House in 1994, but was not enacted.

Analysis

Permitting the IRS to enter into agreements that are designed to promote efficiency through joint tax administration programs with States could reduce the burden on taxpayers because much of the same information could be used by both Governments.

For example, the burden on taxpayers could be significantly reduced through joint electronic filing of tax returns, whereby a taxpayer electronically transmits both Federal and State returns to one location. Joint Federal and State electronic filing could simplify and shorten return preparation time for taxpayers. Also, State governments could benefit from reduced processing costs, while the IRS could benefit from the potential increase in taxpayers who would elect to file electronically because they would be able to fulfill both their Federal and State obligations simultaneously.

35. Low-income taxpayer clinics

Present Law

There are no provisions in present law providing for assistance to clinics that assist low- income taxpayers.

Description of Proposal

The proposal would authorize the Legal Services Corporation to make matching grants for the development, expansion, or continuation of certain low-income taxpayer clinics. Eligible clinics would be those that charge no more than a nominal fee to either represent low-income taxpayers in controversies with the IRS or provide tax information to individuals for whom English is a second language. The term "clinic" would include (1) a clinical program at an accredited law school in which students represent low-income taxpayers, and (2) an organization exempt from tax under Code section 501(c) which either represents low-income taxpayers or provides referral to qualified representatives.

A clinic would be treated as representing low-income taxpayers if at least 90 percent of the taxpayers represented by the clinic have incomes which do not exceed 250 percent of the poverty level and amounts in controversy of $25,000 or less.

The aggregate amount of grants to be awarded each year would be limited to $3,000,000. No taxpayer clinic could receive more than $100,000 per year. The clinic must provide matching funds on a dollar-for-dollar basis. Matching funds may include the allocable portion of both the salary (including fringe benefits) of individuals performing services for the clinic and clinic equipment costs, but not general institutional overhead.

The following criteria would be required to be considered in making awards: (1) number of taxpayers served by the clinic, including the number of taxpayers in the geographical area for whom English is a second language; (2) the existence of other taxpayer clinics serving the same population; (3) the quality of the program; and (4) alternative funding sources available to the clinic.

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

A substantially similar proposal is contained in section 361 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House on November 5, 1997.

Analysis

The proponents believe that the provision of tax services by accredited nominal fee clinics to low-income individuals and those for whom English is a second language will improve compliance with the Federal tax laws and should be encouraged.

36. Disclosure of field service advice

Present Law

Field service advice memoranda are documents prepared by IRS national office attorneys for use by IRS district counsel attorneys. Because field service advice memoranda apply legal principles to the facts of a particular case, they generally contain confidential taxpayer information. In *Tax Analysts* v. *IRS,*[147] the court held that the Freedom of Information Act requires field service advice memoranda issued by the National Office of the Chief Counsel of the Internal Revenue Service to field personnel to be open to public inspection. Section 6103 of the Code prohibits the disclosure of tax return information. Statutory procedures do not currently exist for insuring taxpayer privacy while allowing the public inspection of field service advice memoranda.

Description of Proposal

The proposal would provide that field service advice memoranda are return information in their entirety, which would prohibit their disclosure. The proposal would also provide a structured mechanism[148] for public inspection of field service advice memoranda, subject to a redaction process similar to that applicable to written determinations under section 6110. This would permit the taxpayer whose liability is the subject of the field service advice memorandum to participate in the process of assessing what information should not be disclosed.

Effective Date

The proposal would be effective on the date of enactment. It would also apply to those memoranda that were the subject of the lawsuit on a specifically scheduled basis.

[147] 117 F.3d 607 (D.C. Cir. 1997).
[148] Details concerning the operation of this mechanism are not specified.

Prior Action

No prior action.

Analysis

Some might view the proposal as providing an appropriate resolution to issues currently outstanding in the litigation over disclosure of these memoranda. Others might view the proposal as providing a result that is more restrictive (in terms of providing disclosure) than the result reached in the litigation.

II. PROVISIONS INCREASING REVENUE

A. Accounting Provisions

1. Repeal 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 (Treas. reg. sec. 1.471–2(c)). 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 valuing 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 yearend 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 (Treas. reg. sec. 1.471–8(a)). 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 for sale during the year, even though such mark-downs are reflected in the retail selling prices of the goods of goods on hand at year end (Treas. reg. sec. 1.471–8(d)). As a result, such taxpayer may write down the value of inventory below both its cost and 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. 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.

Prior Action

The proposal is substantially similar to a provision that had been reported favorably by the Senate Committee on Finance in conjunction with the passage of the General Agreement on Tariffs and Trade, but was not included in the final legislation as passed by the Congress in 1994. The proposal is identical to a provision contained in the President's budget proposals for fiscal years 1997 and 1998.

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. In addition, these methods are one-sided in that they allow the recognition of losses, but not gains, even if the items of inventory recover their value in a subsequent year.

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 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 generally is considered to be a more complicated method of accounting than is the FIFO method and often results in less taxable income. Despite this potential tax saving, many taxpayers are deterred from using the LIFO method because of the present-law requirement that the LIFO method must also be used for financial statement purposes, thus reducing financial accounting income.

2. Repeal non-accrual experience method of accounting

Present Law

An accrual method taxpayer generally must recognize income when all events have occurred that fix the right to its receipt and its amount can be determined with reasonable accuracy. An accrual method taxpayer may deduct the amount of any receivable that was previously included in income if the receivable becomes worthless during the year.

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

Description of Proposal

Under the proposal, the non-accrual experience method would be repealed.

Effective Date

The proposal generally would be effective for taxable years ending after the date of enactment. Any required section 481(a) adjustment would be taken into account ratably over a four-year period.

Prior Action

The non-accrual experience method of accounting was enacted by the Tax Reform Act of 1986, which repealed the bad debt reserve method of accounting and required certain taxpayers to use an accrual method of accounting.

Analysis

The principal argument made for repeal of the non-accrual experience method is that it allows accrual method service providers the equivalent of a bad debt reserve, which is not available to other accrual method taxpayers. Opponents of the use of bad debt reserves argue that such reserves allow deductions for bad debts to be taken prior to the time they actually occur. The more favorable regime for service debts under the non-accrual experience method has also given rise to controversies over what constitutes a service (as opposed, for example, to selling property or issuing a loan).

On the other hand, the non-accrual experience method allows an accrual method service provider to avoid the recognition of income that, on the basis of experience, it expects it will never collect. This moderates the disparity in treatment between accrual method service providers and service providers using the cash method of accounting, who generally are not required to recognize income from the performance of services prior to receipt of payment. Most large entities in other lines of business are required to use the accrual method of accounting, either because their inventories are a material income producing factor or they are corporations with gross receipts in excess of $5,000,000. Service providers, however, are frequently organized as partnerships of individuals or as qualified personal service corporations, eligible to use the cash method of accounting. It may be appropriate to continue to allow accrual basis service providers the use of the non-accrual experience method to avoid the disparity of treatment between accrual and cash method competitors that could otherwise result.

While the non-accrual experience method does provide a benefit that is not available to accrual basis sellers of goods, this difference may be appropriate. Sellers of goods may be able to mitigate their bad debt losses by recovering the goods themselves. This option is not available to service providers.

3. Make certain trade receivables ineligible for mark-to-market treatment

Present Law

In general, dealers in securities are required to use a mark-to-market method of accounting for securities (sec. 475). Exceptions to the mark-to-market rule are provided for securities held for investment, certain debt instruments and obligations to acquire debt instruments and certain securities that hedge securities. A dealer in securities is a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or who regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in certain types of securities with customers in the ordinary course of a trade or business. A security includes (1) a share of stock, (2) an interest in a widely held or publicly traded partnership or trust, (3) an evidence of indebtedness, (4) an interest rate, currency, or equity notional principal contract, (5) an evidence of an interest in, or derivative financial instrument in, any of the foregoing securities, or any currency, including any option, forward contract, short position, or similar financial instrument in such a security or currency, or (6) a position that is an identified hedge with respect to any of the foregoing securities.

Treasury regulations provide that if a taxpayer would be a dealer in securities only because of its purchases and sales of debt instruments that, at the time of purchase or sale, are customer paper with respect to either the taxpayer or a corporation that is a member of the same consolidated group, the taxpayer will not normally be treated as a dealer in securities. However, the regulations allow such a taxpayer to elect out of this exception to dealer status (the "Customer paper election").[149] For this purpose, a debt instrument is customer paper with respect to a person if: (1) the person's prin-

[149] Treas. reg. sec. 1.475(c)–1(b), issued December 23, 1996.

cipal activity is selling nonfinancial goods or providing nonfinancial services; (2) the debt instrument was issued by the purchaser of the goods or services at the time of the purchase of those goods and services in order to finance the purchase; and (3) at all times since the debt instrument was issued, it has been held either by the person selling those goods or services or by a corporation that is a member of the same consolidated group as that person.

Description of Proposal

The proposal would provide that certain trade receivables would not be eligible for mark-to-market treatment, whether the taxpayer is a securities dealer required to use mark-to-market treatment or elects such treatment under the Treasury regulation. The trade receivables that would be excluded would include non-interest bearing receivables, and account, note and trade receivables unrelated to an active business of a securities dealer. The proposal would specify that no inference is intended as to the treatment of such receivables under present law and would also grant the Treasury regulatory authority to carry out the purposes of the proposal.

Effective Date

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

Prior Action

The mark-to-market method of section 475 was enacted by the Omnibus Budget Reconciliation Act of 1993.

Analysis

Advocates of the proposal to exclude certain receivables from "mark-to-market" treatment would argue that it is necessary to prevent what is in effect a deduction for bad debt reserves, through the deduction of losses in value of the taxpayer's receivables and that Congress did not intend mark-to-market treatment to reintroduce a bad debt reserve deduction. However, it is not clear that a mark-to-market method is equivalent to a bad debt reserve method. A bad debt reserve method generally attempts to measure the extent to which a creditor will or will not collect the face amount of its accounts receivable.[150] Such collections often are primarily dependent upon the creditworthiness of the debtors. A mark-to-market method of accounting attempts to measure the fair market value of a creditor's accounts receivable. Such value is dependent upon a number of factors, including the creditworthiness of the debtors, the interest rate and other terms borne by the receivables, and the marketability of the receivables.

As a demonstration of the differences between a mark-to-market method and a bad debt reserve method, consider the following two examples. Assume a taxpayer sells goods, on credit, during the taxable year to a variety of debtors, some of whom are of risky creditworthiness. In order to compensate for these potential bad debts,

[150] Under some bad debt reserve methods, this amount may be determined by reference to the taxpayer's bad debt experience in previous years.

the accounts receivable bear a relatively high rate of interest. Under a mark-to-market method, this pool of accounts receivable could be valued at or near their face values, resulting in little or no deductible loss (the fact that some receivables will not be collected is offset by the fact that others will generate above-market interest returns). Under a bad debt reserve method, the taxpayer generally would be allowed a deduction to reflect the fact that a portion of its accounts receivable will not be paid. In this example, a bad debt reserve method would result in a larger deduction during the taxable year than a mark-to-market method. Consider another example. Assume a taxpayer sells goods, on credit, to the Federal Government during the taxable year and that these accounts receivable do not bear interest. Under a "mark-to-market" method, this pool of accounts receivable would be valued below their face values, resulting in a deductible loss (the present value of even the most secure non-interest bearing loan is less than its face value). Under a bad debt reserve method, the taxpayer generally would not be allowed a deduction because the likelihood of its accounts receivable not being paid is, at best, remote. In this example, a mark-to-market method would result in a larger deduction during the taxable year than a bad debt reserve method.

Mark-to-market treatment to allow deductions with respect to receivables has probably been facilitated by the "customer paper election" provided by the recent Treasury regulations. Thus, opponents of the proposal might argue that a regulatory rather than a legislative solution is appropriate. However, even without the customer paper election, taxpayers that regularly acquire receivables in transactions with customers may argue that they are entitled to mark-to-market treatment under present law. The proposal adds simplification in that certain non-traded receivables will not have to be valued. The major argument against the exception of certain receivables from the mark-to-market regime is that mark-to-market always provides a more accurate reflection of the income derived from an asset, even if it produces losses. On the other hand, Congress, in 1993, applied the mark-to-market method to a discrete class of taxpayers and financial instruments (securities of security dealers); thus, it is appropriate to further clarify the limits of the application of the method by explicitly excluding certain accounts receivable.

B. Financial Products and Institutions

1. Defer interest deduction on certain convertible debt

Present Law

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

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

Description of Proposal

The proposal would defer interest deductions for accrued stated interest and OID on convertible debt until such time as the interest is paid. For this purpose, payment would not include: (1) the conversion of the debt into equity of the issuer or a related person (as determined under secs. 267(b) and 707(b)) or (2) the payment of cash or other property in an amount that is determined by reference to the value of such equity. Convertible debt would include debt: (1) exchangeable for the stock of the issuer or a related party, (2) with cash-settlement conversion features, or (3) issued with warrants (or similar instruments) as part of an investment unit in which the debt instrument may be used to satisfy the exercise price of the warrant. Convertible debt would not include debt that is "convertible" solely because a fixed payment of principal or interest could be converted by the holder into equity of the issuer or a related party having a value equal to the amount of such principal or interest. Holders of convertible debt would continue to include the interest on such instruments in gross income as under present law.

Effective Date

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

Prior Action

The proposal was included in the President's fiscal year 1998 budget proposal.

Analysis

The manner in which the proposal would operate may be illustrated in one context by examining its effect upon the tax treatment of instruments commonly known as liquid yield option notes ("LYONs").[151] A LYON generally is an instrument that is issued at a discount and is convertible into a fixed number of shares of the issuer, regardless of the amount of original issue discount ("OID") accrued as of the date of conversion. The conversion option usually is in the hands of the holder, although a LYON may be structured to allow the issuer to "cash out" the instrument at certain fixed dates for its issue price plus accrued OID. If the LYON is not converted into equity at maturity, the holder receives the stated redemption price at maturity (i.e., the issue price plus accrued OID). A LYON is convertible into a fixed number of shares of issuer stock regardless of the amount of accrued OID and does not provide interim interest payments to holders. Thus, a LYON could be viewed

[151] Other convertible debt instruments may have features similar to LYONs and may be issued or traded under different names or acronyms. The reference to "LYONs" in this discussion is intended to be a reference to any other similar instruments.

as providing the holder both a discount debt instrument and an option to purchase stock at a price equal to the maturity value of the debt. If the stock has risen in value from the date of issuance to the maturity date to an amount that is greater than the stated redemption price at maturity of the OID debt, the holder will exercise the option to acquire stock by surrendering the debt. If the stock has not sufficiently risen in value, the holder will cash in the debt and let the option lapse.

As a simplified example, assume ABC Co. issues a LYON that will mature in five years. The LYON provides that, at maturity, the holder has the option of receiving $100 cash or one share of ABC Co. stock. The LYONs are issued for $70 per instrument at time that the ABC Co. stock is trading for less than $70 a share. Thus, at the end of five years, the holder of the LYON has the following choices: (1) if ABC Co. stock is trading at less than $100 a share, the holder will take the $100 cash, but (2) if ABC Co. stock is trading at more than $100 a share, the holder will take the stock. Because the holder is guaranteed to receive at least $100 in value at maturity, present law allows the issuer (and requires the holder) to accrue $30 of OID as interest over the five-year term of the instrument.

The structure of LYONs raises several tax issues. The first is whether the conversion feature of a LYON is sufficiently equity-like to characterize the LYON as equity instead of debt. Under present law, issuers of LYONS deduct (and the holders include in income) the amount of OID as interest as it accrues. A second issue is whether it is appropriate to accrue OID on an instrument when it is unclear whether such instrument (including the accrued OID) will be paid in cash or property other than stock. The proposal provides answers to these two issues by applying a "wait and see" approach, that is, OID on a LYON is not deductible unless and until the amount of OID is paid in cash. In this way, the proposal defers the determination of whether a LYON is debt or equity until maturity. This approach is consistent with present-law section 163(e)(5) that provides that a portion of the OID of applicable high-yield debt instruments is not deductible until paid.

Opponents of the proposal would argue that the determination of whether an instrument is debt or equity should be made at its issuance and, at issuance, a LYON has more debt-like features than equity-like features. They would further point out that the holder of a LYON is guaranteed to receive at maturity at least the amount of the OID and that present law properly allows issuers to accrue such amount over time. Opponents of the proposal also would argue that under present law, taxpayers are allowed deductions when stock is issued for deductible expenses (or taxpayers can issue stock to the public and use the cash to pay deductible expenses) and that the issuance of stock for accrued interest is no different. They further claim that issuers can achieve results that are similar (or better) than the present law treatment of a LYON by issuing callable OID indebtedness and options or warrants as separate instruments and that the tax law should not discourage the efficient combination of the two types of instruments. However, if the two instruments truly trade separately, it is not clear that they are economically equivalent to a LYON. Finally, opponents would argue that it is unfair and contrary to the present-law OID rules to require holders of LYONS to accrue OID in income while deferring or denying related OID deductions to issuers. Again, under present law, holders of applicable high-yield debt instruments are required to include OID in income as it accrues, while OID deductions of issuers of such instruments are deferred or denied.

2. Disallowance of interest on indebtedness allocable to tax-exempt obligations of all financial intermediaries

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) (sec. 265). 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.[152]

Application to non-financial corporations

In Rev. Proc. 72–18, 1972–1 C.B. 740, 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 or carry tax-exempt obligations exists when the proceeds of indebtedness are directly traceable to the purchase of tax-exempt obligations or when such 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 which is not directly traceable to tax-exempt obligations 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 which is not directly traceable to tax-exempt obligations 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

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[152] Section 7701(f) (as enacted in the Deficit Reduction Act of 1984 (sec. 53(c) of Public Law 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.

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 nonsaleable tax-exempt obligations in the ordinary course of business in payment for services performed for, or goods supplied to, State or local governments.[153]

Application to financial institutions

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, 1986, to the average adjusted basis of all assets of the taxpayer (Code sec. 265). For this purpose, a financial institution is (1) a person who accepts deposits from the public in the ordinary course of the taxpayer's business that is subject to Federal or State supervision as a financial institution or (2) a foreign corporation which has a banking business in the United States. 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 (hereinafter the "small issuer exception"), only 20 percent of the interest allocable to such tax-exempt obligations is disallowed (Code sec. 291(a)(3)).

Treatment of securities dealers

A pro rata disallowance rule, similar to the rule applicable to financial institutions, applies to dealers in tax-exempt obligations, but there is no small issuer exception, and the 2-percent de minimis exception does not apply (Rev. Proc. 72–18). Securities dealers are allowed, however, to exclude from the pro rata disallowance rule interest on borrowings that they can prove by tracing were incurred or continued for a purpose other than purchasing or carrying tax-exempt obligations.

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 current tax (generally, tax-exempt interest, deductible intercorporate dividends, and the increase in certain insurance policy cash values) (secs. 807 and 812). 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, (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 an-

[153] *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.

nuity contracts (sec. 832(b)(5)(B)). 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 Administration proposal would extend to all persons engaged in the active conduct of banking, financing, or similar business (such as securities dealers and other financial intermediaries) 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. The proposal would not extend the $10 million small-issuer exception to taxpayers which are not financial institutions. The proposal would not apply to insurance companies.

Effective Date

The proposal would be effective for taxable years beginning after date of enactment with respect to obligations acquired on or after the date of committee action.

Prior Action

Section 10116 of the Omnibus Budget Reconciliation Act of 1987 as reported by the House Committee on the Budget would have disallowed a deduction for interest on indebtedness allocable to tax-exempt installment obligations. In addition, that section would have reduced the non-statutory two-percent de minimis test to the lesser of $1 million or two-percent of the taxpayer's adjusted basis of all of the taxpayer's assets. That bill passed the House, but the provision disallowing a deduction for interest allocable to tax-exempt obligations was subsequently deleted in conference.

The Administration made similar proposals in 1995 and 1997 except that the proposed extension of the interest disallowance rule would have applied to all corporations, not just financial intermediaries. In addition the prior proposal would not have applied to nonsaleable tax-exempt debt acquired by a corporation in the ordinary course of business in payment for goods or services sold to a State or local government. Like the present proposal, the prior proposal would not have applied to an insurance company. Finally, the prior proposal would have applied the interest disallowance provision to all related persons (within the meaning of sec. 267(f)).

Analysis

Premise of proposal

Taxpayers generally are allowed to deduct the amount of interest expense paid or accrued within the taxable year (Code sec. 163(a)). However, present law disallows the deduction of interest expense on indebtedness incurred to purchase or carry tax-exempt obligations (Code sec. 265(a)(2)). The purpose of this disallowance rule is to prevent the tax arbitrage that would otherwise occur if taxpayers could borrow money and deduct any resulting interest expense while excluding from gross income interest income on State or local obligations financed with that borrowing. If unrestricted, tax arbitrage could create an unlimited transfer of funds from the Treasury to State and local treasuries. Moreover, the transfer of funds generally is inefficient in that the Federal tax revenue lost generally exceeds the arbitrage profit earned by State and local governments.

Present law provides more favorable rules on the disallowance of interest expense or reserve deductions allocable to tax-exempt bonds to certain types of financial intermediaries (e.g., property and casualty insurance and finance companies) than other types of financial intermediaries with whom they compete (e.g., banks). If one accepts the premise that all money is fungible and that debt of the taxpayer finances its proportionate share of all of the taxpayer's assets including tax-exempt bonds, a proportional disallowance rule theoretically should apply to all taxpayers. The Administration proposal to apply a proportional disallowance rule to all financial intermediaries is based on the notion that similar taxpayers should be taxed similarly. While uniform treatment may not be appropriate among all taxpayers, there arguably should be uniform treatment among taxpayers that compete against each other.

Scope of proposal

The scope of the proposal is not entirely clear since it applies to persons in the active conduct of businesses "similar" to "banking", "financing," "securities dealers" and "other financial intermediaries." For example, is a retailer who sells appliances or furniture on an installment method in a financing business and, therefore, subject to the proposed rule? Is any retailer who issues its own credit card (e.g., Sears, Macy's, J.C. Penney's, Firestone, etc.) subject to the proposed rule?

Effect of proposal

The primary effect of the proposal would be to disallow the 2-percent de minimis exception and the installment sale exception to taxpayers covered by the proposal.

Repeal of 2-percent de minimis exception.—The Administration proposal to adopt a pro rata rule would repeal the 2-percent de minimis exception for those taxpayers covered by the proposal. Some proponents of the Administration proposal accept the premise that money 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 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 bonds 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 Administration proposal argue that the proposal would have the effect of raising the financing costs for State or local governments. Opponents also note that the de minimis exception avoids the complexity of complying with the proposed pro rata rule. Lastly, opponents note that there is no policy justification for repealing the de minimis exception for financial intermediaries, but not individuals.

Repeal of the installment sale exception.—The Administration proposal to adopt a pro rata rule also would repeal the installment sales exception for those taxpayers covered by the proposal. Opponents of the proposal believe that the present exception for debt arising from installment sales to State and local governments should be retained because such debt often is incurred by governments for acquisition of property that could not easily be financed through debt issued in the public debt markets because of the size of the government or the asset acquisition.

The exemption from the pro rata rule for insurance companies is justified on the grounds that present law already adjusts the deduction for additions to an insurance company's reserves for its tax-exempt income.

C. Corporate Tax Provisions

1. Eliminate dividends-received deduction for certain preferred stock

Present Law

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

The dividends-received deduction is disallowed if the taxpayer has held the stock for 45 days or less during the 90-day period beginning on the date that is 45 days before the date on which such share becomes ex-dividend with respect to such dividend. In the case of certain preferred stock, the dividends received deduction is disallowed if the taxpayer has held the stock for 90 days or less during the 180-day period beginning on the date which is 90 days before the date on which such share becomes ex-dividend with respect to such dividend. The holding period generally does not include any period during which the taxpayer has a right or obligation to sell the stock, or is otherwise protected from the risk of loss otherwise inherent in the ownership of an equity interest. If an instrument was treated as stock for tax purposes, but provided for payment of a fixed amount on a specified maturity date and afforded holders the rights of creditors to enforce such payment, the Internal Revenue Service has ruled that no dividends-received deduction would be allowed for distributions on the instrument.[154]

The Taxpayer Relief Act of 1997 amended sections 351, 354, 355, 356 and 1036 to treat "nonqualified preferred stock" as boot in corporate transactions, subject to certain exceptions. Nonqualified preferred stock is defined in section 351(g) as preferred stock that does not participate (through a conversion privilege or otherwise) in cor-

[154] See Rev. Rul. 94–28, 1994–1 C.B. 86.

porate growth to any significant extent, 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 the stock, (3) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or similar indices, regardless of whether such varying rate is provided as an express term of the stock (as in the case of 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

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

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

Effective Date

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

Prior Action

A substantially similar proposal was included in the President's fiscal year 1998 budget proposal.

Analysis

This proposal extends the denial of the dividends-received deduction to preferred stock that is treated as taxable consideration (or "boot") in certain otherwise non-taxable corporate reorganizations and restructurings.

It is arguable that stock with the particular characteristics identified in the proposal is sufficiently free from risk and from participation in corporate growth that it should be treated as debt for certain purposes, including denial of the dividends received deduction. Many of the types of stock described in the proposal are traditionally marketed to corporate investors (or can be tailored or designed for corporate investors) to take advantage of the dividends received deduction. As one example, a corporation may structure a disposition of a subsidiary taking back this type of preferred stock. The transferor might transform what may be essentially sales proceeds into deductible dividends, based on the future earnings of the former subsidiary corporation after principal ownership has been transferred to others. Features such as puts and calls effectively determine the period within which total payment is expected to occur.

Similarly, so called "auction rate" preferred stock has a mechanism to reset the dividend rate on the stock so that it tracks changes in interest rates over the term of the instrument, thus diminishing any risk that the "principal" amount of the stock would change if interest rates changed. Although it is theoretically possible (and it has sometimes occurred) that an auction will "fail" (i.e., that a dividend rate will not be achieved in the auction that maintains the full value of principal of the investment), this has occurred extremely rarely in actual practice. Investors may view such stock as similar to a floating rate debt instrument.

In addition to section 351(g) which treats the type of stock addressed here as "boot" for purposes of certain otherwise tax-free transactions, the Code in various places treats certain non-participating preferred stock differently from other stock. For example, ceterain preferred stock that does not participate to any significant extent in corporate growth does not count as stock ownership in determining whether two corporations are sufficiently related to file consolidated returns; also such stock does not count in determining whether there has been a change of ownership that would trigger the loss limitation rules of Code section 382.

On the other hand, some argue that a relatively low level of risk and participation in growth, or expectation of termination of the instrument at a particular time, should not be factors governing the availability of the dividends received deduction. Furthermore, it is argued that if this type of instrument is viewed as sufficiently debt-like, then it should be classified as debt for all tax purposes, rather than merely subjected to several detrimental non-stock consequences.

2. Repeal tax-free conversion of larger C corporations to S corporations

Present Law

The income of a corporation described in subchapter C of the Internal Revenue Code (a "C corporation") is subject to corporate-level tax when the income is earned and individual-level tax when the income is distributed. The income of a corporation described in subchapter S of the Internal Revenue Code (an "S corporation") generally is subject to individual-level, but not corporate-level, tax when the income is earned. The income of an S corporation generally is not subject to tax when it is distributed to the shareholders. The tax treatment of an S corporation is similar to the treatment of a partnership or sole proprietorship.

The liquidation of a subchapter C corporation generally is a taxable event to both the corporation and its shareholders. Corporate gain is measured by the difference between the fair market values and the adjusted bases of the corporation's assets. The shareholder gain is measured by the difference between the value of the assets distributed and the shareholder's adjusted basis in his or her stock. The conversion of a C corporation into a partnership or sole proprietorship is treated as the liquidation of the corporation.

The conversion from C to S corporation status (or the merger of a C corporation into an S corporation) generally is not a taxable event to either the corporation or its shareholders.

Present law provides rules designed to limit the potential for C corporations to avoid the recognition of corporate-level gain on shifting appreciated assets by converting to S corporation status prior to the recognition of such gains. Specifically, an S corporation is subject to a tax computed by applying the highest marginal corporate tax rate to the lesser of (1) the S corporation's recognized built-in gain or (2) the amount that would be taxable income if such corporation was not an S corporation (sec. 1374). For this purpose, a recognized built-in gain generally is any gain the S corporation recognizes from the disposition of any asset within a 10–year recognition period after the conversion from C corporation status, or any income that is properly taken into account during the recognition period that is attributable to prior periods. However, a gain is not a recognized built-in gain if the taxpayer can establish that the asset was not held by the corporation on the date of conversion or to the extent the gain exceeds the amount of gain that would have been recognized on such date. In addition, the cumulative amount of recognized built-in gain that an S corporation must take into account may not exceed the amount by which the fair market value of the corporation's assets exceeds the aggregated adjusted basis of such assets on the date of conversion from C corporation status. Finally, net operating loss or tax credit carryovers from years in which the corporation was a C corporation may reduce or eliminate the tax on recognized built-in gain.

The amount of built-in gain that is subject to corporate-level tax also flows through to the shareholders of the S corporation as an item of income subject to individual-level tax. The amount of tax paid by the S corporation on built-in gain flows through to the shareholders as an item of loss that is deductible against such built-in gain income on the individual level.

Description of Proposal

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

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

In addition, the Internal Revenue Service would revise Notice 88–19 [155] to conform to the proposed amendment to section 1374, with an effective date similar to the statutory proposal. As a result, the conversion of a large C corporation to a regulated investment company ("RIC") or a real estate investment trust ("REIT") would

[155] Notice 88–19, 1988–1 C.B. 486, allows C corporations that become RICs or REITs to be subject to rules similar to those of section 1374, rather than being subject to the rules applicable to complete liquidations.

result in immediate recognition by the C corporation of the net built-in gain in its assets.

Effective Date

The proposal generally would be effective for subchapter S elections that become effective for taxable years beginning after January 1, 1999. Thus, C corporations would continue to be permitted to elect S corporation status effective for taxable years beginning in 1998 or on January 1, 1999. The proposal would apply to acquisitions (e.g., the merger of a C corporation into an existing S corporation) after December 31, 1998.

Prior Action

Similar proposals were included in the President's budget proposals for the fiscal years 1997 and 1998.

Analysis

The conversion of a C corporation to an S corporation may be viewed as the constructive liquidation of the C corporation because the corporation has changed from taxable status to passthrough status. The proposal would conform the tax treatment of such constructive liquidation to the tax treatment of an actual liquidation. Thus, the proposal would conform the treatment of the conversion from C corporation status to passthrough entity status where the passthrough entity is an S corporation with the present-law treatment where the passthrough entity is a partnership or a sole proprietorship.

The proposal would eliminate some of the complexity of subchapter S under present law.[156] The rules that trace C corporation built-in gain and C corporation earnings and profits generally would become unnecessary. In addition, the rules imposing corporate tax and the possible loss of S corporation status after the conversion due to excessive passive income also could be eliminated. However, these complex rules would continue to apply to small converting C corporations and it could be argued that these businesses are the least able to handle complexity.

The proposal would create some complexity, as it would require the valuation of C corporation stock to determine if the $5 million threshold has been exceeded and C corporation assets for purposes of determining the amount of gain on the constructive liquidation. However, valuations theoretically are required under present law because of the need to determine whether corporate tax may be due under the built-in gain tracing rules; it is possible that taxpayers may not perform the valuations for all assets in all cases, particularly if they believe that there is no aggregate net built-in gain, or if there is a possibility that built-in gain assets may not be disposed of within the present-law tracing period. It should be noted that the $5 million threshold creates a "cliff" where corporations valued at $5 million or less are not subject to tax while corpora-

[156] A similar proposal was included in a letter to House Ways and Means Chairman Dan Rostenkowski from Ronald A. Pearlman, Chief of Staff of the Joint Committee on Taxation, recommending several simplification proposals. See, Committee on Ways and Means, *Written Proposals on Tax Simplification*, (WMCP 101–27), May 25, 1990, p 24.

tions valued at greater than $5 million would be subject to full taxation. It appears that rules would be required to address step transactions designed to avoid the proposal (e.g., where a series of C corporations, each under the $5 million cap, merge into an S corporation; or where a large C corporation divides into multiple entities so that some or all of the entities are under the $5 million cap). Another issue under the proposal is whether the stock of the corporation is to be valued immediately before the conversion (i.e., as C corporation stock subject to two levels of tax) or immediately after the conversion (i.e., as S corporation stock, subject to one level of tax).

The proposal would create significant shareholder and corporate liquidity concerns for large C corporations planning on converting to S corporation status. Current businesses that organized as C corporations may have done so in anticipation of converting at a relatively low tax cost in the future. Not applying the proposal until taxable years beginning after January 1, 1999, addresses some, but not all, of these concerns.

Finally, the proposal raises significant policy issues regarding the integrity of the separate corporation tax as opposed to integrating the corporate and individual tax regimes. More acutely, the proposal raises issues regarding the need for the continued existence of subchapter S in light of other developments. Recent IRS rulings with respect to the various State limited liability companies and the "check-the-box" Treasury regulations [157] have significantly expanded the availability of pass-through tax treatment for entities that accord their investors limited legal liability. These developments, coupled with the restrictive rules of subchapter S,[158] have decreased the desirability of the subchapter S election for newly-formed entities. This proposal would decrease the desirability of the subchapter S election for existing C corporations. Thus, if the proposal were enacted, the primary application of subchapter S would be limited to existing S corporations and small converting corporations. At that point, one may question whether it is desirable to have a whole separate passthrough regime in the Code that pertains to a limited number of taxpayers. Any repeal of subchapter S would require rules providing for the treatment of existing S corporations.[159]

3. Restrict special net operating loss carryback rules for specified liability losses

Present Law

Under present law, that portion of a net operating loss that qualifies as a "specified liability loss" may be carried back 10 years rather than being limited to the general two-year carryback period. A specified liability loss includes amounts allowable as a deduction with respect to product liability, and also certain liabilities that

[157] Treas. reg. secs. 301.7701–1, –2, and –3, issued in final form on December 17, 1996.

[158] For example, only domestic corporations with simple capital and limited ownership structures may elect to be S corporations.

[159] See, for example, the letter of July 25, 1995, from Leslie B. Samuels, Assistant Treasury Secretary (Tax Policy) to Senator Orrin Hatch, suggesting possible legislative proposals to allow S corporations to elect partnership status or to apply the check-the-box regulations to S corporations.

arise under Federal or State law or out of any tort of the taxpayer. In the case of a liability arising out of a Federal or State law, the act (or failure to act) giving rise to the liability must occur at least 3 years before the beginning of the taxable year. In the case of a liability arising out of a tort, the liability must arise out of a series of actions (or failures to act) over an extended period of time a substantial portion of which occurred at least 3 years before the beginning of the taxable year. A specified liability loss cannot exceed the amount of the net operating loss, and is only available to taxpayers that used an accrual method throughout the period that the acts (or failures to act) giving rise to the liability occurred.

Description of Proposal

Under the proposal, specified liability losses would be defined and limited to include (in addition to product liability losses) only amounts allowable as a deduction that are attributable to a liability that arises under Federal or State law for reclamation of land, decommissioning of a nuclear power plant (or any unit thereof), dismantlement of an offshore oil drilling platform, remediation of environmental contamination, or payments arising under a workers' compensation statute, if the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year. No inference regarding the interpretation of the specified liability loss carryback rules under current law would be intended by this proposal.

Effective Date

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

Prior Action

No prior action.

Analysis

A taxpayer is required to determine and report the taxable income recognized in each taxable year, regardless of whether the taxable year matches the natural business cycle of the taxpayer or whether transactions have occurred which span several years. This is known as the "annual accounting concept." Thus, deductions claimed in the current taxable year may relate to, and be properly matched with, income reported in a different taxable year. In recognition of the restrictions of the annual accounting concept, present law allows taxpayers with net operating losses to carry such losses back to the preceding two taxable years or carried forward to the succeeding 20 years. In addition, present law allows a 10–year carryback of that portion of a net operating loss that relates to certain specified liabilities to the extent these liabilities arose as a result of acts or failures to act that occurred more than three years ago.

The proper interpretation of the specified liability loss provisions has been the subject of controversy. Although the legislative history suggests that these specified liability loss rules were provided to apply to certain liabilities for which a deduction is deferred as a result of the economic performance rules of section 461(h),[160] many taxpayers have not limited their claimed specified liability losses to such deductions. In addition, many taxpayers have interpreted the 3–year requirement and the requirement that the liability arises out of a Federal or State law in a broad manner and the IRS has announced that it will contest many such claims. (See, *e.g.*, Notice 97–36, 1997–26 I.R.B. 6, June 1, 1997.) For example, taxpayers have claimed that accounting fees paid for annual compliance with SEC and ERISA auditing and reporting requirements can be carried back 10 years as specified liability losses on the ground that the taxpayer first became subject to the laws imposing such reporting requirements more than 3 years prior to the year of the current annual expenditures. Taxpayers have also asserted that accounting fees paid in connection with an IRS audit can be carried back 10 years as specified liability losses. In a recent decision, *Sealy Corp.* v. *Commissioner*, 107 T.C. 177 (1996), the Tax Court upheld the IRS position rejecting a 10–year carryback for such claims; however the court did not specify the boundaries of the 10-year carryback provision. It is also possible that taxpayers may continue to take and litigate positions such as those in the *Sealy Corp*. case even on similar facts, seeking to obtain other interpretations in other courts.

The proposal would lessen similar controversies by providing a definitive list of items for which the 10–year carryback is available. It may be argued that the proposal may result in a mismatch between income and expense to the extent a currently deductible liability relates to previously recognized income and the liability is not listed under the proposal. However, proponents of the proposal argue that section 172(f) was originally intended as a relief provision narrowly targeted to certain liabilities for which a deduction is deferred as a result of the economic performance rules of section 461(h), and that narrowing the provision to a limited class of liabilities does not frustrate the original Congressional intent.

4. Clarify definition of "subject to" liabilities under section 357(c)

Present Law

Present law provides that the transferor of property recognizes no gain or loss if the property is exchanged solely for qualified stock in a controlled corporation (sec. 351). Code section 357(c) provides that the transferor generally recognizes gain to the extent that the sum of the liabilities assumed by the controlled corporation and the liabilities to which the transferred property is subject exceeds the transferor's basis in the transferred property. If the transferred property is "subject to" a liability, Treasury regulations have indicated that the amount of the liability is included in the calculation regardless of whether the underlying liability is assumed by the controlled corporation. Treas. Reg. sec. 1.357–2(a).

The gain recognition rule of section 357(c) is applied separately to each transferor in a section 351 exchange.

[160] H. Rept. 98–861, 98th Cong., 2d Sess. 871 (1984).

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

Section 357(c) also applies to reorganizations described in section 368(a)(1)(D).

Description of Proposal

The proposal would eliminate any distinction between the assumption of the liability and the acquisition of an asset subject to a liability. Instead, the extent to which a liability (including a nonrecourse liability) would be treated as assumed for Federal income tax purposes in connection with a transfer of property would be determined on the basis of all the facts and circumstances. Thus, for example, a transferee would not be treated as assuming a liability if the transferor indemnifies the transferee against the possibility of foreclosure. Similarly, the fact that a lender retains a security interest in property securing a recourse liability would not cause the transferee to be treated as assuming the liability if the transferor remains solely liable on the indebtedness without a right of contribution against the transferee. In general, if nonrecourse indebtedness is secured by more than one asset, and any assets securing the indebtedness are transferred subject to the indebtedness without any indemnity agreements, then for all Federal income tax purposes the transferee would be treated as assuming an allocable portion of the liability based upon the relative fair market values (determined without regard to section 7701(g)) of the assets securing the liability. The proposal would authorize the Secretary of the Treasury to issue regulations to carry out the purposes of this proposal, including anti-abuse rules.

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

Effective Date

The proposal would apply to transfers after the date of first committee action.

Prior Action

No prior action

Analysis

In general, a taxpayer recognizes income when he or she is relieved of a liability. Thus, if a taxpayer transfers an asset to a corporation, and the corporation assumes a liability of the taxpayer in an amount greater than the taxpayer's basis in the asset, present law treats the taxpayer as having sold the asset for an amount equal to the relieved liability. Similar rules apply if an asset is transferred subject to a liability.

Present law does not clearly define what "transferred subject to a liability" means. If the transferor has cross-collateralized a liability with several assets, it has been asserted that each of those assets is literally "subject to" the entire amount of the liability, even where the transferor has not been relieved of the liability. A number of cases have applied section 357(c) in a manner or with language suggesting that it is not necessary to consider whether, as a practical matter, the transferor has been relieved of the transferred liability. For example in *Rosen* v. *Commissioner,*[161] the Tax Court stated that ". . . there is no requirement in section 357(c)(1) that the transferor be relieved of liability. Similarly, in *Owen* v. *Commissioner,*[162] the Ninth Circuit Court of Appeals rejected a claim by the taxpayers that the concept of assets "subject to" liabilities only applies to non-recourse liabilities, and stated that continuing personal liability for the loans secured by the transferred equipment was irrelevant.

In *Lessinger* v. *Commissioner,*[163] on the other hand, the Second Circuit Court of Appeals construed the language of section 357(c) to avoid imposing gain recognition on the taxpayer where the taxpayer contributed his own promissory note in the amount of the excess of the transferred liabilities over the basis of the transferred assets.

As a result of this uncertainty in present law, some taxpayers may be reluctant to engage in legitimate transactions or may restructure them, while others may attempt to structure transactions to take advantage of different interpretations.

For example, a taxpayer who has cross-collateralized a liability with assets that the taxpayer now, for valid business reasons, wants to contribute to one or more corporations, may structure the transaction in a manner seeking to take the position that some case law supports non-recognition, or may contribute additional assets with basis sufficient to avoid gain recognition under any of the case law, or may seek to obtain a release of the transferred assets from the lender. It may be difficult or expensive for a taxpayer to obtain such a release.

On the other hand, taxpayers not concerned about current gain recognition (for example, due to losses, credits or status as a non-taxable entity) may attempt to structure transactions to take advantage of different interpretations. For example, assume that transferor A has borrowed $100,000 on a recourse basis, secured by two assets. A transfers one asset with a basis of $20,000 and a fair market value of $50,000 to a controlled domestic corporation, X. Under the literal language of section 357(c), it may be argued that A would recognize $80,000 of gain on the transfer, and X would hold the asset at a basis of $100,000 (A's original basis of $20,000 plus $80,000 recognized gain). If A is a foreign person or a tax-exempt entity or in the position to use expiring loss or credit carryovers to offset the gain, X can obtain a stepped-up basis in the asset without a tax cost to A. X can benefit from this stepped-up basis by increased depreciation deductions or reduced gain on the future sale of the asset.

The proposal is intended to ensure that 357(c) will operate in a manner that reflects the economics of the transaction. While it may be argued that factual uncertainty will remain because this approach involves a facts and circumstances test, it can also be ar-

[161] 62 T.C. 11, 19 (1974), affd. without published opinion 515 F.2d 507 (3d Cir. 1975).
[162] 881 F.2d 832 (9th Cir. 1989).
[163] 872 F.2d 519 (2d Cir. 1989).

gued that the proposal will increase the legal certainty and reduce the potential for results that do not conform to the economic reality of the extent of actual relief from liability (if any) that has occurred in a transfer.

D. Insurance Provisions

1. Increase 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."[164] In 1997, the provision was modified to take into account the increase for a taxable year in the cash value of certain insurance contracts.[165]

Description of Proposal

The proposal would increase the proration percentage applicable to a property and casualty insurance company from 15 percent to 30 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.

Prior Action

No prior action.

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[164] 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.

[165] P.L. 105–34, The Taxpayer Relief Act of 1997, section 1084.

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 1996, property and casualty insurers held between 13 and 14 percent of all tax-exempt debt outstanding,[166] and about 21 percent of these companies' financial assets were invested in tax-exempt debt.[167] 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. 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.[168] 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.[169]

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.

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 an-

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[166] Federal Reserve Board, *Flow of Funds Accounts, Flows and Outstandings,* second quarter 1997.

[167] *Ibid.*

[168] 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

$$r_{te}>r\bullet(1-t),$$

where t is the taxpayer's marginal tax rate.

[169] 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 $(.15)\bullet t$, 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 $r_{te}\bullet(1-(.15)t)>r\bullet(1-t)$. This is equivalent to:

$$r_{te}>r\bullet\{(1-t)/(1-(.15)t)\}.$$

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 $r_{te}>(.726)r$.

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 $(.15)\bullet t$. 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.

other. 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.

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 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.

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.[170] 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.

2. Capitalization of net premiums for credit life insurance contracts

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[171] 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

[170] 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.

[171] A special rule permits a 60-month amortization period for certain small companies.

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:

	Percent
Annuities	1.75
Group life	2.05
Other life (including noncancellable or guaranteed renewable accident and health)	7.70

Group credit life insurance policy acquisition expenses fall within the "group life" category,[172] even though the actual expenses are substantially higher than 2.05 percent of net premiums for the contracts.

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.[173] 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 require insurance companies to capitalize and amortize 7.7 percent of net premiums for the taxable year with respect to all credit life insurance (whether or not it is group credit life insurance), not 2.05 percent.

Effective Date

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

Prior Action

No prior action.

[172] See Recommendations of the Committee on Finance for purposes of the Reconciliation Bill provided for in H. Con. Res. 310 (101st Cong., 2d Sess.) ("Finance Committee Report"), 136 Cong. Rec. S 15693 (Oct. 18. 1990).

[173] See H. Rept. 101–964, Conference Report to accompany H.R. 5835, Omnibus Budget Reconciliation Act of 1990 (101st Cong., 2d Sess.), 1066, 1070.

Analysis

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.[174]

It could be argued that Congress specifically intended group credit life insurance to come within the "group life" category, and that therefore it would not be appropriate to change the amortization percentage applicable to it. Similarly, it could be argued that because Congress believed that the levels of amortizable amounts would in most cases, understate actual acquisition expenses,[175] it is not now necessary to revise the percentage applicable to credit life insurance.

On the other hand, the level of actual policy acquisition expenses for credit life insurance is substantially higher than either 2.05 percent or 7.7 percent. Because the actual expenses are relatively high, it can be argued that it is more accurate to place credit life insurance in the highest-percentage category, even though such insurance may be group insurance. It is also argued that Congress may not have been aware, at the time group credit life insurance was included in the "group life" category, that policy acquisition expenses for credit life insurance were ordinarily rather high.

It also could be argued that even though credit life insurance has relatively high actual acquisition expenses, the contracts tend to have a relatively short duration and therefore the present value of the deduction for these expenses is lower than if the contracts remained in effect for a long period. Therefore, it is argued, the contracts should remain in the 2.05 percent category. On the other hand, the present value of the deduction for acquisition expenses is actually higher than even the highest percentage category, advocates for the proposal argue. Further, they argue, credit life insurance is often reinsured with small companies eligible for the more favorable 60-month amortization period, and consequently the present value of the deduction for acquisition expenses in such a case is greater.

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

[174] Finance Committee Report, supra, at S 15961.
[175] *Ibid.*

the capitalization percentage applicable to credit life insurance. On the other hand, it could be said that determining the proper percentage for the 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. 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.

3. Modify company-owned life insurance (COLI) limitations

Present Law

Exclusion of inside buildup and amounts received by reason of death

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup").[176] 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 (sec. 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 (the "COLI" rules).

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 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.

This rule was enacted in 1996.

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[176] 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 59½ 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)).

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 [177] owned by an entity engaged in a trade or business, which covers one individual who (at the time first insured under the policy or 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.

This rule was enacted in 1997.

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.

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[177] 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 may be needed so that the statute reflects this intent. See Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

Prior Action

No prior action.

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 may be utilized by financial intermediation businesses, which may 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 can be addressed without the purchase of cash value life insurance.

Opponents might also 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.

4. Modify reserve rules for annuity contracts

Present Law

A life insurance company is subject to tax on its life insurance company taxable income (LICTI) (sec. 801). LICTI is life insurance gross income reduced by life insurance deductions. For this purpose, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.

A decrease in reserves arises if (1) the opening balance for reserve items exceeds (2) the closing balance for the reserve items (reduced by certain adjustments). An increase in reserves arises if (1) the closing balance for reserve items (reduced by certain adjustments) exceeds (2) the opening balance for the reserve items.

In determining reserves, a life insurance company takes into account the life insurance reserves (among other items). Life insurance reserves for any contract are the greater of the net surrender value of the contract or the reserve determined using the tax reserve method, but in no event may the reserve for any contract at any time exceed the amount set forth in the annual statement (sec. 807). No additional reserve deduction is allowed for deficiency reserves (sec. 807(c)(3)(C)).

In the case of an annuity contract, the tax reserve method means the Commissioners' Annuities Reserve Valuation Method prescribed by the National Association of Insurance Commissioners (NAIC)[178] which is in effect on the date of the issuance of the contract (CARVM) (sec. 807(d)(3)(B)(ii)).

Present law provides for a 10-year spread of the reserve amount that arises in the event of a change in the basis for determining reserves (807(f)).

On June 11, 1997, the NAIC Life Insurance (A) Committee adopted Actuarial Guideline XXXIII Determining CARVM Reserves for Annuity Contracts with Elective Benefits (NAIC Guideline 33).

NAIC Guideline 33 states that industry practices and methods of reserving under CARVM for some annuity contracts have not been found to be consistent, ranging from relatively low reserves based on cash surrender value to higher reserves representing the greatest actuarial present value of future benefits under the contract. NAIC Guideline 33 provides generally that the ultimate policy reserve must be sufficient to fund the greatest present value of all potential benefits, both guaranteed elective and non-elective benefits under the contract.

NAIC Guideline 33 states that it is effective on December 31, 1998, affecting all contracts issued on or after January 1, 1981. The NAIC Guideline also states that its purpose is "to codify the basic interpretation of CARVM and does not constitute a change of meth-

[178] In general, the NAIC promulgates guidelines relating to accounting for insurance products for purposes of the insurer's annual statement, which generally is filed with the State in which the insurer is subject to State regulation.

od or basis from any previously used method . . .” (NAIC Guideline at page 3).

In 1997, the NAIC also adopted Actuarial Guideline XXXIV, Variable Annuity Minimum Guaranteed Death Benefit Reserves (NAIC Guideline 34), interpreting the standards for the valuation of reserves for “minimum guaranteed death benefits” provided in variable annuity contracts. NAIC Guideline 34 requires that reserves for these benefits be determined assuming an immediate drop in the values of the assets supporting the variable annuity contract, followed by a subsequent recovery at a net assumed return until the maturity of the contract. NAIC Guideline 34 also provides mortality tables that assume increased longevity of individuals, to be used in determining reserves for contracts with these benefits. NAIC Guideline 34 states that it is effective for all contracts issued on or after January 1, 1981.

Description of Proposal

Under the proposal, reserves for any annuity contract with a cash surrender value would equal the lesser of the CARVM reserve for the contract or the contract’s adjusted account value. The proposal would retain the rule of present law that in no event may the reserve for any contract at any time exceed the amount set forth in the annual statement.

For purposes of the proposal, the adjusted account value for a contract would equal the net cash surrender value for the contract, plus a percentage of the net surrender value for the contract. The percentage would be 5.5 percent in the taxable year in which the contract is issued, 5.0 percent in the second year, 4.0 in the third year, 3.0 in the fourth year, 2.5 percent in the fifth year, 1.5 percent in the sixth year, 0.5 percent in the seventh year, and 0 percent in the eighth and all succeeding years.

Effective Date

The proposal would be effective for taxable years ending on or after the date of enactment.

Prior Action

No prior action.

Analysis

In general, an important purpose of “statutory accounting,” the method of accounting used by insurers in reporting to State insurance regulators, is to maintain the solvency of insurers so that they have the funds to pay future benefits under insurance contracts. This method has been characterized as conservative, generally taking account of deductions and losses relatively early and taking income items into account relatively late. If an important goal of an income tax system is the accurate measurement of income, the accounting method used for tax purposes should be less conservative than a method whose goal is company solvency. Acceleration of losses and deductions (including reserve deductions) that may be appropriate for regulatory purposes results in understatement of income for tax purposes, it is argued.

Although present-law tax rules for life insurance companies are based in part on "statutory accounting" methods that the companies utilize under non-tax regulation, the rationale for this may be in part that the advantage of increased accuracy in measuring income is outweighed by the advantage of administrative convenience for insurers. However, it is argued, when the disparity between a normative tax accounting method and "statutory accounting" rules becomes too great, accuracy dictates a divergence from the statutory accounting rule theretofore in use for tax purposes. For example, in 1987 Congress modified the interest rate to be used by life insurance companies in computing reserves so as to take into account the greater of the applicable Federal interest rate or the prevailing State assumed rate. At that time, Congress stated that "the interest rate applied by State insurance regulators may not reflect current market trends, and is likely to be selected with a view towards maintaining insurance company solvency (a regulatory goal) rather than accurately measuring income of the company (a tax goal)."[179]

The effective date of the proposal could be criticized as needlessly broad, in that the proposal applies to reserves for all contracts, whenever issued, starting in taxable years after enactment. Application to previously issued contracts arguably may not be needed, because the scope of the application of NAIC Guidelines 33 and 34 for tax purposes is not clear. For example, although NAIC Guidelines 33 and 34 say that they apply to contracts issued on or after January 1, 1981, perhaps this retroactivity applies for State regulatory purposes but not for Federal tax purposes, because the tax law utilizes the CARVM in effect when the contract is issued. Further, although NAIC Guideline 33 states that it is not a change in basis for determining reserves, that assertion is not necessarily controlling for purposes of the Federal tax law. If NAIC Guidelines 33 and 34 were to apply to any company that was using cash surrender value reserves or otherwise computing reserves less conservatively that would be required under the Guidelines, it could be said that the company would have to spread the change in reserves over a 10-year period under the present-law rule of section 807(f). In addition, to the extent that the Guidelines would require companies to maintain deficiency reserves, they are not deductible under present law. Additional issues may also arise as to the extent to which NAIC Guidelines 33 and 34 apply for tax purposes.

5. Tax certain exchanges of insurance contracts and reallocations of assets within variable insurance contracts

Present Law

Gain or loss realized from the sale or other disposition of property generally is subject to tax under present law. The gain from a sale or other disposition of property is the excess of the amount realized on the disposition over the adjusted basis of the property.

[179] H. Rept. 100–391, Report of the Committee on the Budget, House of Representatives, to accompany H.R. 3545, The Omnibus Budget Reconciliation Act of 1987 (100th Cong., 1st Sess.), 1106.

The loss from a sale or other disposition of property is the excess of the adjusted basis (for determining loss) over the amount realized (sec. 1001).

Gain or loss realized on some transactions is accorded non-recognition treatment under special rules. A special rule resembling other nontaxable exchange rules for like-kind property was enacted in 1954. This rule provides that no gain or loss is recognized on the exchange of certain insurance contracts for other insurance contracts. No gain or loss generally is recognized on the exchange of: (1) a life insurance contract for a life insurance, endowment or annuity contract; (2) an endowment contract for an endowment contract (provided regular payments begin no later than under the exchanged contract) or an annuity contract; or (3) an annuity contract for an annuity contract (sec. 1035).

Additional special rules apply to variable life insurance and variable annuity contracts (sec. 817). A variable life insurance contract generally is a life insurance contract under which the amount of the death benefit (or the period of coverage) is adjusted on the basis of the investment return and the market value of the segregated asset account maintained with respect to the contract. A variable annuity contract generally is an annuity contract under which the amounts paid in, or the amount paid out, reflect the investment return and the market value of the segregated asset account maintained with respect to the contract. In order for a variable life insurance or annuity contract to meet the definition of a life insurance contract (including an annuity contract), and to be eligible for favorable tax rules on distributions under the contract, for any calendar quarter period, the segregated asset account with respect to the contract generally must be adequately diversified (sec. 817(h)).[179a]

The segregated asset accounts for a variable contract may be invested in a variety of investment funds. A variable life insurance or variable annuity contract often gives the holder the option to reallocate assets under the contract among these investment choices, and the practice has developed that no current taxation is imposed if no distribution is made under the contract at the time. In addition, a variable life insurance contract or variable annuity contract may be exchanged for another contract, as described above, without current taxation. Under these special rules, the holder of a variable life insurance or annuity contract may be able to dispose of one or more investment properties and re-invest in different investment properties without current taxation of the gain or loss realized on the disposition.

A variable life insurance contract otherwise has the same tax treatment to the holder as a life insurance contract that is not variable. Generally, 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 (sec. 101(a)). Further, no Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup"). Distributions from a life insurance contract (other than a modified en-

[179a] In addition, the policyholder may not exercise excessive control over the investments. See Rev. Rul. 81–225, 1981–2 C.B. 12; *Christofferson v. U.S.*, 749 F.2d 651 (8th Cir. 1984), cert. denied, 473 U.S. 905 (1985); Rev. Rul. 82–54, 1982–1 C.B. 11.

dowment contract) that are made prior to the death of the insured generally are includible in income only 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)). Present law provides a definition of life insurance designed to limit the investment orientation of the contract (sec. 7702). However, no dollar limit is imposed on the amount that may be paid into a life insurance contract for Federal income tax purposes.

Similarly, a deferred annuity that is a variable contract otherwise has the same tax treatment to the holder as a deferred annuity that is not variable. Generally, no Federal income tax is imposed on a deferred annuity contract holder who is a natural person with respect to the earnings on the contract (inside buildup) in the absence of a distribution under the contract. Annuity distributions generally are treated as partially excludable under an "exclusion ratio" (the ratio of the investment in the contract to the expected return under the contract as of that date) (sec. 72(b)). Other distributions (which for this purpose include loans) are treated as income first, then as a tax-free return of the investment on the contract (sec. 72(e)). An additional 10 percent tax is imposed on the income portion of distributions made before age 59–1/2, and in certain other circumstances (sec. 72(q)). An annuity contract must provide for certain required distributions where the holder dies before the entire interest in the contract has been distributed (sec. 72(s)). No dollar limit is imposed on the amount that may be paid into an annuity contract (that is not a pension plan contract) for Federal income tax purposes.

Description of Proposal

Under the proposal, tax-free treatment for an exchange of any life insurance, endowment or annuity contract for any variable contract would be repealed. Further, tax-free treatment for an exchange for any variable contract for any life insurance, endowment, or annuity contract would be repealed. The proposal also provides that each reallocation of assets among investment options within a variable annuity contract (such as a separate account mutual fund) or to the insurance company's general account under the terms of a variable contract would be treated as an exchange to which tax-free treatment does not apply.

Effective Date

The proposal would apply to contracts issued after the date of first committee action. Reallocation of assets after that date under the terms of an existing variable contract that was issued on or before that date would not be subject to the proposal. However, in the case of a material change to a contract originally issued before the date of first committee action, the contract would be treated as a new contract. Thus, the proposal would apply to any exchange of the new contract for another contract at any time after the material change. In addition, the proposal would apply to any reallocation of assets under the new contract at any time after the material change.

Prior Action

No prior action.

Analysis

The proposal is based on the premise that reallocations of assets within variable contracts, as well as exchanges of the contracts themselves, are sufficiently similar to exchanges of investment assets that ordinarily are subject to current taxation, that these exchanges should be subject to current taxation as well. If a taxpayer invests in a mutual fund, or a particular stock or bond, for example, and then disposes of the fund, the stock or the bond, gain or loss is recognized. If fairness dictates that similarly situated taxpayers should be subject to similar tax treatment, then wrapping the investment in a variable life insurance or annuity contract should not produce different tax results. Congress gave credence to this view in an analogous situation when it modified the tax treatment of "swap funds" in the Taxpayer Relief Act of 1997. In that Act, Congress limited the ability of taxpayers to contribute certain types of investment assets to a pool of other investment assets and diversify or otherwise change the nature of its investments without recognition of gain or loss on the transaction. By analogy, it can be argued that reallocation of assets within a variable contract and exchanges of variable contracts represent transactions that are more properly treated as taxable exchanges.

Opponents argue that variable life insurance and variable annuity contracts, while not strictly pension or retirement vehicles, serve an important function in encouraging savings by individuals. They assert that the tax benefits of tax-free reallocations of assets and exchanges of the contracts should be retained in order to continue this incentive. On the other hand, it could be argued that Congress has already provided targeted incentives for retirement savings in the form of tax-favored treatment for qualified pension plans, section 401(k) plans, SIMPLE plans, and a variety of individual retirement account ("IRA") provisions. In addition, it is argued that these provisions are subject to dollar caps, as well as other restrictions, whereas contributions and benefits under life insurance and annuity contracts generally are not. It is argued that additional tax incentives for savings should be deliberated by Congress rather than evolving through the modification of insurance products, the tax treatment of which was determined long before variable contracts were introduced in the marketplace. Further, as a savings incentive, tax-favored treatment for variable life insurance and variable annuity contracts is arguably extremely inefficient, because of the relatively high fees and transaction costs of such vehicles compared to purchases of mutual funds or other securities.

Opponents of the proposal also argue that, perhaps unintentionally, the proposal destroys the market for variable life insurance and annuity contracts, because individuals will no longer choose to purchase them if the holder may not select at will from an array of investment options depending on current market conditions. It can be countered that limiting tax-free exchanges and reallocations of assets within variable contracts still leaves such contracts more tax-favored than non-insurance vehicles such as mutual funds or direct ownership of stocks, securities or bonds. The proposal, it is argued, would not eliminate the tax deferral or the favorable tax treatment on annuity distributions under the exclusion ratio. Also, the proposal would not eliminate the tax- favored treatment of distributions, such as partial surrenders, under life insurance contracts generally as tax-free return of the investment in the contract first. Nor would the proposal eliminate the opportunity to withdraw the cash surrender value as a loan, and then receive the balance tax-free as a death benefit. It is also argued that the proposal would not affect the market for variable life insurance and annuity contracts in which the purchaser expects to buy and hold for the long term without changing the type of investment.

6. Computation of "investment in the contract" for mortality and expense charges on certain 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 (sec. 101(a)). Further, no Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup").

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). Among other requirements, mortality charges must be reasonable mortality charges which meet the requirements (if any) prescribed in Treasury regulations and which (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables as of the time the contract is issued. Similarly, expense charges must be reasonable and must be charges which (on the basis of the company's experience, if any, with respect to similar contracts) are reasonably expected to be actually paid.

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible 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 59½ 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). The requirements that mortality and expense charges be reasonable also apply to modified endowment contracts.

Generally, no Federal income tax is imposed on a deferred annuity contract holder who is a natural person with respect to the earnings on the contract (inside buildup) in the absence of a distribution under the contract. Annuity distributions generally are treated as partially excludable under an "exclusion ratio" (the ratio of the investment in the contract to the expected return under the contract as of that date) (sec. 72(b)). Other distributions (which for this purpose include loans) are treated as income first, then as a tax-free return of the investment on the contract (sec. 72(e)). An additional 10-percent tax is imposed on the income portion of distributions made before age 59½, and in certain other circumstances (sec. 72(q)). An annuity contract must provide for certain required distributions where the holder dies before the entire interest in the contract has been distributed (sec. 72(s)).

Investment in the contract means the aggregate amount of premiums or other consideration paid for the contract to date reduced by the aggregate amount received under the contract that was excludable from income (sec. 72(e)(6)), for purposes of the distribution rules. These rules do not provide that the investment in the contract is reduced by the portion of the premium paid that is used to pay mortality charges or expense charges. These charges can include the cost of term insurance protection for the current period, or, in the case of a deferred annuity contract, the cost of a payout option such the right to purchase a life annuity at guaranteed rates.

Description of Proposal

The proposal would modify the definition of investment in the contract for purposes of the distribution rules with respect to life insurance and annuity contracts.

For a life insurance contract, investment in the contract (as defined under present law) would be reduced by the mortality charges that are taken into account for purposes of Code section 7702. Investment in the contract would also be reduced by appropriate expense charges, to the extent provided in regulations (or other guidance promulgated by the Treasury Department).

For an annuity contract (other than an immediate annuity described in section 72(u)(4)), the investment in the contract (as defined under present law) would be reduced by the contract's assumed mortality and expense charges. These assumed charges would be defined as the contract's average cash value during the year multiplied by 1.25 percent. In the event that the contract holder used accumulated funds in the contract to exercise a particular payout option such as the right to purchase a life annuity at guaranteed rates, then the assumed mortality and expense charges associated with that option would be added to the investment in the contract at that time.

Effective Date

The proposal would be effective for contracts issued after the date of first committee action.

Prior Action

No prior action.

Analysis

The proposal is based on the premise of tax policy that amounts paid for current expenses should not be included in the basis of an asset. A life insurance contract that has a cash value can be viewed as divisible into two portions: a portion providing current term insurance protection and a cash value portion. The cost of the term insurance portion represents a current expense for a benefit—insurance protection—that does not last beyond the term. The cash value portion, by contrast, has continued value. Thus, because investment in the contract is equivalent to the basis for the contract (for purposes of section 72), the investment in the contract for a life insurance or annuity contract should not include amounts that represent current expenses, such as mortality charges for term insurance coverage for the current period and associated expense charges. It is also argued that the investment in the contract should not include the cost of any payout options that are still contingent and have not been exercised by the holder.

If investment in the contract is overstated by including the amount of current mortality and associated expenses, then the amount of any distribution from a life insurance or annuity contract that is taxable is measurably understated. This understatement of income would arise whether the contract is a modified endowment contract, with respect to which income is taxed before return of basis, or is a life insurance contract eligible for the more favorable distribution rules permitting recoupment of basis before the income is taxed, or is an annuity contract subject to the income- first rule on non-annuity distributions.

On the other hand, it could be argued that the proposal, while increasing the accuracy of the tax law, also increases its complexity by requiring an additional calculation with respect to distributions from life insurance or annuity contracts. Nevertheless, insurance companies already keep track of prior distributions for purposes of computing the investment in the contract, as well as mortality and expense charges, and frequently provide this information to policyholders on an annual basis, so it could be argued that there is not a significant additional record-keeping or reporting burden. It could also be argued that the incremental improvement in accuracy of the tax rules does not outweigh the disadvantage of disrupting present practices and present-law tax treatment for the numerous contracts that would be affected by the proposal.

E. Estate and Gift Tax Provisions

1. 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 a 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 readily marketable 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.

Prior Action

No prior action.

Analysis

It is well established that discounts may be appropriate in valuing minority interests in business entities. See, e.g., *Estate of Andrews,* 79 T.C. 938 (1982). 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. See Rev. Rul. 93–12, 1993–1 C.B. 202. 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 or 70 percent in some cases. See, e.g., *Estate of Barudin,* T.C. Memo. 1996–395 (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 Administration 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.[180] 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 asset's owner. While generally people 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 Administration proposal maintain that it is less clear whether such discounts are appropriate for entities holding marketable 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 is questionable that 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 readily marketable, 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 marketable assets.

Opponents of this approach note that it is inconsistent with observed market outcomes to claim that a minority discount cannot exist when the assets in question are liquid. For example, assume a taxpayer holds a one-third share in a portfolio of New York Stock

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[180] 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-third's share. In this circumstance, the brother would 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. The discounts observed in the marketplace generally are smaller than those often claimed as minority discounts in valuing transfers of business interests for estate and gift tax purposes. For example, over the past six months the discount from net asset value of the Herzfeld Closed-End Average has ranged between 12 percent and 4 percent of net asset value.[181] 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.

The Administration proposal states that valuation discounts would be denied with respect to entities holding "readily marketable assets." It is unclear, however, whether the proposal is actually limited to "readily marketable assets" as that term is commonly understood. The examples listed in the proposal (i.e., 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) indicate that the proposal would apply to most passive assets. However, as noted above, passive assets are not automatically liquid. The liquidity of markets is a qualitative concept. While the market for Treasury securities generally is conceded to be the most liquid market in the world, there are not generally accepted ways to measure the relative liquidity of the market for U.S. Treasury securities to that of pork bellies, to that for Picassos, to that for real estate in New York city. Observers note that Picassos are not sold daily and an effort to quickly convert a Picasso to cash may result in the painting being sold at a discount to its "market value."

To the extent that the Administration proposal is meant to cover assets such as real estate and art that may not actually be readily marketable, the arguments that valuation discounts are inappropriate may not be as applicable.[182] If the proposal does not include

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[181] The Herzfeld Closed-End Average measures 16 equally-weighted closed-end funds that invest principally in equities of U.S. corporations. *Barron's Market Week,* February 9, 1998, p. 89. As an average, the Herzfeld Closed-End Average does not reflect the range of discounts or premiums that may be observed on individual funds.

[182] 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 com-

Continued

a "bright line" definition of those assets to be denied valuation discounts, the proposal could lead to increased taxpayer litigation regarding the standard of "readily marketable assets.'

2. Gifts of "present interests" in a trust (repeal the "Crummey" case rule)

Present Law

Under present law, the first $10,000[183] of gifts of present interest are excluded from Federal gift tax. 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." See, e.g., *D. Clifford Crummey* v. *Commissioner,* 397 F. 2d 82 (9th Cir. 1968). This result has been upheld even where the donee is a minor or lacks knowledge of his right of withdrawal.

In the *Crummey* case, the holder of the withdrawal power was the ultimate beneficiary of the trust. In more recent cases, such as *Estate of Cristofani* v. *Commissioner,* 97 T.C. 74 (1991), and *Estate of Kohlsaat* v. *Commissioner,* 73 T.C.M. 2732 (1997), the trust agreement was drafted to give withdrawal rights to individuals who did not have substantial economic interests in the trust.

Premiums paid by an insured person for a life insurance policy are considered a taxable gift to the beneficiaries of the policy if (1) the policy proceeds are payable to beneficiaries other than the insured's estate, (2) the insured retains no power to receive the economic benefits in himself or his estate, (3) the insured retains no power to change the beneficiaries or their proportionate benefit, and (4) the insured retained no reversionary interest in the insured or his estate. Treas. Reg. sec. 25.2511–1(h)(8). The transfer of cash to an insurance trust is a future interest where the cash is used to pay premiums on an insurance policy and the income from the insurance proceeds after the death of the insured is to be paid to the trust's beneficiary for life. Treas. Reg. sec. 25.2503–3(c), Example (2).

Description of Proposal

The proposal would overrule the *Crummey* decision by amending section 2503(b) to apply only to outright gifts of present interests. Gifts to minors under a uniform act would be deemed to be outright gifts.

Effective Date

The proposal would be effective for gifts completed after December 31, 1998.

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mission 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 taxpayer's expert's testimony as to the appropriate level of discount. *Estate of Williams,* T.C. Memo. 1998–59.

[183] The Taxpayer Relief Act of 1997 provided that this amount will be increased (i.e., indexed) in $1,000 increments for inflation occurring after 1997.

Analysis

Opponents of the Administration proposal argue that the principles of the Crummey decision are longstanding. Taxpayers have made use of Crummey powers to minimize gift taxes with respect to certain transfers in trust for at least 30 years. On the other hand, the Administration argues that use of the Crummey power often is a legal fiction since, typically by understanding or expectation, it is extremely rare for a Crummey power to be exercised. The Administration believes that the continued existence and expansion of the *Crummey* decision undermines the statutory requirement that only a gift of a present interest is eligible for the $10,000 annual gift tax exclusion.

The legislative history of the annual exclusion indicates that its size was established to exempt numerous small gifts and larger wedding and Christmas gifts. That legislative history [184] 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. Opponents of the Treasury proposal argue that, in many cases, the existence of a Crummey power does not make the identity of the donee, or the value of the transfer, unclear and, therefore, use of Crummey powers is consistent with the annual exclusion.

Proponents of the Treasury 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 given to multiple individuals while only the intended donee or donees have substantial economic interests in that trust. In any event, the Treasury proposal would overrule all uses of Crummey powers, not just these situations.

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 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 limitations are adopted on the use of Crummey powers, transitional relief may be appropriate in situations where the insurance policy is a whole life policy, espe-

[184] The Finance Committee report for the Revenue Act of 1932 (Committee Report No. 665 (72d Congress 1st Session)) 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." page 41. Identical language is contained in page 29 of Report of the Committee on Ways and Means (Report Number 708, 72d Cong., 1st Session)

cially where the policy has been irrevocably transferred to the trust and the insured individual is no longer insurable.

3. Eliminate gift tax exemption for personal residence trusts

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 the property in 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, 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.

Prior Action

No prior action.

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, the property would revert to his estate).[185] The trust agreement may further provide that the grantor may

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[185] Reversionary interests commonly are retained so that, if the grantor dies before the end of the trust term, 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.

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, 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, as long as the grantor survives the trust term.[186] Lastly, if the grantor continues to live in the home after the trust term has expired, 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 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 remain-

[186] If the grantor dies during the trust term, 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.

der 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 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 Administration 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 Administration 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.

4. Include qualified terminable interest property ("QTIP") trust assets in 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 (sec. 2207A). 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 any such property in which the decedent had a qualifying income interest for life and a deduction was allowed under the gift or estate tax.

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.

Effective Date

The proposal would be effective for decedents (i.e., surviving spouses) dying after the date of enactment.

Prior Action

No prior action.

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.[187] Under both the gift and estate tax 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 that surviving spouse.

An exception to the terminable interest rule was provided 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 only has an income interest, as long as the transferor elects to include the trust in the spouse's gross estate for Federal estate tax purposes and subjects to gift tax the property in the QTIP if the spouse disposes of the income interest.

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 statute of limitations for assessing tax on the first estate has elapsed, the estate of the second spouse to die argues against inclusion in that second estate due to a technical flaw in the QTIP eligibility or election in the first estate. 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.

[187] 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 qualified domestic trust is a trust which has at least one trustee that is a U.S. citizen or a domestic corporation and no distributions of corpus can be made without withholding from those distributions.

F. Foreign Tax Provisions

1. Replace sales source rules with activity-based rule

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 Internal Revenue Service, 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.

Prior Action

The proposal was included in the President's fiscal year 1998 budget proposal.

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 provides a tax benefit only to U.S. exporters 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 export benefit provided by 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 counterbalance 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.

2. 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 (Treas. Reg. sec. 1.901–2A(e)).

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 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.

Prior Action

The proposal was included in the President's fiscal year 1998 budget proposal. 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.

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.

3. Apply "80/20" company rules on a group-wide basis

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 (secs. 871(a) and 881(a)). 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. 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.

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 based on the source of the income of such company during the three-year testing period.

Description of Proposal

The proposal would apply the 80/20 test on a group-wide basis. Therefore, members of a group would be required to aggregate their gross income for purposes of applying the 80/20 test.

Effective Date

The proposal would apply to interest or dividends paid or accrued more than 30 days after the date of enactment.

Prior Action

No prior action.

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 improper 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. For instance, 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. Some assert that such a dividend timing strategy is not unlike other dividend timing strategies (or so-called "rhythm methods"), such as those previously used to maximize section 902 foreign tax credits prior to the adoption in 1986 of the pooling concept for a foreign subsidiary's earnings and profits and taxes.

The proposal would apply the 80/20 test on a group-wide basis. As a result, members of a group would be required to aggregate their gross income for purposes of the 80/20 test. It is not clear how a "group" should be defined for these purposes. One approach may be to use an affiliated group concept under principles similar to section 1504. Under such an approach, the U.S.-source earnings of a wholly-owned U.S. subsidiary of the payor corporation would be considered in determining whether payments from the payor corporation (or from other group members) qualify for the 80/20 company rules. However, such an approach may be viewed as being overly broad, and may serve to disqualify from the 80/20 company rules payments from group members which in fact are attributable to foreign-source earnings. For instance, interest payments from a group member to unrelated parties that are attributable to foreign-source earnings of such group member may not qualify for the 80/20 company rules if the 80/20 test is applied on such a group basis. It is argued that the degree to which earnings of group members would be tainted under such an approach can be reduced by more narrowly defining the group. For instance, the group could be defined to include only the tested U.S. corporation and certain subsidiaries owned by it. On the other hand, some may argue that a group approach by its nature may not be sufficiently targeted to the specific timing issues raised by the three-year lookback rule.

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.

4. Prescribe regulations regarding foreign built-in losses

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. 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 effectively connected with a U.S. trade or business.

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 involving transfers to 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 into the U.S. taxing jurisdiction. Such losses could be used to offset income or gain that otherwise would be subject to U.S. tax.

Description of Proposal

Under the proposal, the Secretary of the Treasury would be directed to prescribe regulations to determine the basis of assets held directly or indirectly by a non-U.S. person and the amount of built-in deductions with respect to a non-U.S. person or an entity held directly or indirectly by a non-U.S. person as may be necessary or appropriate to prevent the avoidance of tax. No inference would be intended regarding the treatment under present law of transactions involving losses arising outside the U.S. taxing jurisdiction.

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

No prior action.

Analysis

The proposal is intended to address both transactions in which taxpayers acquire built-in losses arising outside the U.S. taxing jurisdiction and transactions in which related income and loss are generated but the income arises outside the U.S. taxing jurisdiction. Such losses could be used to reduce U.S. tax both by U.S. persons and by foreign persons with operations in the United States. The Administration is concerned that existing regulatory authority may not provide the Secretary of the Treasury with sufficient flexibility to address potential abuses in a comprehensive manner. However, granting broad regulatory authority to address the use of built-in foreign losses, without further enumerating the scope of such authority, may be criticized as creating uncertainty and providing insufficient guidance to taxpayers making business decisions. On the other hand, an alternative approach of requiring basis adjustments in all such cases would provide greater certainty but could be criticized as inflexible and unduly harsh. Additional consideration should be given to identifying the specific circumstances where basis adjustments may or may not be appropriate.

5. Prescribe regulations regarding use of hybrids

Present Law

Because of differences in U.S. and foreign tax laws, it is possible for a taxpayer to enter into transactions that are treated in one manner for U.S. tax purposes and in another manner for foreign tax purposes. These transactions are referred to as hybrid transactions. A hybrid transaction may involve the use of a hybrid entity that is treated as a corporation for purposes of the tax law of one jurisdiction but is treated as a branch or partnership for purposes of the tax law of another jurisdiction. Alternatively, a hybrid transaction also may involve the use of hybrid securities, such as a security that is treated as debt or a royalty right in one jurisdiction but is treated as an equity interest in another jurisdiction. Moreover, a hybrid transaction may involve another type of hybrid structure, including a transaction involving a repurchase agreement arrangement that is characterized as a loan in one jurisdiction but is characterized as a non-taxable exchange in another jurisdiction.

Section 894(c), enacted with the Taxpayer Relief Act of 1997, was aimed at addressing the potential tax-avoidance opportunity available for foreign persons that invest in the United States through hybrid entities. Section 894(c) limits the availability of a reduced rate of withholding tax pursuant to an income tax treaty in order to prevent tax avoidance. Under section 894(c), a foreign person is not entitled to a reduced rate of withholding tax under a treaty with a foreign country on an item of income derived through an entity that is treated as a partnership (or is otherwise treated as fiscally transparent) for U.S. tax purposes if (1) such item is not treated for purposes of the taxation laws of such foreign country as an item of income of such person, (2) the foreign country does not impose tax on an actual distribution of such item of income from such entity to such person, and (3) the treaty itself does not contain a provision addressing the applicability of the treaty in the case of income derived through a partnership or other fiscally transparent entity. In addition, the Secretary of the Treasury is authorized to prescribe regulations to determine, in situations other than the situation specifically described in the statutory provision, the extent to which a taxpayer shall not be entitled to benefits under an income tax treaty of the United States with respect to any payment received by, or income attributable to activities of, an entity that is treated as a partnership for U.S. federal income tax purposes (or is otherwise treated as fiscally transparent for such purposes) but is treated as fiscally non-transparent for purposes of the tax laws of the jurisdiction of residence of the taxpayer.

Section 894(c) addresses a potential tax-avoidance opportunity for Canadian corporations with U.S. subsidiaries that arises because of the interaction between the U.S. tax law, the Canadian tax law, and the income tax treaty between the United States and Canada. Through the use of a U.S. limited liability company, which is treated as a partnership (or otherwise fiscally transparent) for U.S. tax purposes but as a corporation for Canadian tax purposes, a payment of interest (which is deductible for U.S. tax purposes) may be converted into a dividend (which is excludable for Canadian tax purposes). Accordingly, interest paid by a U.S. subsidiary through a U.S. limited liability company to a Canadian parent corporation would be deducted by the U.S. subsidiary for U.S. tax purposes and would be excluded by the Canadian parent corporation for Canadian tax purposes; the only tax on such interest would be a U.S. withholding tax, which could have been imposed at a reduced rate of 10 percent (rather than the full statutory rate of 30 percent) pursuant to the income tax treaty between the United States and Canada. Under section 894(c), withholding tax is imposed at the full statutory rate of 30 percent in such case.

Notice 98–5, issued on December 23, 1997, addresses among other things, the treatment of certain hybrid structures under the foreign tax credit provisions of the Code. The Notice states that the Treasury Department and the Internal Revenue Service have concluded that the use of certain hybrid structures creates the potential for foreign tax credit abuse. The hybrid structures identified in Notice 98–5 include transactions that result in the effective duplication of tax benefits through the use of structures designed to exploit inconsistencies between U.S. and foreign tax laws (e.g., an arrangement that generates foreign taxes for which a credit is given in both the United States and a foreign country for the same taxes). The Notice states that it is intended that regulations will be issued to disallow foreign tax credits for such arrangements in cases where the reasonably expected economic profit from the transaction is insubstantial compared to the value of the foreign tax credits expected to be obtained as a result of the arrangement. In addition, the Notice states that Treasury and the Internal Revenue Service are considering various approaches to address structures, such as hybrid entity structures, intended to create a significant mismatch between the time foreign taxes are paid or accrued and the time the foreign-source income giving rise to the relevant foreign tax liability is recognized for U.S. tax purposes; such approaches may include either deferring the foreign tax credits until the taxpayer recognizes the income, or accelerating the income recognition to the time when the credits are allowed. The Notice further states that it is intended that regulations will apply with respect to hybrid arrangements resulting in the effective duplication of tax benefits for foreign taxes paid or accrued on or after December 23, 1997 and, in the case of other hybrid entity structures, no earlier than the date proposed regulations are issued.

Notice 98–11, issued on January 16, 1998, addresses the treatment of hybrid branches under the provisions of subpart F of the Code. The Notice states that the Treasury Department and the Internal Revenue Service have concluded that the use of certain hybrid branch arrangements is contrary to the policy and rules of subpart F. The hybrid branch arrangements identified in Notice 98–11 are structures that are characterized for U.S. tax purposes as part of a controlled foreign corporation (a "CFC") but are characterized for purposes of the tax law of the country in which the CFC is incorporated as a separate entity. The Notice states that it is intended that regulations will be issued to prevent the use of hybrid branch arrangements to reduce foreign tax while avoiding the corresponding creation of subpart F income; such regulations will provide that the branch and the CFC will be treated as separate corporations for purposes of subpart F. The Notice further states that it is intended that such regulations will apply to hybrid branch arrangements entered into or substantially modified on or after January 16, 1998 and, in the case of arrangements entered into before such date, to all payments or other transfers made or accrued after June 30, 1998. The Notice also states that similar issues raised under subpart F by certain partnership or trust arrangements will be addressed in separate regulations projects.

Description of Proposal

Under the proposal, the Secretary of the Treasury would be directed to prescribe regulations clarifying the tax consequences of hybrid transactions. Such regulations would set forth the appropriate tax results with respect to hybrid transactions in which the intended results are inconsistent with the purposes of U.S. tax law or U.S. income tax treaties. The regulations also would provide that the intended results will be respected in the case of hybrid transactions in which the results are not inconsistent with the purposes of U.S. tax law or treaties. In this regard, the regulations would not deny the intended tax results solely because the hybrid transaction involves the inconsistent treatment of entities, items, or transactions.

Effective Date

The proposal would be effective as of the date of enactment.

Prior Action

No prior action.

Analysis

The Administration's description of the proposal provides several examples of specific circumstances where the proposed regulatory authority may be used. One example involves the use of hybrid securities to generate interest deductions in the United States that are viewed as incompatible with the purposes of a U.S. income treaty. Another example is the use of hybrid securities that generate original issue discount deductions in a foreign jurisdiction without corresponding income inclusions in the United States. A third example involves the use of hybrid transactions to generate inappropriate foreign tax credit benefits. However, the proposed regulatory authority is not limited to these examples.

General principles of income taxation include the principle of equitable taxation and the principle of efficient taxation. Some analysts suggest that, in certain cases, hybrid transactions may compromise both the equity and the efficiency of the U.S. income tax. Equity requires that similarly situated taxpayers be treated similarly. The proposal suggests that in certain circumstances hybrid securities may be used to generate interest deductions in the United States that generally could not be claimed by otherwise similar businesses that have not issued such hybrid securities. In such a circumstance, the net capital costs of one business might be higher than those of another because the second business's use of hybrid securities permits it a tax deduction not available to the first business. Such an outcome could put the first business at a competitive disadvantage in the prices it can charge for its product. To the extent that the only difference between the two businesses is the hybrid structure, an inequity may be created by the income tax that would not exist in the market in the absence of the tax.

Such disparate treatment of different hybrid structures also might produce market inefficiencies. For example, if certain businesses or industries are able to use hybrid structures to reduce their income tax burden compared to that of other businesses or industries, their after-tax rate of return will increase. In the capital market, increases in rates of return act as signals to investors as to where more investment funds are needed. Investors may respond by making more investment funds available to these businesses or industries and less to other businesses or industries. To the extent changed rates of return are a consequence of the income tax and not of underlying market conditions, investor decisions will be distorted. Too little investment monies may go to some businesses and too much to others. A misallocation of investment monies can dampen future economic growth.

Hybrid structures might create a further form of inefficiency in investment. Such structures might increase the after-foreign-tax earnings of foreign subsidiaries. Because active foreign subsidiaries are permitted to defer U.S. income tax on their net foreign earnings, hybrid structures might create an inefficient incentive for domestic businesses to locate certain facilities abroad.

Hybrid structures may induce a third type of inefficiency as well. Creation of hybrid entities or hybrid securities requires real resources, the time and effort of many individuals, and other such costs. These resources represent funds spent to reduce tax liability rather than funds spent to produce more goods or services for sale to the public.

It may be the case that certain hybrid transactions are purely a matter of form over substance. On the other hand, other hybrid transactions may have business purposes in addition to whatever ancillary tax saving they produce. The development of such transactions reflects the growing financial sophistication of world capital markets and the desire to spread risk efficiently. The ability to divide business claims more finely than in the old simple distinctions of "bond" or "stock" generally has improved the efficiency of the financial markets, allocated risk more efficiently to those better able to bear risk and, thereby, has reduced the cost of capital, making possible more investment and greater future economic growth potential. Moreover, hybrid transactions are not inherently inequitable. Any business may choose to organize itself to take advantage of the benefits of these structures. New innovations in business, be it in management structure or financial structure, often create an advantage for the innovator, but such outcomes are not inherently unfair.

The use of hybrid transactions to circumvent provisions of the U.S. tax law is potentially troublesome. Moreover, the availability of these transactions may have been exacerbated by the so-called "check-the-box" entity classification regulations issued in 1996. However, given the numerous types of hybrid transactions, a broad grant of regulatory authority to specify the tax consequences of hybrid transactions in general may not be the most appropriate solution. Granting broad authority, without further enumerating the reach of the authority, could create an environment of uncertainty that has the potential for stifling legitimate business transactions. In addressing the issues raised by hybrid transactions, additional consideration should be given to identifying both the specific circumstances where a hybrid transaction is inconsistent with the purposes of the U.S. tax law and the appropriate tax treatment of such transactions. Finally, it should be noted that the Treasury Department and the Internal Revenue Service have announced their intention to issue regulations addressing the treatment of hybrid branches under the subpart F provisions (Notice 98–11); it is not entirely clear how this proposal for regulatory authority may interact with that regulation project.

6. 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 (secs. 871(b) and 882). Detailed rules apply for purposes of determining whether income is treated as effectively connected with a U.S. trade or business (sec. 864(c)). Under these rules, foreign-source income is treated as effectively connected with a U.S. trade or business only in limited circumstances (sec. 864(c)(4)).

Income derived from the sale of personal property other than inventory property generally is sourced based on the residence of the seller (sec. 865(a)). 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) (secs. 865(b) and 861(a)(6)). 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 (sec. 865(e)(2)(A)). 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 (sec. 865(e)(2)(B)). Accordingly, income from the sale by a foreign person of inventory property attributable to an office or other 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.

Prior Action

No prior action.

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.

7. Modify controlled foreign corporation exemption from U.S. tax on transportation income

Present Law

The United States generally imposes a 4-percent tax on the U.S.-source gross transportation income of foreign persons that is not effectively connected with the foreign person's conduct of a U.S. trade or business (sec. 887). Foreign persons generally are subject to U.S. tax at regular graduated rates on net income, including transportation income, that is effectively connected with a U.S. trade or business (secs. 871(b) and 882).

Transportation income is any income derived from, or in connection with, the use (or hiring or leasing for use) of a vessel or aircraft (or a container used in connection therewith) or the performance of services directly related to such use (sec. 863(c)(3)). Income attributable to transportation that begins and ends in the United States is treated as derived from sources in the United States (sec. 863(c)(1)). Transportation income attributable to transportation that either begins or ends (but not both) in the United States is treated as derived 50 percent from U.S. sources and 50 percent from foreign sources (sec. 863(c)(2)). U.S.-source transportation income is treated as effectively connected with a foreign person's conduct of a U.S. trade or business only if the foreign person has a fixed place of business in the United States that is involved in the earning of such income and substantially all of such income of the foreign person is attributable to regularly scheduled transportation (sec. 887(b)(4)).

An exemption from U.S. tax is provided for income derived by a nonresident alien individual or foreign corporation from the international operation of a ship or aircraft, provided that the foreign country in which such individual is resident or such corporation is organized grants an equivalent exemption to individual residents of the United States or corporations organized in the United States (secs. 872(b)(1) and (2) and 883(a)(1) and (2)). In the case of a foreign corporation, this exemption does not apply if 50 percent or more of the stock of the foreign corporation by value is owned by individuals who are not residents of a country that provides such an exemption unless the foreign corporation satisfies one of two alternative tests (sec. 883(c)). Under these alternative tests, the exemption applies to a foreign corporation without regard to the residence of the corporation's shareholders either if the foreign corporation is a controlled foreign corporation (a "CFC") or if the stock of the corporation is primarily and regularly traded on an established securities market in the United States or in a foreign country that provides an equivalent exemption. Accordingly, the exemption for transportation income applies to any CFC formed in a country that provides an equivalent exemption, regardless of whether the owners of the stock of the CFC are residents of such a country.

A foreign corporation is a CFC if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or by value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (secs. 957 and 951(b)). For this purpose, a U.S. partnership is considered a U.S. person (secs. 957(c) and 7701(a)(30)). The U.S. 10-percent shareholders of a CFC are required to include in income currently for U.S. tax purposes their pro rata shares of certain income of the CFC and their pro rata shares of the CFC's earnings invested in U.S. property (sec. 951).

Description of Proposal

The proposal would modify the provision under which a CFC organized in a country that provides an equivalent exemption is eligible for the exemption from U.S. tax for transportation income without regard to the residence of the shareholders of the CFC. Under the proposal, a CFC would qualify for this exemption only if the CFC is more than 50-percent owned by U.S. shareholders that are individuals or corporations. A CFC that does not satisfy this test would be eligible for the exemption for transportation income only if it satisfies either the requirement as to the residence of its shareholders or the public trading test of present law.

Effective Date

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

Prior Action

No prior action.

Analysis

The proposal is intended to prevent the use of the CFC test by foreign persons that are not residents of a country that grants an equivalent exemption to obtain the benefit of the exemption from U.S. tax for transportation income. Under present law, if 50 percent or more of the stock of a foreign corporation is owned by individuals who are residents of countries that do not provide an equivalent exemption, such foreign corporation generally is not eligible for the exemption from U.S. tax for transportation income (even though the corporation is itself organized in an equivalent exemption country). However, if such persons hold the stock of the foreign corporation through a U.S. partnership, the corporation will constitute a CFC and therefore under present law will qualify for the exemption. The proposal would prevent this result and would permit CFCs to qualify for the exemption from U.S. tax for transportation income only if U.S. persons subject to U.S. tax (i.e., individuals or corporations) own more than 50 percent of the stock of the CFC.

The proposal could give rise to double taxation in certain circumstances. The U.S. 10-percent shareholders of a CFC are required to include in income currently their pro rata shares of certain income of the CFC, including certain shipping income. Under the proposal, a CFC that does not satisfy the ownership requirements set forth in the proposal would not be eligible for an exemption from the U.S. 4-percent tax on transportation income. Thus, income of such a CFC would be subject to the U.S. 4-percent tax at the CFC-level and also could be includible in the incomes, and therefore subject to U.S. tax, of any U.S. 10-percent shareholders. It should be noted that the same potential for double taxation could occur under present law in the case of a CFC organized in a foreign country that does not grant an equivalent exemption.

G. Administrative Provisions

1. Increased information reporting penalties

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.

Prior Action

The proposal was included in the President's fiscal year 1998 budget proposal.

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.[188] 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.

2. 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, and (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.

Prior Action

The proposal was included in the President's fiscal year 1998 budget proposal.

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[188] 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 utlimately reported on the income tax return.

Analysis

Opponents might argue that altering the present-law penalty to make it apply automatically to large corporations 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.

3. Repeal exemption for withholding on gambling winnings from bingo and keno in excess of $5,000

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 or keno.

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.

Prior Action

The proposal was included in the President's fiscal year 1998 budget proposal.

Analysis

It is generally believed that imposing withholding on winnings from bingo and keno will improve tax compliance and enforcement.

4. Modify the deposit requirement for Federal unemployment ("FUTA") taxes

Present Law

If an employer's liability for Federal unemployment ("FUTA") taxes is over $100 for any quarter, it 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, 2003.

Prior Action

A substantially similar proposal was included in the President's fiscal year 1998 budget proposal.

Analysis

Proponents of the proposal argue that the new deposit requirements will: (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 find no evidence that more frequent deposits reduce employer delinquencies. Further, opponents contend that the proposal's administrative burden significantly outweighs its benefits.

5. Clarify and expand mathematical error procedures

Present Law

Taxpayer identification numbers ("TIN"s)

The Internal Revenue Service ("IRS") may deny a personal exemption for a taxpayer, the taxpayer's spouse or the taxpayer's dependents if the taxpayer fails to provide a correct TIN for each person for whom the taxpayer claims an exemption. This TIN requirement also indirectly effects other tax benefits currently conditioned on a taxpayer being able to claim a personal exemption for a dependent (e.g., head-of-household filing status and the dependent care credit). Other tax benefits, including the adoption credit, the child tax credit, the Hope Scholarship credit and Lifetime Learning credit, and the earned income credit also have TIN requirements. For most individuals, their TIN is their Social Security Number ("SSN"). The mathematical and clerical error procedure currently applies to the omission of a correct TIN for purposes of personal exemptions and all of the credits listed above except for the adoption credit.

Mathematical or clerical errors

The IRS may summarily assess additional tax due as a result of a mathematical or clerical error without sending the taxpayer a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60–day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. The request for abatement of the assessment is the only procedure a taxpayer may use prior to paying the assessed amount in order to contest an assessment arising out of a mathematical or clerical error. Once the assessment is satisfied, however, the taxpayer may file a claim for refund if he or she believes the assessment was made in error.

Description of Proposal

The proposal would provide in the application of the mathematical and clerical error procedure that a correct TIN is a TIN that was assigned by the Social Security Administration (or in certain limited cases, the IRS) to the individual identified on the return. For this purpose the IRS would be authorized to determine that the individual identified on the tax return corresponds in every aspect (including, name, age, date of birth, and SSN) to the individual to whom the TIN is issued. The IRS would be authorized to use the mathematical and clerical error procedure to deny eligibility for the dependent care tax credit, the child tax credit, and the earned income credit even though a correct TIN has been supplied if the IRS determines that the statutory age restrictions for eligibility for any of the respective credits is not satisfied (e.g., the TIN issued for the child claimed as the basis of the child tax credit identifies the child as over the age of 17 at the end of the taxable year).

Effective Date

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

Prior Action

The Small Business Job Protection Act of 1996 extended the mathematical and clerical error procedure to the omission of a correct TIN for personal exemptions and therefore indirectly to other tax benefits which are currently conditioned on the taxpayer being able to claim a personal exemption for a dependent (e.g., head-of-household status and the dependent care tax credit). The Taxpayer Relief Act of 1997 extended the mathematical and clerical error procedure to the omission of a correct TIN for the child tax credit and the Hope Scholarship credit and Lifetime Learning tax credits.

Analysis

One argument in favor of the proposal is that treating age discrepancies as evidence of an incorrect TIN and applying the mathematical and clerical error procedure will increase compliance with the Internal Revenue Code. Also, in the case of the refundable earned income credit, the proposals will reduce the amount of erroneously large refunds in excess of tax liability sent to taxpayers and ease the IRS burden in trying to recoup the erroneous portion of the refund from lower-income taxpayers. One response to the proposal is that the IRS already has general regulatory authority to implement it. Others question whether the IRS has the ability to apply these new proposals without incorrectly denying tax benefits to some taxpayers.

H. Real Estate Investment Trust Provisions

1. Freeze grandfathered status of stapled or paired-share 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 essentially 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 a tax at the REIT level. If an entity qualifies as a REIT by satisfying the various requirements described below, the entity is taxable as a corporation on its real estate investment trust taxable income ("REITTI") and on certain other amounts. REITTI is the taxable income of the REIT with certain adjustments, the most significant of which is a deduction for dividends paid. The allowance of this deduction is the mechanism by which the REIT becomes a pass-through entity for Federal income tax purposes.

In general, a REIT must derive its income from passive sources and not engage in any active trade or business. Accordingly, in addition to the tax on its REITTI, a 100–percent tax is imposed on the net income of a REIT from "prohibited transactions" (sec. 857(b)(6)). A prohibited transaction is the sale or other disposition of property held for sale in the ordinary course of a trade or business other than certain foreclosure property.

Requirements for REIT status

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. These tests are intended to allow pass-through treatment only if there really is a pooling of investment arrangement, if the entity's investments are basically in real estate assets, and if its income is passive income from real estate investment, as contrasted with income from the operation of a business involving real estate. In addition, substantially all of the entity's income must be passed through to its shareholders on a current basis.

Under the organizational structure tests, a REIT must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees (sec. 856(a)). The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership. 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.

Under the source-of-income tests, at least 95 percent of its gross income generally must be derived from rents, dividends, interest and certain other passive sources. In addition, at least 75 percent of its income generally must be from real estate sources, including rents from real property.

For purposes of these tests, rents from real property generally include charges for services customarily rendered in connection with the rental of real property, whether or not such charges are separately stated. Services provided to tenants are regarded as customary if, in the geographic market within which the building is located, tenants in buildings that are of a similar class (for example, luxury apartment buildings) are customarily provided with the service. Where a REIT furnishes non-customary services to tenants, amounts received generally are not treated as qualifying rents unless the services are furnished through an independent contractor (sec. 856(d)(2)(C)). In general, an independent contractor is a person who does not own more than a 35–percent interest in the REIT (sec. 856(d)(3)(A)), and in which no more than a 35–percent interest is held by persons with a 35–percent or greater interest in the REIT (sec. 856(d)(3)(B)).

The requirements relating to the nature of the REIT's assets includes a rule mandating that, at the close of each quarter of its taxable year, at least 75 percent of the value of the entity's assets be invested in real estate assets, cash and cash items, and government securities (sec. 856(c)(5)(A)).

The income distribution requirement provides generally that at least 95 percent of a REIT's income (with certain minor exceptions) must be distributed to shareholders as dividends (sec. 857(a)).

Stapled REITs

In a stapled REIT structure, both the shares of a REIT and a C corporation may be traded, often including public trading, but are subject to a provision that they may not be sold separately. Thus, the REIT and the C corporation have identical ownership at all times.

In 1984, Congress became concerned that the net effect of a separate treatment of an active business stapled to a REIT is to eliminate the corporate tax on an active business. Accordingly, Congress adopted Code section 269B in the Deficit Reduction Act of 1984 (the "1984 Act"). The provision relevant to REITs requires that in applying the tests for REIT status, all stapled entities are treated as one entity (sec. 269B(a)(3)). This provision generally was effective upon enactment. However, the 1984 Act included grandfather rules, one of which provided that certain stapled REITs were not subject to the new provision (sec. 136(a)(2) of the 1984 Act). The rule provided that the new provision did not apply to a REIT that was a part of a group of stapled entities if the group of entities was stapled on June 30, 1983, and included a REIT on that date.

Description of Proposal

The proposal would limit the tax benefits of the existing stapled REITs that qualify under the 1984 Act's grandfather rules. Under the proposal, the general rules treating the REIT and the stapled C corporation as a single entity for purposes of the REIT qualification tests (sec. 269B) would be applied to properties acquired by grandfathered entities on or after the effective date and activities or services relating to such properties performed on or after the effective date.

Effective Date

The proposal would be effective as of the date of first committee action.

Prior Action

No prior action.

Analysis

In a stapled REIT structure, the shares of a REIT are stapled to a C corporation that operates an active business. The REIT holds real estate assets used in the C corporation's business, which it rents to the C corporation. The goal of a stapled REIT structure is to achieve a single level of tax on the part of a corporation's income that is attributable to the return on its real estate assets, often where that corporation is publicly-traded. A corporation operating a business cannot itself meet the requirements for REIT status, especially the rule that at least 95 percent of a REIT's gross income must be from real property rents and other passive sources (sec. 856(c)(2)). A publicly-traded corporation generally cannot qualify for pass-through treatment as a partnership (sec. 7704). Thus, absent a stapled REIT or similar structure, all of the income of a publicly-traded corporation is subject to both income tax at the corporate level and tax at the shareholder level when dividends or liquidation proceeds are paid.

For stapled REITs that are grandfathered under the 1984 Act, the structure allows an amount of the C corporation's income equal to the rent paid to the REIT for assets used in the C corporation's business to be excluded from corporate-level taxation. The C corporation claims a deduction for the rent paid. Although the rental income is taxed to the REIT's shareholders, who also are the C corporation's shareholders, the corporate tax on this income has been eliminated.

The 1984 Act generally prevents these benefits by treating the REIT and the stapled C corporation as one entity for purposes of the tests for REIT qualification. In many situations, combining the activities of the C corporation and the REIT would cause all income attributable to a property to be treated as other than rents from real property. This could cause a violation of the 95–percent gross-income test, resulting in disqualification of the REIT. Thus, the REIT would be treated as a C corporation.

A small number of stapled REITs which are still in existence are excepted from the 1984 Act's changes under the grandfather rule. These entities thus continue to derive the benefits of the stapled REIT structure that the 1984 Act rules generally prevent. Recently, some of these grandfathered stapled REITs have engaged in acquisitions of real estate assets worth billions of dollars.[189] Moreover, some of the grandfathered REITs have been acquired by new owners who have changed their lines of business and vastly increased their assets.[190]

It can be argued that this grandfather rule, like similar transition rules, was probably provided with the intent of preventing the application of the new rules to some entities already in existence, the owners of which had made large investments based on the assumption that the tax benefits of the structure would continue to be available. However, it can be argued that Congress did not intend that the grandfathered REITs would engage in large-scale acquisitions of assets or that new owners would acquire the grandfathered REITs in order to utilize their grandfathered status for different businesses. Furthermore, the ability of the current grandfathered REITs to utilize the benefits of their grandfathered status for new asset acquisitions raises concerns of competitiveness. Because other publicly traded entities that engage in businesses involving real estate are taxed as corporations and, thus, are subject to two levels of tax, they probably must charge higher prices in order to obtain a comparable economic rate of after-tax return on their assets.

Particular aspects of the proposal may be criticized. For example, it may be considered unfair to apply the proposal to all new properties acquired by grandfathered entities. In addition, it is not clear what constitutes a "property" for purposes of the proposal. A new parking lot added to an existing structure would constitute separate property for some tax purposes (e.g., the depreciation rules). If the concept of a new property under the proposal is this expansive, the required allocations of income and activities could be onerous. Further, the application of the general rules for stapled REITs (i.e., combining the REIT and the stapled C corporation for purposes of the REIT qualification tests) only to specific properties of

[189] "Hiltons They Aren't; 2 Guys In a Hurry," *The New York Times,* September 7, 1997, sec. 3, p. 1.

[190] "Pavlovian Capitalists; Stapled REITs," *The Wall Street Journal,* April 17, 1997, p. C1.

grandfathered REITs could be viewed as overly complicated or unfair. The proposal's approach appears to require a tracing of income to the business conducted by the C corporation with *each* new property acquired by the REIT. For example, such tracing would be required to apply the 95-percent gross income test to the combined entities. On the other hand, any complexity arising the proposal is limited to a small number of taxpayers who derive a benefit not available to other taxpayers.

Finally, it is unclear whether the proposal would apply to properties acquired by the REIT prior to the effective date but leased to the C corporation thereafter.

2. Restrict impermissible businesses indirectly conducted by 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.

To satisfy the REIT asset requirements, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and government securities (sec. 856(c)(5)(A)). Moreover, not more than 25 percent of the value of the REIT's assets can be invested in securities (other than government securities and other securities described in the preceding sentence). The securities of any one issuer may not comprise more than five percent of the value of a REIT's assets.

Finally, the REIT may not own more than 10 percent of the outstanding securities of any one issuer, determined by voting power (sec. 856(c)(4)(B)).

A REIT is permitted to have a wholly-owned subsidiary subject to certain restrictions. A REIT's subsidiary is treated as one with the REIT (sec. 856(i)).

Description of Proposal

The proposal would prohibit a REIT from holding more than 10 percent of the outstanding stock of any one issuer, determined by either vote or value.

Effective Date

The proposal would be effective with respect to stock acquired on or after the date of first committee action. Stock acquired before such date would become subject to the proposal when the corporation in which stock is owned engages in a trade or business in which it does not engage on the date of first committee action or if the corporation acquires substantial new assets on or after such date.

Prior Action

No prior action.

Analysis

The 10-percent limitation on a REIT's ownership of the stock of any one issuer arguably is consistent with several other requirements for REIT status that prevent the REIT from engaging in an active business, as opposed to passive real estate investments. If a REIT owns a majority or even a substantial minority position in a corporation that engages in an active business, the REIT could in effect conduct an active business indirectly through such corporation, although the REIT would be prohibited from conducting such a business directly.

The present-law rule that a REIT may not own more than 10 percent of the voting securities of any one issuer could be viewed as insufficient to prevent a REIT from having a substantial interest in an active trade or business. Because only voting securities are counted, a REIT can own a large interest in the value and income of a corporation, provided the REIT has a 10–percent-or-less voting interest. Apparently, some REITs may have acquired large interests in the income and value of corporations conducting real estate development or management businesses, which the REIT could not conduct itself, by using preferred stock structures that do not violate the more-than–10–percent voting securities test. In some instances, the employees and officers of the corporation owned also may be employees and officers of the REIT. By comparison, other tax rules that depend on ownership of a threshold level of stock have adopted a test based on percentage of vote or value similar to that of the proposal (e.g., secs. 355(d)(4) and sec.957(a)).

Opponents of the proposal would argue that it adds complexity and in some cases would cause unfair results. Because the proposal would prevent a REIT from having a greater-than-10-percent stock interest by vote or value, it would be possible that a REIT investing primarily in preferred stock of a corporation would not violate this test at the time the stock was acquired, but subsequently would violate it due to a decline in the corporation's value. Additional complexity would arise from the requirement of monitoring the value of shares.

3. Modify treatment of closely held REITs

Present Law

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

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

Under the organizational structure test, except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons. Generally, no more than 50 percent of the value of the REIT's stock can be owned by five or fewer individuals during the last half of the taxable year. Certain attribution rules apply in making this determination.

Description of Proposal

The proposal would impose as an additional requirement for REIT qualification that no person can own stock of a REIT possessing more than 50 percent of the combined voting power of all classes of voting stock or more than 50 percent 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)).

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.

Prior Action

No prior action.

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 insure 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 has been the so-called "step-down preferred" transaction. In such a transaction, the REIT issues a class of preferred stock that pays disproportionately high dividends in the REIT's early years and "steps down" to disproportionately low dividends in later years. Such stock may be sold to a tax-exempt entity. One or more corporate shareholders hold the REIT's common stock and are 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 fund the high dividends paid to the preferred shareholders by making deductible rent payments to the REIT for real property it leases to the corporate shareholders. [191]

By preventing a shareholder from owning a greater-than–50–percent interest in the REIT, the proposal would 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. 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 provision would argue that it adds complexity and in some cases would 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 complex-

[191] Cf. 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.

ity 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 50 percent or more of a REIT's shares by value.

I. Earned Income Credit Compliance Provisions

1. Simplification of foster child definition under the earned income credit

Present law

For purposes of the earned income credit ("EIC'), qualifying children may include foster children who reside with the taxpayer for a full year, if the taxpayer "cares for the foster children as the taxpayer's own children." (Code sec. 32(c)(3)(B)(iii)(I)). All EIC qualifying children (including foster children) must either be under the age of 19 (24 if a full-time student) or permanently and totally disabled. There is no requirement that the foster child either be (1) placed in the household by a foster care agency or (2) a relative of the taxpayer.

Description of Proposal

For purposes of the EIC, a foster child would be defined as a child who (1) is cared for by the taxpayer as if he or she were the taxpayer's own child, and (2) either is the taxpayer's niece, nephew, or sibling 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.

Effective Date

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

Prior Action

A substantially similar proposal was included in a list of eight proposals to reduce errors on tax returns with respect to the EIC released by the Department of the Treasury on April 23, 1997. [192]

Analysis

Some advocates of this proposal contend that the element of present law which requires that a foster child be cared for by the taxpayer as the taxpayer's own child is open to intentional noncompliance by some taxpayers. They continue that the vagueness of this element of present law also creates a compliance burden on the IRS as well as the taxpayer. They believe that this proposal would: (1) reduce potential abuse by tax cheats; (2) prevent unintentional errors by confused taxpayers; and (3) provide better guidance to the IRS when investigating questionable EIC claims.

[192] A further discussion of these proposals can be found in the Joint Committee on Taxation document, *Description of the Administration's Proposals Relating to the Earned Income Credit* (JCX–14–97), May 7, 1997.

Opponents respond that there are legitimate family living arrangements (e.g., care for a godchild) where a taxpayer deserves the EIC because the taxpayer is caring for the foster child even though that child meets neither the proposed familial relationship with the taxpayer, nor was formally placed with the taxpayer by an agency of the State or a tax-exempt child placement agency licensed by the State. Further, they contend that this proposal does not reduce any ambiguity found in present law. Since the EIC requirement that the foster child be cared for by the taxpayer as the taxpayer's own child is retained for all foster children, both the IRS and taxpayers with foster children will still be required to interpret its meaning.

2. Clarify the operation of the earned income credit where more than one taxpayer satisfies the requirements with respect to the same child

Present law

In general

In order to claim the earned income credit ("EIC'), an individual must be an eligible individual. To be an eligible individual, an individual must either have a qualifying child or meet other requirements. In order to claim the EIC without a qualifying child, an individual must not be a dependent and must be over age 24 and under age 65.

Qualifying child

A qualifying child must meet a relationship test, an age test, an identification test, and a residence test. Under the relationship and age tests, an individual is eligible for the EIC with respect to another person only if that other person: (1) is a son, daughter, or adopted child (or a descendent of a son, daughter, or adopted child); a stepson or stepdaughter; or a foster child of the taxpayer (a foster child is defined as a person whom the individual cares for as the individual's child; it is not necessary to have a placement through a foster care agency [193]); and (2) is under the age of 19 at the close of the taxable year (or is under the age of 24 at the end of the taxable year and was a full-time student during the taxable year), or is permanently and totally disabled. Also, if the qualifying child is married at the close of the year, the individual may claim the EIC for that child only if the individual may also claim that child as a dependent.

To satisfy the identification test, an individual must include on their tax return the name, age, and taxpayer identification number ("TIN") of each qualifying child.

The residence test requires that a qualifying child must have the same principal place of abode as the taxpayer for more than one-half of the taxable year (for the entire taxable year in the case of a foster child), and that this principal place of abode must be located in the United States. For purposes of determining whether a qualifying child meets the residence test, the principal place of

[193] See discussion in Part II.I.1., above, of this pamphlet relating to the President's proposal to simplify the foster child definition under the earned income credit.

abode shall be treated as in the United States for any period during which a member of the Armed Forces is stationed outside the United States while serving on extended active duty.

Tie-breaker rule

If more than one taxpayer would be treated as an eligible individual with respect to the same qualifying child for a taxable year only the individual with the highest modified adjusted gross income ("modified AGI") is treated as an eligible individual with respect to that child. For these purposes, modified AGI means AGI with certain losses disregarded and the addition of two items of nontaxable income. The losses disregarded are: (1) net capital losses (if greater than zero); (2) net losses from trusts and estates; (3) net losses from nonbusiness rents and royalties; and (4) 75 percent of the net losses from businesses, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses. The two items of nontaxable income added to AGI to determine modified AGI are: (1) tax-exempt interest; and (2) non-taxable distributions from pensions, annuities, and individual retirement accounts (but only if not rolled over into similar vehicles during the applicable rollover period).

Historically, the Internal Revenue Service ("IRS") has interpreted this tie-breaker rule to deny the EIC to other taxpayers meeting the definition of eligible individual regardless of whether the taxpayer with the highest modified AGI had claimed the EIC with respect to the child on the taxpayer's tax return. The Tax Court in *Lestrange* v. *Commissioner,* T.C.M. 1997–428 (1997) held that the tie-breaker rule does not apply to deny the EIC to a taxpayer unless another taxpayer actually claimed the EIC with respect to the child on the taxpayer's return. The Tax Court decision hinged on the determination that the child was not a qualifying child with respect to the taxpayer with the highest modified AGI because the identification test was not met by that taxpayer with respect to the child. Under this view, because the taxpayer with the highest modified AGI did not satisfy the qualifying child requirement, there was not more than one eligible individual and the tie-breaker rule did not apply.

Description of Proposal

The proposal clarifies that the identification requirement is a requirement for claiming the EIC, rather than an element of the definition of "qualifying child". Thus, the tie-breaker rule would apply where more than one individual otherwise could claim the same child as a qualifying child on their respective tax returns, regardless of whether the child is listed on any tax return. A similar change would be made to the definition of "eligible individual". No inference is intended as to the operation of the tie-breaker rule under present law.

Effective Date

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

Analysis

Proponents of the clarification believe that it is necessary to provide the EIC efficiently and appropriately. They argue that the present-law rules including the residency test are simpler and more verifiable that the old support test.[194] They continue that the tie-breaker is necessary in all cases where more than one taxpayer could claim the same qualifying child, to ensure that only needy taxpayers receive the EIC. For example, a taxpayer with a qualifying child should not qualify for the EIC if that taxpayer is sharing a household with the taxpayer's own higher-income parent. To allow these taxpayers to essentially elect out of the tie-breaker rule by failing to claim the child on the return of the higher-income parent would undermine Congressional intent with regards to the EIC.

J. Other Revenue-Increase Provisions

1. 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 freely prospect 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

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[194] The Omnibus Budget Reconciliation Act of 1990 replaced the old EIC requirement that the taxpayer be eligible to claim a dependency exemption with the present-law rules. Generally, the dependency exemption requirement was not satisfied unless the taxpayer could establish that the taxpayer had provided over one-half of the cost of maintaining the household which included the child for the year.

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 extracted from any land where title to the land or the right to extract minerals from such land was originally obtained pursuant to the provisions of the Mining Law of 1872.

Effective Date

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

Prior Action

The proposal was included in the President's fiscal year 1997 and 1998 budget proposals.

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, the Administration 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.[195]

2. Modify depreciation method for tax-exempt use property

Present Law

Taxpayers are allowed to recover the cost of property used in a trade or business through annual depreciation deductions. The depreciation deductions for most tangible property are determined

[195] The Administration has indicated that it may consider a transition rule that would address this issue.

under the modified Accelerated Cost Recovery System ("MACRS") of section 168.[196]

Under MACRS, depreciation for tangible personal property is determined using accelerated methods over specified recovery periods that are generally shorter than the class lives of the property. Depreciation for real property is determined using the straight-line method over 27.5 years (for residential real property) or 39 years (for nonresidential real property). The class life of real property generally is 40 years, whether or not the property is residential.

Accelerated depreciation under MACRS generally is unavailable for property that is (1) used predominantly outside the United States, (2) financed with tax-exempt bonds, or (3) leased to a tax-exempt entity ("tax-exempt use property"). For this purpose, a tax-exempt entity means (1) the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing, (2) any organization exempt from tax (other than farmer's cooperatives), and (3) any foreign person or entity. Tax-exempt use property generally is depreciated using the straight-line method over a period equal to the greater of (1) the property's class life, or (2) 125 percent of the lease term.[197] Property used predominantly outside the United States or financed with tax-exempt bonds generally is depreciated using the straight-line method over the property's class life.

The class lives of property are periods that had been developed by the Treasury Department for purposes of computing depreciation allowances under prior law. Prior to the enactment of section 168 in 1981, depreciation deductions generally were determined based on the taxpayers' estimates of the useful lives of its depreciable property. Such a "facts and circumstances" system often led to disputes between taxpayers and the IRS as to the proper period over which depreciation should be computed. Class lives for different types of property were developed to give taxpayers safe harbors over which to depreciate such property.

Description of Proposal

Tax-exempt use property would be depreciated using the straight-line method over a period equal to 150 percent of the class life of the property. The proposal would not affect the depreciation of property other than tax-exempt use property.

Effective Date

The proposal would be effective for property placed in service after December 31, 1998. The proposal would also be effective for property that first becomes tax-exempt use property after December 31, 1998, or becomes subject to a new lease after that date.

Prior Action

No prior action.

[196] The Tax Reform Act of 1986 installed MACRS as the successor system to the Accelerated Cost Recovery System ("ACRS"). ACRS generally provided more generous depreciation allowances than MACRS for property placed in service after 1980 and before 1987.

[197] Special exemptions are provide for certain real property, qualified technological equipment, and property subject to a short-term lease.

Analysis

Theoretically, depreciation deductions for property would be most accurately determined by "economic depreciation." Under economic depreciation, property is valued and "marked-to market" on an annual basis and any decrease in value from one year to the next is allowed as a depreciation deduction. Economic depreciation generally is conceded to be difficult to administer due to the case-by-case, annual valuations of each property that would be required. Because of these administrative difficulties and in order to provide an incentive to invest in tangible property, depreciation deductions generally have been determined under ACRS and MACRS since 1981. Depreciation allowances under ACRS and MACRS are determined pursuant to statutorily mandated schedules that often are more generous than the depreciation allowances determined under economic depreciation.

The purpose of the special depreciation rules for tax-exempt use property is to prevent the benefits of accelerated depreciation from accruing to users of property who do not pay U.S. income taxes. However, to the extent the class life of a leased asset is shorter than the economic useful life of the asset, and because taxpayers have control over the term of a lease, current law may continue to provide depreciation that is too rapid compared to economic depreciation. In such cases, the class lives of all property, including tax-exempt use property should be extended.

There is no empirical evidence that suggests that the class lives of all property, or tax- exempt-use property, is too short. The Treasury Department's Office of Tax Analysis has, from time-to-time, issued reports on the useful lives of specific types of property.[198] Some of these studies have suggested that the present-law class lives are too short for some types of property, and too long for other types of property. Pursuant to a provision in the Omnibus Budget Reconciliation Act of 1988, the Treasury Department may not change the class lives of property. Such authority had been granted by the Tax Reform Act of 1986.

3. 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

[198] See, Department of the Treasury, *Report to Congress on the Depreciation of Clothing Held for Rental*, July 1989; Department of the Treasury, *Report to Congress on the Depreciation of Fruit and Nut Trees*, March 1990; Department of the Treasury, *Report to Congress on the Depreciation of Scientific Instruments*, March 1990; Department of the Treasury, *Report to Congress on the Depreciation of Horses*, March 1990; Department of the Treasury, *Report to Congress on the Depreciation of Business-Use Passenger Cars*, April 1991; and Department of the Treasury, *Report to Congress on the Depreciation of Business-Use Light Trucks*, September 1991.

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.

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 20 percent of the consideration for acquiring the payment 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 acquiror.

Prior Action

No prior action.

Analysis

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.

It could be argued that imposing a tax on the acquisition of the payment stream would only worsen the risk that the injured person would receive an excessively discounted value for the payment stream. It is possible that the acquiror may reduce the consideration even further by the amount of the excise tax. It can be argued that sellers may not accept such a deep discount in many cases, however. One possible response to the concern relating to excessively discounted payments might be to raise the excise tax to a level that is certain to stop the transfers (perhaps 100 percent), or to modify the present-law rules to impose a different penalty on transfer of the payment stream, such as a rule of current inclusion of the amount the structured settlement company originally received for agreeing to the qualified assignment.

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. On the other hand, 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.

4. Reinstate Oil Spill Liability Trust Fund excise tax

Present Law

A 5-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.

Description of Proposal

The proposal would reinstate the Oil Spill Liability Trust Fund tax during the period after the date of the proposal's enactment and before October 1, 2008. The proposal also would increase the $1 billion limit on the unobligated balance in this Oil Spill Liability Trust Fund to $5 billion.

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

The President's fiscal year 1998 budget proposal included a similar provision.

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.

III. OTHER MEASURES AFFECTING RECEIPTS

A. 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;

(2) An excise tax on certain hazardous chemicals, imposed at rates that varied from $0.22 to $4.87 per ton;

(3) An excise tax on imported substances made with the chemicals subject to the tax in (2), above; and

(4) An income tax on corporations calculated using the alternative minimum tax rules.

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, 2008. The corporate environmental income tax would be reinstated for taxable years beginning after December 31, 1997, and before January 1, 2009.

Revenues from reinstatement of these taxes would be deposited in the Superfund Trust Fund.

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

The President's fiscal year 1998 budget proposal included a similar provision.

Analysis

The Superfund Trust Fund 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.

B. Extend Excise Taxes on Gasoline, Diesel Fuel, and Special Motor Fuels

Present Law

Overview

The current highway transportation excise taxes consist of:

(1) taxes on gasoline, diesel fuel, kerosene, and special motor fuels;

(2) a retail sales tax imposed on trucks and trailers having gross vehicle weights in excess of prescribed thresholds;

(3) a tax on manufacturers of tires designed for use on heavy highway vehicles; and

(4) an annual use tax imposed on trucks and tractors having taxable gross weights in excess of prescribed thresholds.

Special motor fuels include liquefied natural gas ("LNG'), benzol, naphtha, liquefied petroleum gas (e.g., propane), natural gasoline, and any other liquid (e.g., ethanol and methanol) other than gasoline or diesel fuel. Compressed natural gas ("CNG") also is subject to tax as a special motor fuel.

With the exception of 4.3 cents per gallon of the motor fuels excise tax rates, these taxes are scheduled to expire after September 30, 1999.

Highway motor fuels taxes

The current highway motor fuels excise tax rates are shown in Table 4.

Table 4.—Federal Highway Trust Fund Motor Fuels Excise Tax Rates, as of October 1, 1997[1]

[Rates shown in cents per gallon]

Highway fuel	Tax rate[2]
Gasoline[3]	18.3
Diesel fuel[4]	24.3
Special motor fuels generally	[5] 18.3
CNG	[6] 4.3

[1] The rates shown include the 4.3-cents-per-gallon tax rate which is transferred to the Highway Fund effective on October 1, 1997.

[2] Effective on October 1, 1997, an additional 0.1–cent-per-gallon rate was imposed on these motor fuels to finance the Leaking Underground Storage Tank Trust Fund.

[3] Gasoline used in motorboats and in certain off-highway recreational vehicles and small engines is subject to tax in the same manner and at the same rates as gasoline used in highway vehicles. 6.8 cents per gallon of the revenues from the tax on gasoline used in these uses is retained in the General Fund; the remaining 11.5 cents per gallon is deposited in the Aquatic Resources Trust Fund (motorboat and small engine gasoline), the Land and Water Conservation Fund ($1 million of motorboat gasoline tax revenues), and the National Recreational Trails Trust Fund (the "Trails Trust Fund") (off-highway recreational vehicles). Transfers to these Trust Funds are scheduled to terminate after September 30, 1998. Transfers to the Trails Trust Fund are contingent on appropriations occurring from that Trust Fund; to date, no appropriations have been enacted. Of the 6.8–cents-per-gallon tax, 2.5 cents per gallon is scheduled to expire after September 30, 1999. The remaining 4.3-cents-per-gallon rate is permanent.

[4] Kerosene is taxed at the same rate as diesel fuel.

[5] The rate is 13.6 cents per gallon for propane, 11.9 cents per gallon for liquefied natural gas, and 11.3 cents per gallon for methanol fuel from natural gas, in each case based on the relative energy equivalence of the fuel to gasoline.

[6] The statutory rate is 48.54 cents per thousand cubic feet ("MCF").

Present law includes numerous exemptions (including partial exemptions for specified uses of taxable fuels or for specified fuels) typically for governments or for uses not involving use of the highway system. Because the gasoline and diesel fuel taxes generally are imposed before the end use of the fuel is known, many of these exemptions are realized through refunds to end users of tax paid by a party that processed the fuel earlier in the distribution chain. These exempt uses and fuels include:

(1) Use in State and local government and nonprofit educational organization vehicles;

(2) Use in buses engaged in transporting students and employees of schools;

(3) Use in private local mass transit buses having a seating capacity of at least 20 adults (not including the driver) when the buses operate under contract with (or are subsidized by) a State or local governmental unit;

(4) Use in private intercity buses serving the general public along scheduled routes (totally exempt from the gasoline tax and exempt from 17 cents per gallon of the diesel tax); and

(5) Use in off-highway uses such as farming.

LNG, propane, CNG, and methanol derived from natural gas are subject to reduced tax rates based on the energy equivalence of these fuels to gasoline.

Ethanol and methanol derived from renewable sources (e.g., biomass) are eligible for income tax benefits (the "alcohol fuels credit") equal to 54 cents per gallon (ethanol) and 60 cents per gallon (methanol).[199] In addition, small ethanol producers are eligible for a separate 10-cents-per-gallon credit.[200] The 54-cents-per-gallon ethanol and 60-cents-per-gallon renewable source methanol tax credits may be claimed through reduced excise taxes paid on gasoline and special motor fuels as well as through credits against income tax.[201]

Non-fuel Highway Fund excise taxes

In addition to the highway motor fuels excise tax revenues, the Highway Fund receives revenues produced by three excise taxes imposed exclusively on heavy highway vehicles or tires. These taxes are:

(1) A 12–percent excise tax imposed on the first retail sale of highway vehicles, tractors, and trailers (generally, trucks having a gross vehicle weight in excess of 33,000 pounds and trailers having such a weight in excess of 26,000 pounds);

(2) An excise tax imposed at graduated rates on highway tires weighing more than 40 pounds; and

(3) An annual use tax imposed on highway vehicles having a taxable gross weight of 55,000 pounds or more. (The maximum rate for this tax is $550 per year, imposed on vehicles having a taxable gross weight over 75,000 pounds.)

Description of Proposal

The proposal would extend the excise taxes on nonaviation gasoline, diesel fuel (including kerosene), and special motor fuels that currently are scheduled to expire after September 30, 1999. (The currently scheduled, March 31, 2005, expiration date for the Leaking Underground Storage Tank Trust Fund rate would be retained.)

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

In a separate 1997 proposal, the Administration proposed extending all of the highway excise taxes through September 30, 2005, a part of legislation to extend Highway Trust Fund expenditure authorizations.

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[199] The alcohol fuels credit is scheduled to expire after December 31, 2000, or earlier, if the Highway Fund excise taxes actually expire before that date.

[200] The small ethanol producer credit is available on up to 15 million gallons of ethanol produced by persons whose annual production capacity does not exceed 30 million gallons.

[201] Authority to claim the ethanol and renewable source methanol tax benefits through excise tax reductions is scheduled to expire after September 30, 2000 (or earlier, if the underlying excise taxes actually expire before September 30, 2000).

Analysis

The current structure of highway transportation excise taxes relies heavily on a 1982 DOT cost allocation study.[202] Average cost allocation is offered as an equitable way to recover the costs incurred in provision of highway services. One result of 1982 excise tax changes is that users of the freight shipping services of heavy trucks bear a heavier tax than do users of passenger automobiles. The higher tax rates for trucks (fuel and non-fuel taxes) were imposed in an attempt to reflect the greater road damages from trucks and heavy trucks in particular. The structure of these taxes demonstrates compromises reached to accommodate administrability of the tax system to the desire to recover costs equitably. Administrative costs could have been minimized by relying solely on the fuels excise taxes, but the three additional excise taxes permit policymakers to distinguish between heavy cross-country vehicles that burn diesel fuel and smaller, lighter local delivery vehicles that also burn diesel fuel. Given this apparent goal, the annual use tax reflects further compromise with the goal of administrability. The annual use tax is the same dollar amount whether the truck drives 5,001 miles or 100,000 miles in the year. Collecting a tax based on actual miles driven (e.g., a "weight-distance" tax) would be more precise, but more difficult to administer.

Highway Trust Fund taxes are like "prices" that highway users must pay to use the roadways. To promote economic efficiency, prices should equal society's marginal, or incremental, cost of providing the service. The extent to which the current highway transportation excise taxes promote the efficient use of highway system depends upon the extent to which these taxes approximate the incremental cost of the Government's provision of the highway services.[203] In the presence of economies of scale, taxes that reflect average costs may move the tax (price) further away from marginal costs, thereby decreasing efficiency. Because these taxes are set at average rates to apply nationally, the taxes can never be fully efficient. It is more costly to build and maintain roads in some geographic locations than in others. For example, it is less expensive to build highways across flat rural areas than through mountains or in urban areas. Similarly, the tax and expenditure policy is unlikely to follow cost or tax burdens imposed exactly. The excise taxes generally apply to all motor fuel purchased, while the expenditures (benefits) are provided only to the users of certain highways. Any change in the taxes assessed on different highway users may be expected to change the pattern of use of the highways by the different users.

A majority of the revenues from the highway excise taxes is dedicated to the Highway Trust Fund. Part of the fuels tax revenues finance programs of the Aquatic Resources Trust Fund, the Land and Water Conservation Fund, and the National Recreational

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[202] Department of Transportation, Federal Highway Administration, *Final Report on the Federal Highway Cost Allocation Study, Report of the Secretary of Transportation to the United States Congress Pursuant to Public Law 95–599, Surface Transportation Assistance Act of 1978* (May 1982).

[203] For a more complete discussion of the issues of efficiency and equity related to highway taxes see, Joint Committee on Taxation, *Present Law and Background on Transportation Excise Taxes and Trust Fund Expenditure Programs* (JCS–10–96), November 14, 1996.

Trails Trust Fund. Extension of all of the fuels tax rates and non-fuels highway taxes is necessary as part of reauthorization of these programs.

The President's budget proposal addresses only extension of the fuels taxes. In general, under the Budget Enforcement Act, excise taxes dedicated to trust funds are assumed by the Congressional Budget Office to be permanent, despite any statutory expiration dates. A small portion (2.5 cents per gallon) of the expiring taxes on gasoline blended with ethanol and on gasoline used in motorboats is retained in the General Fund. It is understood that the budget proposal addresses only the fuels taxes because the Office of Management and Budget economic forecast does not assume these General Fund components of the fuels tax rates to be permanent. During any period when the fuels taxes are imposed, the Congressional Budget Office forecast assumes the entire tax rate (as opposed to just the 11.5-cents-per-gallon Trust Fund component) to be permanent. Thus, for purposes of Congressional budget scorekeeping, this proposal has no revenue effect.

C. Convert Airport and Airway Trust Fund Excise Taxes to Cost-Based User Fees to Pay for Federal Aviation Administration Services

Present Law

Airport and Airway Trust Fund excise taxes with scheduled expiration dates

Excise taxes are imposed on commercial and noncommercial[204] 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.[205] These tax rates currently are being phased-in, as follows:

October 1, 1997–September 30, 1998: 9 percent of the fare, plus $1 per domestic flight segment;

October 1, 1998–September 30, 1999: 8 percent of the fare, plus $2 per domestic flight segment; and

October 1, 1999–December 31, 1999: 7.5 percent of the fare, plus $2.25 per domestic flight segment.

After December 31, 1999, the *ad valorem* rate will remain at 7.5 percent. The domestic flight segment component of the tax will increase to $2.50 (January 1, 2000–December 31, 2000), to $2.75

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[204] 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).

[205] A flight segment is transportation involving a single take-off and a single landing.

(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 tax per arrival or departure.

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.

Commercial air cargo transportation

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 is subject to a permanent 4.3-cents-per-gallon excise tax rate. Receipts from this tax (since October 1, 1997), like the taxes with scheduled expiration dates, are deposited in the Airport Trust Fund.

Description of Proposal

The proposal states that legislation to phase out aviation excise taxes and to replace those taxes with cost-based user fees will be proposed at a later date. (The budget proposal, as transmitted, addresses only those taxes that currently are scheduled to expire after September 30, 2007.) Under the proposal, the aviation excise taxes would be phased out over the period fiscal year 1999 through fiscal year 2003 (with the first reduction on October 1, 1999, and full phase-out on October 1, 2002). Other details of the proposal have not been specified.

Prior Action

The proposal is similar to a proposal contained in the President's fiscal year 1998 budget, for which details were not submitted to the Congress. The structure and level of aviation taxes to support the Federal Aviation Administration (the "FAA") was 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.

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 user fees for excise taxes which were raised before the Congress during consideration of the 1997 Act may be noted.[206]

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 is 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 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.

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[206] For a more 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.

Tax vs. 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 business-like 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.[207] 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 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 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.[208]

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

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[207] 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. . . ."

[208] 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.

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.[209]

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.[210]

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. Finally, 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 Administration's proposal could eliminate 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.

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[209] 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 to undertake the investment, even though provision of the service would create marginal benefits that exceed marginal costs.

[210] 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.

D. Tobacco Legislation

Present Law and Background

There are no special rules limiting the liability of manufacturers and sellers of tobacco products. Although the tobacco industry has agreed to certain voluntary limitations on its ability to advertise products, the constitutionality of mandatory limitations has not been established.

A number of States have brought suit against the manufacturers of tobacco products. These suits generally allege that the tobacco companies were negligent in that they failed to exercise reasonable care in the design, manufacture and marketing of cigarettes and other tobacco products. These suits further allege that the tobacco companies sold dangerous and defective products, suppressed technologies that could have resulted in safer products, and engaged in false advertising, deceit and fraud. Some of these suits also allege violations of the Federal Racketeer Influenced and Corrupt Organizations Act (RICO), Federal anti-trust statutes, and other Federal and State laws.

The States' suits generally have sought compensation for the costs attributable to smoking that the litigant States have incurred through the Medicaid Program, the State's employee retirement program, the State's employee health insurance program, and through charity care. These suits generally also have sought injunctive relief that would prohibit certain types of marketing of tobacco products, particularly cigarettes and smokeless tobacco.

Settlements have been filed in three states: Florida; Mississippi; and Texas.[211] These settlements provide for the payment of substantial monetary damages to the States and require the tobacco companies to fund certain anti-smoking initiatives and change their marketing practices. The terms of these settlements may be modified if a proposed nationwide resolution[212] advanced by certain tobacco companies and certain States is enacted.

The proposed nationwide resolution provides for the payment by the tobacco companies to the various States and the Federal Government of a lump sum payment of $10 billion and base payments with a face value totaling $358.5 billion over 25 years. The actual amount that would be paid under the proposed nationwide resolution could be more or less, depending upon certain factors. In addition, the proposed nationwide resolution would place significant restrictions on the marketing and advertising of tobacco products, clarify the scope of FDA authority over tobacco, and establish nationwide standards for second-hand smoke.

The proposed nationwide resolution is contingent on the enactment of Federal legislation that would limit the potential civil liability of the tobacco companies to private individuals for the tobacco companies" past and future conduct. Such legislation would cap the amount the tobacco companies could be required to pay as damages in any year, prohibit class action suits, make certain evi-

[211] Settlements have been approved by the courts in Florida and Mississippi, approval is pending in Texas.

[212] The proposed resolution is memorialized in a document marked "for settlement discussion purposes only" and dated June 20, 1997.

dence inadmissible and (with regard to past conduct of the tobacco companies only) prohibit punitive damages.

Several bills have been introduced in the 105th Congress that follow the terms of the proposed nationwide resolution with certain changes. In addition, other legislation has been introduced in the 105th Congress that would increase the excise tax on tobacco products.

Description of Proposal

The President's budget for fiscal year 1999 does not include a specific proposal related to the treatment of tobacco products or the proposed settlement. However, the budget does include "receipts from tobacco legislation" of $9.795 billion in fiscal year 1999, $11.787 billion in 2000, $13.283 billion in 2001, $14.544 billion in 2002, and $16.085 billion in 2003, for a five-year total of $65.494 billion.

Prior Action

Excise taxes on tobacco products were last increased in the Balanced Budget Act of 1997.

E. Other Provisions Affect Receipts

Certain of the outlay proposals contained in the President's budget result in changes in receipts. These provisions are as follows:

1. Expand use of Federal highway monies to include use for certain "creative financing" projects and for State infrastructure bank programs

Interest on State and local government bonds is tax-exempt if the bonds are used to finance activities carried out and paid for by these governments. Governmentally owned and maintained highways, transit systems, and rail systems are eligible for this financing. Interest on bonds issued to finance activities of private businesses ("private activity bonds") is taxable unless a specific exception is included in the Code. The private business activities for which tax-exempt bond financing is available do not include privately owned and/or operated highways (e.g., private toll roads). Tax-exempt private activity bonds may be issued, subject to certain limits, to finance mass transit and high-speed intercity rail facilities (other than rolling stock).

The proposal would authorize the use of Federal highway monies to provide credit enhancement to certain highway projects, such as toll roads, transit, and high-speed intercity rail facilities. The credit enhancement could be provided through direct loans, letters of credit, or loan guarantees, each of which could be used to leverage issuance of larger amounts of tax-exempt bonds. The proposal further would authorize the use of Federal highway monies for funding of State infrastructure banks. These banks would serve as revolving pools of funds for financing of transportation projects (including leveraged financing and credit enhancement).

The direct effect of the proposal would be to increase issuance of long-term tax-exempt bonds by expanding the revenue sources available to repay (or secure repayment of) transportation debt.

2. Allow Federal housing funds to be used to leverage tax-exempt bond financed low-income housing credit projects

Present law provides an income tax credit for low-income rental housing. In general, the credit is paid over 10 years and is equal to 70 percent of the basis of newly constructed low-income housing units. The credit percentage is reduce to 30 percent in the case of existing housing and of housing that receives other Federal subsidies, including tax-exempt bond financing. In general, each State annually may allocate credits equal $1.25 per resident of the State. Credits for low-income housing projects financed with the proceeds of tax-exempt State or local government bonds are not subject to this volume limit.

Tax-exempt bonds may be issued to finance activities that are carried out by and paid for by States and local governments. Interest on bonds issued by these governments to finance activities of private businesses ("private activity bonds") is taxable unless a specific exception is included in the Code. One such exception allows issuance of tax-exempt private activity bonds to finance low-income rental housing, defined in generally the same manner as under the low-income housing credit provision. Issuance of most tax-exempt private activity bonds is subject to annual State volume limits of $50 per resident ($150 million, if greater).

The proposal would allow Federal housing monies to be used to establish State revolving funds to be used to provide additional security for repayment of tax-exempt debt.[213]

The proposal can be expected to result in increased issuance of tax-exempt bonds and in increased utilization of low-income housing income tax credits, which would be available without regard to the low-income housing credit volume limit.

3. Employer buy-in (COBRA continuation coverage) for certain retirees

Under the proposal, the termination of retiree health benefits for retirees age 55 to 64 and their dependents would become a COBRA qualifying event. Affected retirees would be eligible to enroll in the health plan of their former employer, and would be required to pay a premium no greater than 125 percent of the average premium for active employees of the former employer. The affected retirees would remain eligible for the COBRA continuation coverage until they reach age 65. This proposal would have no effect on Federal outlays, because the cost would be paid by the private sector. However, in many cases the cost of providing the COBRA coverage would exceed 125 percent of the premium for active employees. The additional costs would be borne by the former employers providing the coverage, resulting in a reduction in taxable income. Thus the proposal would result in an indirect reduction in Federal tax revenues.

[213] The President's budget proposal includes an unrelated proposal to increase the State low-income housing credit limit. (See, discussion in Part I.F.1., above.)

4. Consumer bill of rights and responsibilities

The proposal would require that private health plans implement a series of consumer protection initiatives, including enhanced information disclosure, an expansion of the grievance and appeal process, and enhanced access to specialty care. These consumer protection initiatives will result in a small increase in health care costs, and in particular, a small increase in average premiums for employer-sponsored health plans. This will result in an increase in employee compensation paid in nontaxable form, which will result in an indirect decline in Federal tax revenues.