[JOINT COMMITTEE PRINT]

DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2000 BUDGET PROPOSAL

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation ("Joint Committee staff"), provides a description and analysis of the revenue provisions contained in the President's Fiscal Year 2000 Budget proposal, as submitted to the Congress on February 1, 1999.[2] The pamphlet generally follows the order of the proposals as included in the Department of the Treasury's explanation.[3] 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 analysis of issues related to the proposal.

This pamphlet does not contain a description of certain proposed user fees (other than the proposed user fees associated with the financing of the Airport and Airway Trust Fund and the Harbor Maintenance Trust Fund) or other fees included in the President's Fiscal Year 2000 Budget.[4] Also, this pamphlet does not contain a description of the Social Security and Universal Savings Account Provisions of the President's Fiscal Year 2000 Budget.[5]

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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 2000 Budget Proposal* (JCS–1–99), February 22, 1999.

[2] See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2000: Analytical Perspectives* (H. Doc. 106–3, Vol. III), pp. 47–92.

[3] See Department of the Treasury, *General Explanations of the Administration's Revenue Proposals*, February 1999.

[4] See *Budget of the United States Government, Fiscal Year 2000: Analytical Perspectives*, pp. 93–104.

[5] See *Budget of the United States Government, Fiscal Year 2000* (H. Doc. 106–3, Vol. I), pp. 35–41 and 253–255.

I. PROVISIONS REDUCING REVENUES

A. Health Care Tax Provisions

1. Long-term care tax credit

Present Law

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

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

Description of Proposal

A taxpayer would be allowed to claim a $1,000 credit if he or she has long-term care needs. A taxpayer also would be allowed to claim the credit with respect to a spouse or each qualifying dependent who has long-term care needs. The credit (aggregated with the child credit and the proposed disabled worker credit) would be phased out for taxpayers with modified AGI above certain thresholds. Under the proposal, the sum of the otherwise allowable present-law child credit, the proposed disabled workers credit, and the proposed long-term care credit would be phased out at a rate of $50 for each $1,000 (or fraction thereof) of modified AGI above the threshold amount. Modified AGI and the threshold amounts would be the same as under the present-law phaseout of the child tax credit. Thus, modified AGI would be AGI plus the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively). The threshold amount would be $110,000 for married individuals filing a joint return, $75,000 for unmarried taxpayers, and $55,000 for married taxpayers filing separate returns. These threshold amounts would not be indexed for inflation. An individual may be able to claim both this credit and the proposed disabled workers tax credit.

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

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

An individual age 6 or older would be considered to have long-term care needs if he or she were certified by a licensed physician (prior to the filing of a return claiming the credit) as being unable for at least 6 months to perform at least 3 activities of daily living ("ADLs") without substantial assistance from another individual, due to a loss of functional capacity (including individuals born with a condition that is comparable to a loss of functional capacity).[6] As under the present-law rules relating to long-term care, ADLs would be eating, toileting, transferring, bathing, dressing, and continence. Substantial assistance would include both hands-on assistance (that is, the physical assistance of another person without which

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

the individual would be unable to perform the ADL) and stand-by assistance (that is, the presence of another person within arm's reach of the individual that is necessary to prevent, by physical intervention, injury to the individual when performing the ADL).

As an alternative to the 3-ADL test described above, an individual would be considered to have long-term care needs if he or she were certified by a licensed physician as (a) requiring substantial supervision for at least 6 months to be protected from threats to health and safety due to severe cognitive impairment and (b) being unable for at least 6 months to perform at least one or more ADLs or to engage in age appropriate activities as determined under regulations prescribed by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services.

A child between the ages of 2 and 6 would be considered to have long-term care needs if he or she were certified by a licensed physician as requiring substantial assistance for at least 6 months with at least 2 of the following activities: eating, transferring, and mobility. A child under the age of 2 would be considered to have long-term care needs if he or she were certified by a licensed doctor as requiring for at least 6 months specific durable medical equipment (for example, a respirator) by reason of a severe health condition or requiring a skilled practitioner trained to address the child's condition when the parents are absent. The Department of the Treasury and the Department of Health and Human Services would be directed to report to Congress within 5 years of the date of enactment on the effectiveness of the definition of disability for children and recommend, if necessary, modifications to the definition.

The taxpayer would be required to provide a correct taxpayer identification number for the individual with long-term care needs, as well as a correct physician identification number (e.g., the Unique Physician Identification Number that is currently required for Medicare billing) for the certifying physician. Failure to provide correct taxpayer and physician identification numbers would be subject to the mathematical error rule. Under that rule, the IRS may summarily assess additonal tax due without sending the individual a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Further, the taxpayer could be required to provide other proof of the existence of long-term care needs in such form and manner, and at such times, as the Secretary requires.

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

Effective Date

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

Prior Action

No prior action.

Analysis

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

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

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

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

It could further be argued that phaseouts are inequitable because they increase marginal tax rates for taxpayers in the phaseout range.[7] On the other hand, it could be argued that a phaseout is needed if the proposal is to be targeted to individuals with limited ability to pay.

2. Disabled workers tax credit

Present Law

Tax credit for elderly and disabled individuals

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

Deduction for impairment-related work expenses

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

Description of Proposal

In general

The proposal would provide a tax credit to disabled individuals, not to exceed the lesser of $1,000 or the individual's earned income for the taxable year. The credit (aggregated with the child credit and the proposed long-term care credit) would be phased out for taxpayers with modified AGI above certain thresholds. Under the proposal, the sum of the otherwise allowable present-law child tax credit, the proposed disabled workers credit, and the proposed long-

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

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

Disability rules

An individual would qualify as a disabled individual if the individual is certified by a licensed physician as being unable for a period of at least one year to perform at least one activity of daily living ("ADL") without substantial assistance from another person, due to a loss of functional capacity. As under the present-law rules relating to long-term care, ADLs would be eating, toileting, transferring, bathing, dressing, and continence. Substantial assistance would include both hands-on assistance (that is, the physical assistance of another person without which the individual would be unable to perform the ADL) and stand-by assistance (that is, the presence of another person within arm's reach of the individual that is necessary to prevent, by physical intervention, injury to the individual when performing the ADL). The initial certification by a licensed physician would be required prior to the filing of the tax return in which the individual initially claims the disabled workers credit. A portion of the period certified by the physician would have to occur within the taxable year for which the credit is claimed. After the initial certification, the individual would have to be recertified by a licensed physician every three years or such other period as the Secretary prescribes.

The individual would be required to provide a correct physician identification number (e.g., the Unique Physician Identification Number that is currently required for Medicare billing) for the physician making the certification. Failure to provide a correct physician identification number would be subject to the mathematical error rule (sec. 6213). Under that rule, the IRS may summarily assess additional tax due without sending the individual a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. The taxpayer could be required to provide other proof of the existence of disability in such form and manner, and at such times, as the Secretary requires.

Tax liability limitation; refundable credits

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

Effective Date

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

Prior Action

No prior action.

Analysis

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

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

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

The proposal also may be criticized for increasing the effective marginal tax rates with their inherent efficiency, equity, and complexity questions for taxpayers in the phase-out ranges.[8] Proponents may respond, however, that phase-outs are necessary to appropriately target the benefits of the proposal to lower- and middle-income taxpayers. Others may argue that the proposal is inequitable, because it gives a $1,000 tax credit to a disabled worker with a modified AGI of $100,000 who files a joint return, but no tax credit to an unmarried worker with an equivalent modified AGI.

Another issue presented by the proposal is its efficiency. For example, a direct expenditure program could be designed to subsidize all disabled workers, even if the disabled workers had no tax liability. Such an approach would provide a benefit to a broader category of disabled workers than the tax credit structure of the proposal, because some workers are not eligible for the refundable credit under the proposal. It could also be argued that the refundable aspect of the credit adds complexity to the tax law. One response to this criticism is that the present-law child tax credit has similar rules, which may already be familiar to taxpayers and tax practitioners. Finally, some might question whether the IRS is the government agency best suited to the responsibility for verifying the disability of each worker and the identification numbers of each physician making disability certifications.

3. Provide tax relief for small business health plans

Present Law

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

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

A multiple employer welfare arrangement ("MEWA") is an employee benefit plan or other arrangement that provides medical or certain other benefits to employees of two or more employers. MEWAs are generally subject to applicable State insurance laws, including provisions of State insurance law that generally comply with requirements imposed on insurance issuers under the Health

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

Insurance Portability and Accountability Act of 1996 ("HIPAA") and other Federal laws. MEWAs (whether or not funded through insurance) are also regulated under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") with respect to reporting, disclosure, fiduciary, and claims procedures.

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

Description of Proposal

In general

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

Foundation grants to qualified health benefit purchasing coalitions

Under the proposal, any grant or loan made by a private foundation to a qualified coalition to support the coalition's initial operating expenses would be treated as a grant or loan made for charitable purposes. As with any other grant or loan to a noncharitable organization for exclusively charitable purposes, private foundations would be required to comply with the "expenditure responsibility" recordkeeping and reporting requirements under present law.

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

Small business health plan tax credit

The proposal also would create a temporary tax credit for small businesses that purchase employee health insurance through qualified coalitions. The credit would be available to employers with at least 2, but not more than 50, employees, counting only employees with annual compensation (including 401(k) and SIMPLE employer contributions) of at least $10,000 in the prior calendar year. Eligible employers could not have had an employee health plan during any part of 1997 or 1998. The credit would be available only with respect to insurance purchased through a qualified coalition. The credit would equal 10 percent of employer contributions to employee health plans. The maximum credit amount per policy would be $200 per year for individual coverage and $500 per year for family coverage (to be ratably reduced if coverage is provided for less than 12 months during the employer's taxable year). The credit would be allowed to a qualifying small employer only with respect to contributions made during the first 24 months that the employer purchases health insurance through a qualified coalition. For employers that begin to purchase health insurance in 1999, this 24-month limit would not include months beginning before January 1, 2000. As a condition of qualifying for the credit, employers would need to cover at least 70 percent of those workers who have compensation (including 401(k) and SIMPLE employer contributions) of at least $10,000 and who are not covered elsewhere by an employer health plan.[9] A self-employed individual who is eligible to take a deduction for health insurance premiums would not be allowed to include any of the premiums eligible for the deduction in the calculation of the credit amount. The small business health plan credit would be treated as a component of the general business credit, and would be subject to the limitations of that credit. The amount of the credit would reduce the employer's deduction for employee health care expenses.

Requirements imposed on qualified health benefit purchasing coalitions

A qualified coalition would be required to operate on a non-profit basis and to be formed as a separate legal entity whose objective is to negotiate with health insurers for the purpose of providing health insurance benefits to the employees of its small business members. A qualified coalition would be authorized to collect and distribute health insurance premiums and provide related administrative services. It would need to be certified annually by an appropriate State or Federal agency as being in compliance with the following requirements. Its board would be required to have both employer and employee representatives of its small business members, but could not include service providers, health insurers, insurance agents or brokers, and others who might have a conflict of interest with the coalition's objectives. The qualified coalition could not bear insurance or financial risk, or perform any activity relating to the

[9] This rule applies whether or not the plan is subsidized by the employer.

licensing of health plan issuers. Where feasible, the coalition would have to enter into agreements with three or more unaffiliated, licensed health plans, and would be required to offer at least one open enrollment period per calendar year. The qualified coalition would have to service a significant geographic area, but would not be required to cross State boundaries. It would be required to accept as members all eligible employers on a first-come, first-served basis, and would need to market its services to all eligible employers within its designated area. An eligible employer would be defined as any small employer, as defined under HIPAA (generally, businesses that employ an average of at least 2, but not more than 50, employees).

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

Effective Date

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

Analysis

The proposal is intended to encourage small employers to purchase health insurance for their employees. Health insurance coverage of employees of small businesses is significantly lower than that of larger employers. One possible reason for this lower coverage is that the costs of setting up and operating health plans in the current small business insurance market can be higher than those for larger employers. Consequently, small employers may pay more for similar employee health insurance benefits than do larger employers. In addition, insurance companies may need a minimum number of covered employees in order to be able to provide insurance to a group. This makes it difficult for small employers to offer multiple health plans to their employees. Most small businesses that offer health insurance benefits do not provide their workers with a choice of health plans.

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

Health benefit purchasing coalitions pool employer workforces, negotiate with insurers over health plan benefits and premiums, provide comparative information about available health plans to participating employees, and may administer premium payments made by employers and their participating employees. Such coalitions may provide an opportunity for small employers to purchase health insurance for their workers at reduced cost and to offer a greater choice of health plans than is currently available to employees of small businesses. However, some small businesses that want to take advantage of the credit may not be able to do so because qualified coalitions may not operate in all areas, or may operate differently in some areas than others.

It is unclear whether coalitions will operate as intended. Under present law, in some cases MEWAs have proved unsuccessful in reducing costs, and have in some cases failed to provide the promised coverage. In some cases this has been due to fraud, while in other cases simply to mismanagement. The requirements imposed on purchasing coalitions under the proposal may reduce the likelihood of such occurrences under the proposal.

Proponents of the proposal relating to private foundations argue that the formation of health benefit purchasing coalitions has been hindered by their limited access to capital. Some private foundations have indicated a willingness to fund coalition start-up expenses, however, private foundations are prohibited under the Internal Revenue Code from making grants for other than charitable purposes. Present law provides no assurance that the funding of start-up expenses of health benefit purchasing coalitions would qualify as a "charitable purpose." Consequently, private foundations are reluctant to make grants to fund coalition start-up expenses.

B. 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

As an alternative to traditional tax-exempt bonds, certain States and local governments are given the authority to issue "qualified zone academy bonds." 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 is allocated each year to the States according to their respective populations of individuals below the poverty line.[10] Each State, in turn, allocates the credit to qualified zone academies within such State. A State may carry over any unused allocation into subsequent years.

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate (set monthly by Treasury Department regulation at 110 percent of the applicable federal rate for the month in which the bond is issued) multiplied by the face amount of the bond (sec. 1397E). The credit rate applies to all such bonds issued in each month. A taxpayer holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability.

The Treasury Department sets the credit rate 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 is determined using as a discount rate of 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 one of the 31 designated empowerment zones or one of

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[10] 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.

the 95 designated enterprise communities,[11] 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.

Because 1998 was the first year of the qualified zone academy bond program, very little of the applicable bond cap has been issued. According to one report, less than $30 million of the 1998 cap had been issued by November, 1998.[12] Accordingly, most of the 1998 allocation was carried forward into 1999.

Description of Proposal

In general

The proposal would authorize the issuance of additional qualified zone academy bonds and of qualified school modernization bonds. It also would establish new requirements applicable to qualified zone academy bonds, qualified school modernization bonds, and so-called "Better America Bonds" (described in Part I.D.2., below). All of these bonds are generally referred to as "tax credit bonds." The new requirements would apply to tax credit bonds issued after January 1, 2000.

Rules generally applicable to tax credit bonds

The proposal sets forth certain rules that would apply to any "tax credit bond" (i.e., qualified zone academy bonds, qualified school modernization bonds, and so-called "Better America Bonds").

Similar to the tax benefits available to holders of present-law qualified zone academy bonds, the holders of tax credit 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 and could be claimed against regular income tax liability and alternative minimum tax liability. As with present-law qualified zone academy bonds, the "credit rate" for tax credit bonds would be set by the Secretary of the Treasury so that, on average, such bonds would be issued without interest, discount, or premium.[13] The maximum term of the tax credit bonds would be 15 years.

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[11] Pursuant to the Omnibus Budget Reconciliation Act of 1993, the Secretaries of the Department of Housing and Urban Development and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994 (sec. 1391). In addition, the Taxpayer Relief Act of 1997 provided for the designation of 22 additional empowerment zones (secs. 1391(b)(2) and 1391(g)). 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).

[12] *The Bond Buyer* (Nov. 16, 1998).

[13] To this end, the credit rate would be set equal to a measure of the yield on outstanding corporate bonds, as specified in Treasury regulations, for the business day prior to the date of issue. It is anticipated that the credit rate would be set with reference to a corporate AA bond rate which could be published daily by the Federal Reserve Board or otherwise determined under Treasury regulations. This measure for setting the credit rate for the tax credit bonds is different from the measure currently used to set the credit rate for qualified zone academy bonds.

Any taxpayer would be able to hold a tax credit bond and thereby claim the tax credit.[14] Treasury would provide regulations regarding the treatment of credits that flow through from a mutual fund to the holder of mutual fund shares. Unused credits could not be carried back, but could be carried forward for 5 years. The proposal would grant regulatory authority to the Treasury to require information returns to be provided with respect to holders (including corporations) that are entitled to credits.

Under the proposal, issuers of tax credit bonds must reasonably expect, on the date of issue, that 95 percent of the proceeds of the bonds (including any investment earnings on such proceeds) would be spent on qualifying purposes within three years. In addition, the issuer must incur a binding obligation with a third party to spend at least 10 percent of proceeds of the issue within 6 months of the date of issue.

During the 3-year period after the date of issue, unexpended proceeds must be invested only in bank accounts or U.S. Treasury securities with a maturity of three years or less. If the issuer established a sinking fund for the repayment of the principal, all sinking fund assets would be required to be held in State and Local Government Securities (SLGS) issued by the Treasury. Any proceeds of the bonds (including any investment earnings on those proceeds) not expended for qualifying purposes at the end of the 3-year period would be required to be used to redeem a pro rata portion of the bonds within 90 days.

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

Qualified zone academy bonds

The proposal would authorize the issuance of an additional $1 billion of qualified zone academy bonds in 2000 and $1.4 billion in 2001. 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 until the end of the third succeeding year.

The proposal would expand the list of permissible uses of proceeds of qualified zone academy bonds to include school construction. In addition, the proposal would clarify that property financed with the sale proceeds of qualified school zone academy bonds must be owned by a State or local government.

[14] Accordingly, the present-law restriction on eligible holders of qualified zone academy bonds would not apply to bonds issued after December 31, 1999.

Qualified school modernization bonds

Under the proposal, State and local governments would be able to issue "qualified school modernization bonds" to fund the construction, rehabilitation, or repair of public elementary and secondary schools.[15] Property financed with the sale proceeds of qualified school modernization bonds would be required to be owned by a State or local government.

A total of $11 billion of qualified school modernization bonds could be issued in each of 2000 and 2001, with this amount to be allocated among the States and certain school districts. One half of this annual $11 billion cap would be allocated among the 100 school districts with the largest number of children living in poverty and up to 25 additional school districts that the Secretary of Education determined to be in particular need of assistance.[16] The remaining half of the annual cap would be divided among the States and Puerto Rico.[17]

An additional $200 million of bonds in each of 2000 and 2001 would be allocated by the Secretary of the Interior for the construction, rehabilitation, and repair of the Bureau of Indian Affairs-funded elementary and secondary schools.

Allocated amounts unissued in the year of allocation could be issued up until the end of the third following year. A qualifying school district could transfer any unused portion of its allocation to the State in which it is located at any time prior to that date.

Under the proposal, a bond would be treated as a qualified school modernization bond only if the following three requirements were satisfied: (1) the Department of Education approved the modernization plan of the State or eligible school district, which plan must (a) demonstrate that a comprehensive survey had been undertaken of the construction and renovation needs in the jurisdiction, and (b) describe how the jurisdiction would assure that bond proceeds were used as proposed;[18] (2) the State or local governmental entity issuing the bond received an allocation for the bond from the appropriate entity; and (3) at least 95 percent of the bond proceeds were used to construct, rehabilitate, or repair elementary or secondary school facilities. In contrast to qualified zone academy bonds, the proposed qualified school modernization bonds would not be conditioned on contributions from private businesses.

Effective Date

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

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

[16] The cap would be allocated among the school districts and among States based on the amounts of Federal assistance received under the Basic Grant Formula for Title I of the Elementary and Secondary Education Act of 1965. This assistance is based primarily upon the number of low-income children residing in the district, with an adjustment for differences in per-pupil expenditures. States would not be restricted to using the Title I Basic Grant Formula to allocate the cap among school districts, but could use any appropriate mechanism.

[17] A small portion of the total cap would be set aside for each U.S. possession (other than Puerto Rico) based on its share of the total U.S. poverty population.

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

Prior Action

A similar proposal was included in the President's fiscal year 1999 budget proposal.

Analysis

The Administration'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 States and local governments. This would enable States and local governments to spend the savings on other government functions or to reduce taxes.[19] In this event, the stated objective of the proposals would not be achieved.

Though called a tax credit, the Federal subsidy for tax credit bonds is equivalent to the Federal Government directly paying the interest on a taxable bond issue on behalf of the State or local government that benefits from the bond proceeds.[20] To see this, consider any taxable bond that bears an interest rate of 10 percent. A thousand dollar bond would thus produce an interest payment of $100 annually. The owner of the bond that receives this payment would receive a net payment of $100 less the taxes owed on that interest. If the taxpayer were in the 28-percent Federal tax bracket, such taxpayer would receive $72 after Federal taxes. Regardless of whether the State government or the Federal Government pays the interest, the taxpayer receives the same net of tax return of $72. In the case of tax credit bonds, no formal interest is paid by the Federal Government. Rather, a tax credit of $100 is allowed to be taken by the holder of the bond. In general, a $100 tax credit would be worth $100 to a taxpayer, provided that the taxpayer had at least $100 in tax liability. However, for tax credit bonds, the $100 credit also has to be claimed as income. Claiming an additional $100 in income costs a taxpayer in the 28-percent tax bracket an additional $28 in income taxes, payable to the Federal Government. With the $100 tax credit that is ultimately claimed, the taxpayer nets $72 on the bond. The Federal Government loses $100 on the credit, but recoups $28 of that by the requirement that it be included in income, for a net cost of $72, which is exactly the net return to the taxpayer. If the Federal Government had simply agreed to pay the interest on behalf of the State or local government, both the Federal Government and the bondholder/taxpayer

[19] 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.

[20] 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.

would be in the same situation. 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 or local government also would be in the same situation in both cases.

The proposed tax credit regime to subsidize public school investment raises some questions of administrative efficiencies and tax complexity. Because potential purchasers of the zone academy bonds and school modernization bonds must educate themselves as to whether the bonds qualify for the credit, certain "information costs" are imposed on the buyer. Additionally, since the determination as to whether the bond is qualified for the credit ultimately rests with the Federal Government, further risk is imposed on the investor. These information costs and other risks serve to increase the credit rate and hence the costs to the Federal Government for a given level of support to the zone academies or school modernization efforts. For these reasons, and the fact that tax credit bonds will be less liquid than Treasury Securities, the bonds would bear a credit rate that is equal to a measure of the yield on outstanding corporate bonds.[21]

The direct payment of interest by the Federal Government on behalf of States or localities, which was discussed above as being economically the equivalent of the credit proposal, would involve less complexity in administering the income tax, as the interest could simply be reported as any other taxable interest. Additionally, the tax credit approach implies that non-taxable entities would not invest in the bonds to assist school investment. In the case of a direct payment of interest, by contrast, tax-exempt organizations would be able to enjoy such benefits.

2. Exclusion for employer-provided educational assistance

Present Law

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

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

In order for the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The educational assistance program must not discriminate in favor of highly compensated employees. In addition, not more than 5 percent of the amounts paid or incurred by the employer during the year for educational assist-

[21] 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.

ance under a qualified educational assistance plan can be provided for the class of individuals consisting of more than 5-percent owners of the employer (and their spouses and dependents).

Educational expenses that do not qualify for the section 127 exclusion may be excludable from income as a working condition fringe benefit.[22] In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.[23]

Description of Proposal

The proposal would extend the present-law exclusion for employer-provided educational assistance to undergraduate courses beginning before January 1, 2002. The proposal would also extend the exclusion to graduate education, effective for courses beginning after June 30, 1999, and before January 1, 2002.

Effective Date

The proposal to extend the exclusion for undergraduate courses would be effective for courses beginning before January 1, 2002. The exclusion with respect to graduate-level courses would be effective for courses beginning after June 30, 1999 and before June 1, 2002.

Prior Action

A similar proposal to extend the exclusion to graduate-level courses was included in the President's fiscal year 1997 and 1999 budget proposals and in the Senate version of the Taxpayer Relief Act of 1997. An extension of the exclusion to graduate-level courses also was included in the Senate version of H.R. 2646 (105th Cong.) (the Education Savings and School Excellence Act of 1998); H.R. 2646 was vetoed by the President on July 21, 1998.

The Senate version of the Taxpayer Relief Act of 1997 would have permanently extended the exclusion.

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

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

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

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 over consumption of education.[24]

Proponents of extending and expanding the benefits provided by section 127 observe that more education generally leads to higher future wages for the individuals who receive the education. Thus, proponents argue that higher future tax payments by these individuals will compensate for the tax expenditure today. While empirical evidence does indicate that more education leads to higher wages, whether the government is made whole on the tax expenditure depends upon to which alternative uses the forgone government funds may have been put. For example, proponents of increased government expenditures on research and development point to evidence that such expenditures earn rates of return far in excess of those on most private investments.[25] If such returns exceed the financial returns to education, reducing such expenditures to fund education benefits may reduce future tax revenues.

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

[24] 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.

[25] For a discussion of the returns to expenditures on research and development see Part I.G.4 of this pamphlet.

may find more courses of study directly related to his or her current job and not qualifying him or her for a new trade than would a clerk.

The section 127 exclusion for employer-provided educational assistance may counteract this effect by making the exclusion widely available regardless of the employee's current job status or job description. Proponents argue that the exclusion is primarily useful to nonhighly compensated employees to improve their competitive position in the work force. In practice, however, the scant evidence available seems to indicate that those individuals receiving employer-provided educational assistance are somewhat more likely to be higher-paid workers, particularly if the exclusion is extended to graduate level courses.[26] 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.[27]

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

[26] See, for example, The National Association of Independent Colleges and Universities, "Who Benefits from Section 127," December 1995; Coopers & Lybrand, "Section 127 Employee Educational Assistance: Who Benefits? At What Cost?," June 1989, 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.

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

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

Present Law

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

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

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

Educational expenses that do not qualify for the section 127 exclusion may be excludable from income as a working condition fringe benefit.[28] In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.[29]

Description of Proposal

Employers who provide certain literacy, English literacy, and basic education programs for their eligible employees would be allowed to claim a credit against the employer's Federal income taxes. The amount of the credit would equal 10 percent of the employer's eligible expenses incurred with respect to qualified education programs, with a maximum credit of $525 per eligible em-

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

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

ployee. The credit would be treated as a component of the general business credit, and would be subject to the limitations of that credit.

Qualified education would be limited to (1) basic skills instruction at or below the level of a high school degree, and (2) English literacy instruction. In general, the credit could not be claimed with respect to an employee who has received a high school degree or its equivalent. The employer could claim a credit with respect to employees with high school degrees but who lack sufficient mastery of basic educational skills to function effectively in the workplace only if an eligible provider both assesses the educational level of the employees and provides the instructional program for the employer. With respect to English literacy instruction, eligible employees would be employees with limited English proficiency. Eligible employees must be citizens or resident aliens aged 18 or older who are employed by the taxpayer in the United States for at least six months.

To be eligible for the credit, the provision of literacy or basic education by an employer must meet the nondiscrimination requirements for educational assistance programs under present-law section 127. Expenses eligible for the credit (up to $5,250) would be excludable from income and wages as a working condition fringe benefit if not otherwise excludable under section 127.[30]

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

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

Effective Date

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

Prior Action

No prior action.

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

Analysis

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

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

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

4. Tax credit for contributions to qualified zone academies

Present Law

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, certain States and local governments are given the authority to issue "qualified zone academy bonds." 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 is allocated each year to the States according to their respective populations of individuals below the poverty line.[31] Each State, in turn, allocates the credit to qualified zone academies within such State. A State may carry over any unused allocation into subsequent years.

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate (set monthly by Treasury Department regulation at 110 percent of the

[31] 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.

applicable federal rate for the month in which the bond is issued) multiplied by the face amount of the bond (sec. 1397E). The credit rate applies to all such bonds issued in each month. A taxpayer holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability.

The Treasury Department sets the credit rate 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 one of the 31 designated empowerment zones or one of the 95 designated enterprise communities,[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.

Rules applicable to corporate contributions

The maximum charitable contribution deduction that may be claimed by a corporation for any one taxable year is limited to 10 percent of the corporation's taxable income for that year (disregarding charitable contributions and with certain other modifications) (sec. 170(b)(2)). Corporations also are subject to certain limitations based on the type of property contributed. In the case of a charitable contribution of short-term gain property, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis (generally, cost) in the property.

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[32] Pursuant to the Omnibus Budget Reconciliation Act of 1993, the Secretaries of the Department of Housing and Urban Development and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994 (sec. 1391). In addition, the Taxpayer Relief Act of 1997 provided for the designation of 22 additional empowerment zones (secs. 1391(b)(2) and 1391(g)). 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).

However, special rules in the Code provide augmented deductions for certain corporate[33] contributions of inventory property for the care of the ill, the needy, or infants[34] (sec. 170(e)(3)), certain corporate contributions of scientific equipment constructed by the taxpayer, provided the original use of such donated equipment is by the donee for research or research training in the United States in physical or biological sciences (sec. 170(e)(4)),[35] and certain contributions of computer technology and equipment to eligible donees to be used for the benefit of elementary and secondary school children (sec. 170(e)(6)). Under these special rules, the amount of the augmented deduction available to a corporation making a qualified contribution generally is equal to its basis in the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold. However, the augmented deduction cannot exceed twice the basis of the donated property.

Description of Proposal

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

The credit would be available only if a credit allocation has been made with respect to the corporate sponsorship payment by the local governmental agency with responsibility for implementing the strategic plan of the empowerment zone or enterprise community under section 1391(f)(2), in consultation with the local educational agency with jurisdiction over public schools in the zone or community. The local governmental agency for each of the 31 designated empowerment zones would be allowed to designate up to $8 million of sponsorship payments to qualified zone academies as eligible for the 50-percent credit (that is, up to $4 million of credits). The local governmental agency for each of the 95 designated enterprise communities would be allowed to designate up to $2 million of contributions to qualified zone academies as eligible for the 50-percent credit (that is, up to $1 million of credits). There is no limit on the

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

[34] Treas. Reg. sec. 1.170A–4(b)(2)(ii)(F) defines an "infant" as a minor child (as determined under the laws of the jurisdiction in which the child resides). Treas. Reg. sec. 1.170A–4(b)(2)(ii)(G) provides that the "care of an infant" means performance of parental functions and provision for the physical, mental, and emotional needs of the infant.

[35] Eligible donees under section 170(e)(3) are public charities (but not governmental units) and private operating foundations. Eligible donees under section 170(e)(4) are limited to post-secondary educational institutions, scientific research organizations, and certain other organizations that support scientific research. Eligible donees under section 170(e)(6) are (1) any educational organization that normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on, and (2) Code section 501(c)(3) entities that are organized primarily for purposes of supporting elementary and secondary education. Under section 170(e)(6)(C), a private foundation also is an eligible donee, provided that, within 30 days after receipt of the contribution, the private foundation contributes the property to an eligible donee described above.

amount of allocated credits that could be claimed by any one corporate sponsor; thus one sponsor could claim all the credits available in a particular zone or community. The deduction otherwise allowed for a corporate sponsorship payment would be reduced by the amount of the credit claimed with respect to such payment by the corporate sponsor. The proposed credit would be subject to the general business credit rules under present-law section 38.

Effective Date

The proposal would be effective for corporate sponsorship payments made after December 31, 1999.

Prior Action

No prior action.

Analysis

The proposal's objective is to encourage private sector support of and participation in educational programs conducted at certain qualified zone academies located in empowerment zones and enterprise communities. By offering a tax credit to participating corporations, the proposal would lower the after-tax cost of a corporate contribution beyond that currently provided by the deduction for charitable contributions. Specifically, under present law, a corporate taxpayer in the 35-percent bracket faces an after-tax cost of only 65 cents for each dollar of charitable contributions, since the dollar deduction yields a tax saving of 35 cents. With the proposed 50-percent credit, this same taxpayer would have more than half of its contribution, in effect, subsidized by the federal government. In addition to the 50-cent credit per dollar of contribution, the taxpayer would still be permitted to deduct from taxable income 50 cents of that dollar (the contribution amount minus the credit). Such 50-cent deduction would be worth 17.5 cents to a corporate taxpayer in the 35-percent tax bracket. Thus, the total after-tax cost of a dollar contribution under the proposal is only 32.5 cents (1 dollar less the 50-cent credit less the 17.5-cent value of the 50-cent deduction), as compared to 65 cents under present-law rules. The effect of the credit cuts the taxpayer's cost of giving in half compared to present law.[36]

The purpose of the present-law charitable deduction, and the proposed credit, is to encourage charitable giving by making giving less expensive. Economic studies have generally found that, at least with respect to individual donors, the charitable contribution deduction[37] has both encouraged giving, and done so efficiently in that the additional charitable contributions that the deduction encourages exceed the revenue cost to the federal government of the deduction. Thus, to the extent that the charitable contribution serves a useful public service, it is argued that the deduction is cheaper than appropriating the funds that would be necessary to achieve the same public service. At the same time, it is also argued

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

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

that private organizations can in many instances perform a charitable function more efficiently than a government agency. Others argue that not all activities subsidized by the deduction serve a truly public purpose, and thus would prefer to see the deduction eliminated and replaced with greater direct public spending. However, since the proposed credit is restricted to certain purposes, the latter objection is not relevant provided a true public service is promoted by the credit.

The proposal does not clarify what types of goods or services (e.g., inventory, used property, services) would qualify for purposes of the credit for certain in-kind contributions. In particular, the possibility of donated services raises valuation and compliance concerns. For example, the proposal does not address whether it would be appropriate to value donated services performed by a high-level corporate executive by reference to the executive's salary.

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

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

Present Law

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

The maximum allowable deduction is $1,500 in 1999, $2,000 in 2000, and $2,500 in 2001 and thereafter. The deduction is phased out ratably for individual taxpayers with modified adjusted gross income (“AGI”) of $40,000–$55,000 and $60,000–$75,000 for joint returns. The income ranges will be indexed for inflation after 2002.

Description of Proposal

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

Effective Date

The proposal would generally be effective for interest paid on qualified education loans after December 31, 1999.

Prior Action

No prior action.

Analysis

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

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

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

Some have argued that the 60-month rule (or an alternative) is unnecessary, because there are already sufficient limits on the amount of the deduction. For example, it is argued that the AGI limits may effectively limit the number of years over which an individual can deduct student loan interest, if AGI increases over time. It if further argued that the additional limitation of the 60-month rule is not justified given its complexity.

In addition to simplifying the student loan interest deduction, the proposal would eliminate possible inconsistent treatment of taxpayers based on how a lender structures the interest payments on a qualified loan and when a taxpayer chooses to make payments. For example, a taxpayer who elects to capitalize interest that accrues on a loan while the taxpayer is enrolled in college (and the loan is in deferment) may be able to deduct more total interest payments than a taxpayer (with the same size qualified education loan) who elects to pay the interest currently during college. This is because the 60-month rule is suspended during the deferment, but would continue to elapse in the latter case while payments are being made.

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

Present Law

Tax treatment of student loan forgiveness

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

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

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

Federal Direct Loan Program; income-contingent repayment option

A major change in the delivery of Federal student loans occurred in 1993. The Student Loan Reform Act ("SLRA"), part of the Omnibus Budget Reconciliation Act of 1993, converted the Federal Family Education Loans ("FFEL"), which were made by private lenders and guaranteed by the Federal Government, into direct loans made by the Federal Government to students through their schools (the William D. Ford Direct Loan Program).[38] The Direct Loan Program began in academic year 1994–95 and was to be phased in, with at least 60 percent of all student loan volume to be direct loans by the 1998–1999 academic year.

Federal Direct Loans include Federal Direct Stafford/Ford Loans (subsidized and unsubsidized), Federal Direct PLUS loans, and Federal Direct Consolidation loans. The SLRA requires that the Secretary of Education offer four alternative repayment options for direct loan borrowers: standard, graduated, extended, and income-contingent. However, the income-contingent option is not available to Direct PLUS borrowers. If the borrower does not choose a repayment plan, the Secretary may choose one, but may not choose the income-contingent repayment option.[39] 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), AGI during the repayment period, and family size.[40] Generally, a borrower's monthly loan payment is capped at 20 percent of discretionary income (AGI minus the poverty level adjusted for family size).[41] If the loan is not repaid in full at the end of a 25-

[38] 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.

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

[40] 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.

[41] 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.

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

Description of Proposal

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

Effective Date

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

Prior Action

The proposal was included in the President's fiscal year 1998 and 1999 budget proposals, as well as in the House and Senate versions of the Taxpayer Relief Act of 1997. The proposal was not included in the conference agreement on the Taxpayer Relief Act of 1997.

Analysis

There are three types of expenditures incurred by students in connection with their education: (1) direct payment of tuition and other education-related expenses; (2) payment via implicit transfers received from governments or private persons; and (3) forgone wages. The present-law income tax generally treats direct payments of tuition as consumption, neither deductible nor amortizable. By not including the implicit transfers from governments or private persons in the income of the student, present law offers the equivalent of expensing of those expenditures undertaken on behalf of the student by governments and private persons. This expensing-like treatment also is provided for direct transfers to students in the form of qualified scholarships excludable from income. Similarly, because forgone wages are never earned, the implicit expenditure incurred by students forgoing present earnings also receives expensing-like treatment under the present-law income tax.[42]

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, excluding a scholarship from income or not including a forgiven loan in income is equivalent to permitting a deduction for tuition paid.

While present-law section 117 generally excludes scholarships from income, regardless of the recipient's income level, to the extent they are used for qualified tuition and related expenses, certain other education tax benefits are subject to expenditure and in-

[42] 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.

come 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).[43] In addition, the HOPE and Lifetime Learning credits are limited to taxpayers with modified adjusted gross incomes of $50,000 ($100,000 for joint filers) or less. No comparable expenditure or income limitations would apply to individuals who benefit from loan forgiveness under the proposal. For example, the expenditure limitation contained in section 117 would not apply; thus, the provision could permit students to exclude from income amounts in excess of the qualified tuition and related expenses that would have been excludable under section 117 had the loan constituted a scholarship when initially made. However, it could be argued that expenditure limits are not necessary because the Federal Direct Loan program includes restrictions on the annual amount that a student may borrow, and that income limitations are unnecessary because an individual who has not repaid an income contingent loan in full after 25 years generally would be a lower-income individual throughout most of that 25-year period.

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

As of May 1, 1996, 15 percent of the Direct Loan borrowers in repayment had selected the income-contingent option.[44] Among those who choose the income-contingent repayment option, the Department of Education has estimated that slightly less than 12 percent of borrowers will fail to repay their loans in full within 25 years and, consequently, will have the unpaid amount of their loans discharged at the end of the 25-year period.[45] Thus, the primary revenue effects associated with this provision would not commence until 2019—25 years after the program originated in 1994.

7. Tax treatment of education awards under certain Federal programs

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

Present Law

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a de-

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[43] 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.

[44] CRS, *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.

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

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

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

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

The National Health Service Corps Scholarship Program (the "NHSC Scholarship Program") and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the "Armed Forces Scholarship Program") provide education awards to participants on condition that the participants provide certain services. In the case of the NHSC Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health-care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility. These education awards generally involve the payment of higher education expenses (under the NHSC Program, the awards may be also used for the repayment or cancellation of existing or future student loans). Because the recipients are required to perform services in exchange for the education awards, the awards used to pay higher education expenses are taxable income to the recipient.

Description of Proposal

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

Effective Date

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

Prior Action

A similar provision was included in H.R. 2646 (105th Cong.) (the Education Savings and School Excellence Act of 1998), as passed by the Congress on June 15, 1998. The President vetoed H.R. 2646 on July 21, 1998.

b. Eliminate tax on repayment or cancellation of student loans under NHSC Scholarship Program, Americorps Education Award Program, and Armed Forces Health Professions Loan Repayment Program

Present Law

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

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

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

The NHSC Scholarship Program, the Americorps Education Award Program, and the Armed Forces Health Professions Loan Repayment Program provide education awards to participants that may be used for the repayment or cancellation of existing or future student loans. However, the repayment or cancellation of student loans under these programs appears not to meet the requirements for exclusion under current-law section 108(f), because the repayment or cancellation of student loans in some instances is not contingent on the participant's working for any of a broad class of employers.

Description of Proposal

The proposal would provide that any repayment or cancellation of a student loan under the NHSC Scholarship Program, the Americorps Education Award Program, or the Armed Forces Health Professions Loan Repayment Program is excludable from income. The tax-free treatment would apply only to the extent that the student incurred qualified tuition and related expenses in excess of those which were taken into account in determining the amount of any education credit claimed during academic periods when the student loans were incurred.[46]

Effective Date

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

Prior Action

No prior action.

Analysis for a. and b.

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

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

C. Child Care Provisions

1. Expand the dependent care credit

Present Law

In general

A taxpayer who maintains a household which includes one or more qualifying individuals may claim a nonrefundable credit

[46] For this purpose, qualified expenses were not taken into account to the extent that the otherwise allowable credit was reduced due to the taxpayer's AGI.

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. In the case of married taxpayers, the credit is not available unless they file a joint return.

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

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

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

Interaction with employer-provided dependent care assistance

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

Additional credit for taxpayers with dependents under the age of one

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

Description of Proposal

The proposal would make several changes to the dependent care tax credit. First, the credit percentage would be increased to 50 percent for taxpayers with 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 a married couple filing separately, while the credit would be extended to one qualifying spouse filing a separate return, the spouse claiming the dependent care tax credit would 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 beginning in 2001. Finally, the proposal would extend up to $250 of additional credit ($500 for two or more qualifying dependents) to taxpayers with a qualifying dependent under the age of one at the end of the taxable year. This additional credit, computed as the applicable credit rate times $500 ($1,000 for two or more qualifying dependents), would be available regardless of whether the taxpayer actually incurred any out-of-pocket child care expenses.

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, 1999. The starting point of the phase-down range and the maximum amounts of eligible employment-related expenses generally would be indexed for inflation for taxable years beginning after December 31, 2000. The maximum amount of the additional credit for taxpayers with infant dependents would be indexed for inflation for taxable years beginning after December 31, 2000.

Prior Action

A substantially similar proposal (not including the additional credit for taxpayers with qualifying dependents under the age of one) was included in the President's fiscal year 1999 budget proposal.

Analysis

Overview

The proposed expansion of the dependent care tax credit involves several issues. One issue is the government's role in encouraging parents 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.[47] 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.[48] Work in the home, though clearly valuable, is not taxed. One way to see the potential impact of this bias is to consider the case of a parent who could work outside the home and earn $10,000. Assume that in so doing the family would incur $10,000 in child care expenses. Thus, in this example, the value of the parent's work inside or outside the home is recognized by the market to have equal value.[49] 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.[50] This parent would be better off by staying at home and enjoying the full $10,000 value of home labor without taxation.[51]

Because labor in the home is not taxed, most economists view the income tax as being biased towards the provision of home labor, resulting in inefficient distribution of labor resources. For example, if the person in the above example could earn $12,000 in work outside the home and pay $10,000 in child care, work outside the home would be the efficient choice in the sense that the labor would be applied where its value is greatest. However, if the $12,000 in labor resulted in $2,000 or more in additional tax burden, this individual would be better off by working in the home. The government could eliminate or reduce this bias in several ways. First, it could consider taxing the value of "home production." Most would consider this unfair and not feasible for administrative reasons. The second alternative would be to eliminate or reduce the burden of taxation on "secondary" earners when they do enter the formal labor force. This approach was implemented through the two-earner deduction (from 1982–1986), which allowed a deduction for some portion of the earnings of the lesser-earning spouse.[52] Another approach, and part of present law, is to allow a tax credit for child care expenses, provided both parents (or if un-

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

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

[49] 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.

[50] 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.

[51] 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.

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

married, a single parent) work outside the home. This latter approach is targeted to single working parents and two-earner families with children, whereas the two-earner deduction applied to all two-earner couples regardless of child care expenses.

The proposal to expand the 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.

Opponents of the proposal contend that all families with children should be given any available tax breaks aimed at children, regardless of whether they qualify for the dependent care tax credit. In this regard, they may support the element of the proposal extending a tax benefit to all taxpayers with dependents under the age of one. This latter group may cite as support for their position that the size of the personal exemption for each dependent is much smaller than it would have been had it been indexed for inflation in recent decades. In their view, even with the addition of the child tax credit, the current 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.[53] Conversely, those for whom one parent stays at home generally benefit from a "marriage bonus."

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

The proposal to increase the dependent care credit can be thought of as a proposal to decrease the marriage penalty for families with children.[54]

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.

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.C.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. For those families the application of a phase-out is an increase in complexity. In contrast, families with income levels who would be subject to the present-law phase-down range but not the phase-out range under the proposal would enjoy a reduction in complexity.

Additionally, the 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 phaseout range. This proposal would reduce the credit rate by 1 percent

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

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.[55]

2. Tax credit for employer-provided child care facilities

Present Law

Generally, present law does not provide a tax credit to employers for supporting child care or child care resource and referral services.[56] 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.

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[55] 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.

[56] 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.

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, 1999.

Prior Action

The proposal was included in the President's fiscal year 1999 budget proposal.

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 on 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 in the hiring and retaining of workers for nonprofit organizations who cannot take advantage of these new tax benefits.

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

D. Tax Incentives to Revitalize Communities

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 percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent qualified expenditures.

Except in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit and certain carry-over amounts the aggregate credit authority provided annually to each State is $1.25 per resident. Credits that remain unallocated by States after prescribed periods are reallocated to other States through a "national pool."

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, 1999.

Prior Action

A substantially similar proposal was included in the President's fiscal year 1999 budget proposal.

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.[57] 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.[58] 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

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

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

available low-income housing units because the subsidy is less likely to displace otherwise planned activity.

The theory of subsidizing demand assumes that, by providing low-income families with more spending power, their increase in demand for housing will ultimately lead to more or better housing being available in the market. However, if the supply of housing to these families does not respond to the higher market prices that rent subsidies ultimately cause, the result will be that all existing housing costs more, the low-income tenants will have no better living conditions than before, and other tenants will face higher rents.[59] 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 equiva-

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

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

Targeting the benefits of tax subsidies

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

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

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

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

Data relating to the low-income housing credit

Comprehensive data from tax returns concerning the low-income housing tax credit currently are unavailable. However, Table 1, below, presents data from a survey of State credit allocating agencies.

Table 1.—Allocation of the Low-Income Housing Credit, 1987–1997

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

[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 (1998).

Table 1 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 1999 tax expenditure resulting from the low-income credit will total $3.4 billion.[60] This estimate would include revenue lost to the Federal Government from buildings placed in service in the 10 years prior to 1999. 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 vouch-

[60] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1999–2003* (JCS–7–98), December 14, 1998, p. 18.

er program.[61] 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 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 39.9 percent price inflation between 1986 and the third quarter of 1998. Had the per capita credit allocation been indexed for inflation, using this index to reflect increased construction costs, the value of the credit today would be approximately $1.75.[62] 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. Tax credits for holders of Better America Bonds

Present Law

Tax-exempt bonds

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to

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

[62] Most Code provisions are indexed to the Consumer Price Index ("CPI"). Over this same period, cumulative inflation as measured by the CPI was approximately 49.5 percent. Indexing the $1.25 to the CPI would have produced a value of approximately $1.87 today.

carry out governmental functions of those entities or the debt is repaid with governmental funds ("governmental bonds"). These bonds may include bonds used to finance the acquisition of land (or interests in land) and buildings. Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person ("private activity bonds") is taxable unless the purpose of the borrowing is approved specifically in the Code or in another provision of a revenue Act. These specified purposes include, but are not limited to, privately owned and/or operated: (1) sewage facilities; (2) solid waste disposal facilities; and (3) water systems. Issuance of most qualified private activity bonds is subject to annual state volume limits, currently the greater of $50 per resident, or $150 million if greater.

Tax credits for interest on bonds

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

Expensing of certain environmental remediation expenses

Taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred (sec. 198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. A qualified contaminated site generally is any property that: (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within certain targeted areas; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). In the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any qualified environmental remediation expenditure deductions are subject to recapture as ordinary income upon sale or other disposition of the property (sec. 1245). The provision applies only to eligible expenditures paid or incurred in taxable years ending after August 5, 1997, and before January 1, 2001.

Description of Proposal

In general

The proposal would provide a tax credit to holders of a new category of bonds, Better America Bonds ("BABs"),[63] issued by State or local governments for certain specified purposes. The taxpayer holding a BAB on the credit allowance date (i.e., the annual anniversary of the bond's issuance) would be entitled to the credit. The amount of the credit would determined by multiplying that BAB's credit rate (set by the Treasury Department when the BAB was issued) by the face amount of the holder's BAB. The credit would be includible in gross income (as if it were an interest payment on the bond), and could be claimed against regular income tax liability and alternative minimum tax liability.

Authority to issue BABs

The Administrator of the Environmental Protection Agency ("EPA") would be given authority to allocate $1.9 billion dollars of BAB authority to eligible issuers (i.e., States and local governments, including tribal governments, U.S. Possessions) annually for five years beginning in the year 2000. Any amounts unallocated for a year could be allocated in the following year. Any amounts allocated to an eligible issuer in any year could be used for bond issuance in that year or in any of the following three years.

The EPA would be directed to publish guidelines, before January 1, 2000, establishing the criteria to be used in an annual competition for authority to issue the BABs. Eligible issuers would apply for an allocation of authority to issue the BABs and the EPA, in consultation with other Federal agencies, would review these applications and allocate authority to issue BABs in conjunction with the Community Empowerment Board.

Qualifying purposes for BABs

The proposal would limit the purposes for which BABS could be issued by eligible issuers for: (1) acquisition of land for open space, wetland, public parks or green ways to be owned by the State or local government or 501(c)(3) entity whose exempt purpose includes environmental preservation; (2) construction of visitors' facilities to be owned by the State or local government or 501(c)(3) entity whose exempt purpose includes environmental preservation; (3) remediation of land, in order to improve water quality, acquired under (1) above, or of publicly owned open space, wetlands, or parks, by undertaking reasonable measures to control erosion and remediating conditions caused by prior disposal of toxic or other waste; (4) acquisition of easements on privately owned open land that prevent commercial development and any substantial change in the use or character of the land; or (5) environmental assess-

[63] The structure of BABs would be identical to the structure in the Administration's fiscal year 2000 budget proposal for qualified school modernization bonds and qualified zone academy bonds. (See discussion in Part I.B.1, above.)

ment and remediation of contaminated property owned by State or local governments because it was abandoned by the prior owner.

Other rules applicable to BABs

No depreciation for tax purposes would be allowed with respect to property financed with BABs. Also, no expenditures financed with BAB proceeds would be eligible for expensing under the environmental remediation rules of section 198.

Issuers of BABs would be required to allow eligible 501(c)(3) organizations to purchase the credit financed property at any time after the end of its qualified use (e.g., at the end of the 15-year period beginning on the date of issuance of the BAB) before selling to another party. An eligible 501(c)(3) organization would have the right, but not the obligation to purchase the property at that time before the sale to another party. An eligible 501(c)(3) organization must: (1) have exempt purposes which include environmental protection; (2) covenant to maintain the property in qualifying use in perpetuity; and (3) hold an option to purchase the property. The purchase price to the 501(c)(3) under the option would be the price paid in conjunction with the expenditure of bond proceeds at the beginning of the 15-year period. This option would be created when the proceeds of the bond were are expended to purchase the property and recorded pursuant to State law as a restrictive covenant binding upon all successors. The actual option could be granted at any time during the 15-year period beginning on the date of issuance.

Rules generally applicable to tax credit bonds

The proposal sets forth certain rules that would apply to any "tax credit bond" (i.e., BABs, qualified zone academy bonds, qualified school modernization bonds).

Similar to the tax benefits available to holders of present-law qualified zone academy bonds, the holders of tax credit bonds would receive annual Federal income tax credits in lieu of interest payments. Because the proposed credits would compensate the holder for lending money, the 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 present-law qualified zone academy bonds, the "credit rate" for tax credit bonds would be set by the Secretary of the Treasury so that, on average, the bonds would be issued without interest, discount, or premium.[64] The maximum term of the tax credit bond would be 15 years.

Any taxpayer would be able to hold a tax credit bond and thereby claim the tax credit. The Treasury Department would provide regulations regarding the treatment of credits that flow through from a mutual fund to the holder of mutual fund shares. Unused credits could not be carried back, but could be carried forward for 5 years. The proposal would grant regulatory authority to the Secretary to

[64] To this end, the credit rate would be set equal to a measure of the yield on outstanding corporate bonds, as specified in Treasury regulations, for the business day prior to the date of issue. It is anticipated that the credit rate would be set with reference to a corporate AA bond rate which could be published daily by the Federal Reserve Board or otherwise determined under Treasury regulations.

require information returns to be provided with respect to holders (including corporations) that are entitled to credits.

Under the proposal, issuers of tax credit bonds must reasonably expect that, on the date of issue, 95 percent of the proceeds of the bonds (including any investment earnings on such proceeds) would be spent on qualifying purposes within three years and that any property financed with bond proceeds would be used for a qualified purpose for at least a 15-year period. In addition, the issuer must incur a binding obligation with a third party to spend at least 10 percent of proceeds of the issue within 6 months of the date of issue.

During the 3-year period after the date of issue, unexpended proceeds must be invested only in bank accounts or U.S. Treasury securities with a maturity of three years or less. If the issuer established a sinking fund for the repayment of the principal, all sinking fund assets would have to be held in State and Local Government Securities (SLGS) issued by the Treasury. Any proceeds of the bonds (including any investment earnings on those proceeds) not expended for qualifying purposes at the end of the 3-year period must be used to redeem a pro rata portion of the bonds within 90 days.

Any property financed with tax credit bond proceeds must be used for a qualifying purpose for at least a 15-year period after the date of issuance. If the use of a bond-financed facility changed to a non-qualifying use within that 15-year period, the bonds would cease to be qualifying bonds and would accrue no further tax credits. Further, the issuer would be required to reimburse the Treasury for all tax credits (including interest) which accrued within three years of the date of noncompliance. If the issuer failed to make a full and timely reimbursement of tax credits, the Federal government could proceed to collect against current holder(s) of the bond for any remaining amounts.

Effective Date

The proposal would apply to bonds issued on or after January 1, 2000.

Prior Action

No prior action.

Analysis

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

Though called a tax credit, the Federal subsidy for BABs would be economically equivalent to a direct payment by the Federal government of interest on taxable bonds, on behalf of the eligible issuers that benefits from the bond proceeds.[65] To illustrate, consider any taxable bond that bears an interest rate of 10 percent. A $1,000 bond would produce an interest payment of $100 annually. The bondholder receiving this payment would have $100, less the tax owed on the interest income. If the taxpayer were in the 28-percent Federal tax bracket, taxpayer would have $72 after Federal tax. Regardless of whether the eligible issuer or the Federal Government pays the interest, the taxpayer receives the same net-of-tax return of $72. In the case of BABs, interest is not actually paid by the Federal Government, but rather, a tax credit of $100 is allowed to the holder of the bond. In general, a $100 tax credit would be worth $100 to a taxpayer, provided that the taxpayer had at least $100 in tax liability. However, the BABs proposal requires the amount of the $100 credit to be included in the taxpayer's income. The taxpayer in the 28-percent tax bracket nets $72 after Federal tax, just as on the bond. Similarly, the Federal Government would be in the same position under the BABs proposal as if it had paid the $100 interest on the bond. The Federal Government loses $100 on the credit, but recoups $28 of that by the requirement that it be included in income, for a net cost of $72. The State and local government would also be in the same situation in both cases.

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

Finally, the use of a tax credit has the effect that non-taxable entities may not invest in these bonds to improve the environment because they are unable to use the tax benefits provided under the proposal. In the case of a direct payment of interest, by contrast, tax-exempt organizations would be able to enjoy such benefits.

[65] 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.

3. New markets tax credit

Present Law

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

Description of Proposal

The proposal would create a new tax credit for qualified investments made to acquire stock (or other equity interests) in selected community development entities ("CDE"). The credits would be allocated to CDEs pursuant to Treasury Department regulations. During the period 2000–2004, the maximum amount of investments that would qualify for the credit would be capped at an aggregate annual amount of $1.2 billion (a maximum of $6 billion for the entire period of the tax credit). If a CDE fails to sell equity interests to investors up to the amount authorized within five years of the authorization, then the remaining authorization would be canceled, and the Treasury Department would have up to two years to authorize another CDE to issue equity interests for the unused portion.

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

A "qualified investment" refers to an equity interest acquired directly from a CDE in exchange for cash.[66] The equity interest must not be redeemed (or otherwise cashed out) by the CDE for at least five years. Substantially all of the investment proceeds must be used by the CDE to make "qualified low-income community investments," meaning equity investments in, or loans to, qualified active businesses located in low-income communities.[67] Qualified low-in-

[66] To ensure that credits are available only for new equity investments in CDEs, the term "qualified investment" would not include any stock or other equity interest acquired from a CDE which made a substantial stock redemption or distribution (without a bona fide business purpose therefor) in an attempt to avoid the purposes of the proposal.

[67] If at least 85 percent of the aggregate gross assets of the CDE are invested (directly or indirectly) in equity interests in, or loans to, qualified active businesses located in low-income com-

come community investments could be made directly by a CDE, or could be made indirectly through another CDE.[68]

A CDE would include (but would not be limited to) Community Development Financial Institutions, Community Development Corporations, Small Business Investment Corporations-LMIs, New Market Venture Capital Firms, America's Private Investment Corporations, or other investment funds (including for-profit subsidiaries of nonprofit organizations). To be selected for a credit allocation, the CDE's primary mission must be serving or providing investment capital for low-income communities or low-income persons. The CDE also must maintain accountability to residents of low-income communities (through representation on governing or advisory boards, or otherwise), and at least 60 percent of its gross assets must be invested in "qualified low-income community investments" or residential property located in low-income communities.[69]

As part of the credit allocation process, the Treasury Department would certify entities as eligible CDEs. Certified entities would be required to file annual reports demonstrating that they continue to meet the requirements for initial certification, and would be required to identify the amount (and purchasers) of equity interests with respect to which allocated credits may be claimed by the purchaser and to demonstrate that the entity monitors its investments to ensure that capital is used in low-income communities. If an entity fails to be a CDE during the five-year period following the taxpayer's purchase of an equity interest in the entity, or if the equity interest is redeemed by the issuing entity during that five-year period, then any credits claimed with respect to the equity interest would be recaptured and no further credits would be allowed.

A "low-income community" would be defined as census tracts with either (1) poverty rates of at least 20 percent (based on the most recent census data), or (2) median family income which does not exceed 80 percent of metropolitan area income (or for a non-metropolitan census tract, 80 percent of non-metropolitan statewide median family income). A "qualified active business" generally would be defined as a business[70] which satisfies the requirements of an "enterprise zone business" as defined in sec. 1397B(a) except that there is no requirement that the employees of the business be residents of the low-income community. Rental of improved commercial real estate located in a low-income community (e.g., an office building or shopping mall) would be a qualified active business, regardless of the characteristics of the commercial tenants of the property. In addition, a qualified active business that receives a loan from a CDE could include an organization that is organized and operated on a non-profit basis. The purchase and holding of

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munities, then there would be no need to trace the use of the proceeds from the particular stock (or other equity ownership) issuance with respect to which the credit is claimed.

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

[69] Expenditures made by a CDE to provide financial counseling and certain other services to businesses located in, and residents of, low-income communities would also be treated as "qualified low-income community investment."

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

unimproved real estate would not be a qualified active business. In addition, a qualified active business would not include (a) any business consisting predominantly of the development or holding of intangibles for sale or license; (b) operation of any facility described in sec. 144(c)(6)(B); or (c) any business if a significant equity interest in such business is held by a person who also holds a significant equity interest in the CDE.

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

Effective Date

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

Prior Action

No prior action.

Analysis

The Administration proposal would create a new incentive for taxpayers that make capital available for use in inner cities and isolated rural communities, in the form of a guaranteed return on an equity investment. Generally, a non-preferred equity investment carries few or no guarantees of return. The incentive provided under the Administration proposal is a guarantee of a 6-percent return annually for five years (in the form of a tax credit). Hence, for taxpayers who can claim the new markets tax credit, their equity investment in the CDE is similar to owning preferred stock in the CDE which converts to common stock after five years, except that the preferred dividend (the tax credit) is guaranteed by the Federal government rather than backed by the revenue of the CDE. By guaranteeing a return, the proposal both reduces the aggregate return the CDE must hope to earn in order to attract investors to the CDE and reduces the risk of an investment in a CDE. Thus, the proposal should reduce the cost of raising capital to the CDE. The proposal requires the CDE to use the new capital to make equity investments or loans to certain qualified low-income investments.

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

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

Opponents would argue that a higher cost of capital[71] does not imply that markets are inefficient. The cost of capital reflects investors' perceptions of risk. Where a business locates may increase the probability of its failure and thereby increase its cost of capital. Artificially diverting investment funds in one direction results in certain investments that offer a lower rate of return being funded in lieu of other investments that offer a higher rate of return. Moreover, the proposal does not limit the CDE's investments to those investments that otherwise have a higher cost of capital. Loans to a Fortune 500 company would be permissible under the proposal.

Proponents would argue that, even if the higher cost of capital to such businesses is not the result of inefficiency of the capital market, an important social goal can be achieved by helping target investment to low-income communities. Opponents would argue that this objective could be addressed through existing programs, such as the community development corporations, the empowerment zones and enterprise communities, and by requirements of the Community Reinvestment Act and other similar legislation.[72] The objective also is addressed, in part, by the SBA's subsidized loan program and present-law Code sections 1045 and 1202.[73] They also would question whether the proposal is the most efficient means of achieving this objective. It will take time and resources to implement this proposal. By contrast, the SBA already has programs in place that are designed to achieve similar objectives.

The proposal is expected to result in the imposition of new recordkeeping and other administrative burdens on CDEs. Each CDE presumably would have to establish extensive procedures by which it evaluates, selects and monitors the businesses and residential properties in which it invests (and with its community accountability requirements) on an ongoing basis to ensure its continued qualification as a CDE. For example, a CDE that makes a loan to a qualified active business in the low-income community would need

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

[72] The proposal does not specify any rule for coordination of tax benefits under the new markets tax credit with empowerment zone tax benefits, nor does it specify coordination with any appropriated funds that the taxpayer may receive as a result of undertaking a qualified investment.

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

to verify that the business satisfies the requirements of a "qualified active business" throughout the term of the loan. Each CDE also would need to develop a process by which it allocates the tax credit to investors, and keep sufficient records concerning its investors (and former investors) in the event it fails to maintain its CDE status (which would result in a recapture of any credits claimed by investors within the previous five years). The CDEs also would have additional reporting requirements for the Internal Revenue Service.

The proposal provides that the Treasury Department allocate the tax credits among CDEs.[74] In the absence of legislative criteria providing qualifications for the allocation of the credits among CDEs, some might question whether the proposal raises concerns regarding the delegation of such taxing power by the Congress to the Executive Branch.

4. 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[75] from the sale of qualifying small business stock held more than five years. An SSBIC is automatically deemed to satisfy the active business requirement which a corporation must satisfy to qualify its stock for the exclusion.

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

For purposes of these provisions, an SSBIC means any partnership or corporation that is licensed by the Small Business Administration under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993). SSBICs make long-term loans to, or 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

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[74] The proposal is silent as to how the Treasury Department is expected to allocate the credits among the CDEs.

[75] 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.

preferred stock (as well as common stock) in an SSBIC an eligible investment, and (3) increasing the lifetime caps to $750,000 in the case of an individual and to $2 million in the case of a corporation, and repealing the annual caps.

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

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

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

Effective Date

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

Prior Action

A similar proposal was included in the President's fiscal year 1999 budget proposal.

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.

5. Extend wage credit for two new empowerment zones

Present Law

Pursuant to the Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993"), the Secretaries of the Department of Housing and Urban Development and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994. Of the nine empowerment zones, six are located in urban areas and three are located in rural areas.[76]

[76] The six urban empowerment zones are located in New York City, Chicago, Atlanta, Detroit, Baltimore, and Philadelphia-Camden (New Jersey). The three rural empowerment zones are located in the Kentucky Highlands (Clinton, Jackson and Wayne counties, Kentucky), Mid-Delta

In general, businesses located in these empowerment zones qualify for the following tax incentives: (1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the empowerment zone (the "wage credit");[77] an additional $20,000 of section 179 expensing for "qualified zone property" placed in service by an "enterprise zone business"; and (3) special tax-exempt financing for certain zone facilities. Businesses located in enterprise communities are eligible for the special tax-exempt financing benefits but not the other tax incentives available in the empowerment zones. The tax incentives for empowerment zones and enterprise communities generally remain in effect 10 years.

The Taxpayer Relief Act of 1997 ("1997 Act") authorized the designation of two additional urban empowerment zones (the "new urban empowerment zones"),[78] and the designation of 20 additional empowerment zones. The new urban empowerment zones, whose designations take effect on January 1, 2000, are eligible for substantially the same tax incentives as the nine empowerment zones authorized by OBRA 1993 except that the wage credit is phased down beginning in 2005 and expires after 2007. Thus, the wage credit rate for the two urban empowerment zones is 20 percent during the period 2000 to 2004, 15 percent for calendar year 2005, 10 percent for calendar year 2006, and 5 percent for calendar year 2007. Businesses in the 20 additional empowerment zones are not eligible for the wage credit (but are eligible to receive up to $20,000 of additional section 179 expensing and to utilize the special tax-exempt financing benefits).

Description of Proposal

The proposal would provide that the wage credit for the new urban empowerment zones would remain in effect for a 10-year period. The wage credit would be phased down using the same percentages that apply to the empowerment zones designated under OBRA 1993. Thus, the wage credit rate for the new urban empowerment zones would be 20 percent during the period 2000 to 2006, 15 percent for calendar year 2007, 10 percent for calendar year 2008, and 5 percent for calendar year 2009.

Effective Date

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

Prior Action

No prior action.

Analysis

The proposal would equalize the period during which the wage credit is available for businesses in the new urban empowerment

Mississippi (Bolivar, Holmes, Humphreys, Leflore counties, Mississippi), and Rio Grande Valley Texas (Cameron, Hidalgo, Starr, and Willacy counties, Texas).

[77] For wages paid in calendar years during the period 1994 through 2001, the credit rate is 20 percent. The credit rate is reduced to 15 percent for calendar year 2002, 10 percent for calendar year 2003, and 5 percent for calendar year 2004. No wage credit is available after 2004.

[78] The new urban empowerment zones are located in Los Angeles, California and Cleveland, Ohio.

zones with the other tax benefits (i.e., the additional section 179 expensing and special tax-exempt financing for certain zone facilities). Equalizing the period during which the wage credit is available with the period during which the other tax benefits are available may be appropriate if the tax benefits are viewed as mutually interdependent to entice economic development to the new urban empowerment zones. The proposal also would have the effect of providing the new urban empowerment zones with the same length of wage credit benefit as the nine original empowerment zones.

Currently, the effect of the wage credit and the other empowerment zone tax benefits is unclear. According to a June 1998 report by the General Accounting Office (GAO), the IRS did not have sufficient reliable data on the use of the wage credit (nor on the sec. 179 expensing benefit) in the nine original empowerment zones to determine how often these incentives were used.[79] The GAO is in the process of collecting additional data from businesses within the nine original empowerment zones that should help Congress evaluate the effectiveness of the wage credit as a stimulus for economic development, as well as provide data on businesses' use of other Federal tax incentives targeted at these empowerment zones.

E. Energy and Environmental Tax Provisions

1. 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. 48(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 of either 10 or 20 percent would be provided for the purchase of certain types of highly energy-efficient building equipment: fuel cells, electric heat pumps, advanced natural gas water heaters, natural gas heat pumps, central air conditioners, electric heat

[79] GAO Report, *Community Development Information on the Use of Empowerment Zone and Enterprise Community Tax Incentives* (GAO/RCED–98–203), June 1998.

pump hot water heaters and residential size electric heat pumps, and advanced central air conditioners. The credit would be nonrefundable and subject to the dollar caps as specified. For businesses, it would be subject to the limitations on the general business credit and would reduce the basis of the equipment.

10-percent credit

A credit of 10 percent of the purchase price (up to a maximum of $250 per unit) would be allowed for the purchase of the following building equipment:

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

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

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

20-percent credit

A credit of 20 percent of the purchase price would be allowed for the purchase of the following building equipment:

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

Electric heat pump hot water heaters (equipment using electrically powered vapor compression cycles to extract heat from air and deliver it to a hot water storage tank) with an Energy Factor of at least 1.7 in the standard DOE test procedure. The maximum credit would be $500 per unit.

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

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

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

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

Effective Date

The 10-percent credit would be available for final purchases from unrelated third parties after December 31, 1999, and before January 1, 2002. The 20-percent credit would be available for final purchases from unrelated third parties after December 31, 1999, and before January 1, 2004.

Prior Action

The proposal is similar to a proposal in the President's fiscal year 1999 budget proposal.

2. Tax credit for the purchase of energy-efficient new 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 that meet energy-efficiency standards for heating, cooling and hot water that significantly exceed those of the IECC. A taxpayer may claim the credit only if the new home is the taxpayer's principal residence and reduces energy use by prescribed amounts as compared to the IECC for single family residences. The tax credit would be $1,000 for new homes that are at least 30 percent more energy efficient than the IECC standard, $1,500 for new homes that are at least 40 percent more energy efficient than the IECC standard, and $2,000 for new homes that are at least 50 percent more energy efficient than the IECC standard.

Effective Date

The $1,000 credit would be available for final homes purchased after December 31, 1999, and before January 1, 2002. The $1,500 credit would be available for final homes purchased after December 31, 1999, and before January 1, 2003. The $2,000 credit would be available for final homes purchased after December 31, 1999, and before January 1, 2005.

Prior Action

The proposal is similar to a proposal in the President's fiscal year 1999 budget proposal.

3. Extend 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 extend the present credit for qualified electric vehicles and provide temporary tax credits for fuel-efficient hybrid vehicles:

(1) *Credit for electric vehicles.*—The phase down of the credit for electric vehicles would be eliminated and the credit would be extended through 2006. Thus, the maximum $4,000 credit would be available for purchases before 2007.

(2) *Credit for fuel-efficient hybrid vehicles.*—The credit would be: (a) $1,000 for each vehicle that is one-third more fuel efficient than a comparable vehicle in its class; (b) $2,000 for each vehicle that is two-thirds more fuel efficient than a comparable vehicle in its class; (c) $3,000 for each vehicle that is twice as fuel efficient as a comparable vehicle in its class; and (d) $4,000 for each vehicle that is three times as fuel efficient as a comparable vehicle in its class.

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

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

Effective Date

The $1,000 credit would be effective for purchases of qualifying vehicles after December 31, 2002 and before January 1, 2005; the $2,000 credit would be effective for purchases of qualifying vehicles after December 31, 2002 and before January 1, 2007; the $3,000 credit would be effective for purchases of qualifying vehicles after December 31, 2003 and before January 1, 2007; and the $4,000 credit would be effective for purchases of qualifying vehicles after December 31, 2003 and before January 1, 2007.

Prior Action

The proposal is similar to a proposal in the President's fiscal year 1999 budget proposal.

4. 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 5 to 10 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 an 8-percent investment credit for qualified CHP systems with an electrical capacity in excess of 50 kilowatts or with a capacity to produce mechanical power in excess of 67 horsepower (or an equivalent combination of electrical and mechanical energy capacities). CHP property would be defined as property comprising a system that uses the same energy source for the simultaneous or sequential generation of (1) electricity or mechanical shaft power (or both) and (2) steam or other forms of useful thermal energy (including heating and cooling applications). A qualified CHP system would be required to produce at least 20 percent of its total useful energy in the form of thermal energy and at least 20 percent of its total useful energy in the form of electrical or mechanical power (or a combination thereof) and would also be required to satisfy an energy-efficiency standard. For CHP systems with an electrical capacity in excess of 50 megawatts (or a mechanical energy capacity in excess of 67,000 horsepower), the total energy efficiency of the system would have to exceed 70 percent. For smaller systems, the total energy efficiency would have to exceed 60 percent. For this purpose, total energy efficiency would be calculated as the sum of the useful electrical, thermal, and mechanical power produced by the system at normal operating rates, measured on a Btu basis, divided by the lower heating value of the primary fuel source for the system supplied. The credit would be allowed with respect to qualified CHP property only if its eligibility is verified under regulations prescribed by the Secretary of the Treasury. The regulations would require taxpayers claiming the credit to obtain proper certification by qualified engineers that the system meets the energy-efficiency and percentage-of-energy tests.

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

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

Effective Date

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

Prior Action

The proposal is similar to a proposal in the President's fiscal year 1999 budget proposal.

5. 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, 1999 and before January 1, 2005 for solar water heating systems, and for equipment placed in service after December 31, 1999 and before January 1, 2007 for rooftop photovoltaic systems.

Prior Action

Other than delaying the effective date for one year, the proposal is identical to a proposal in the President's fiscal year 1999 budget proposal.

6. 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 1.7 cents (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 the current credit for 5 years, to facilities placed in service before July 1, 2004, and would expand eligible biomass sources for facilities placed in service before July 1, 2004. In addition, biomass that is co-fired in coal plants to produce electricity would be eligible for the credit at a reduced rate (1.0 cent per kilowatt hour adjusted for inflation after 1999) through June 30, 2004. Biomass qualifying for the credit would include (in addition to closed-loop biomass) any solid, nonhazardous, cellulosic waste material, that is segregated from other waste materials, and that is derived from the following forest-related resources: mill residues, pre-commercial thinnings, slash and brush, but not including old growth timber, waste pallets, crates, and dunnage, and landscape or right-of-way tree trimmings, and biomass derived from agriculture sources, including orchard tree crops, vineyard grain, legumes, sugar, and other crop-by-products or residues. Unsegregated municipal solid waste (garbage) would not qualify for the credit.

Effective Date

The proposal would be effective on the date of enactment, for facilities placed in service prior to July 1, 2004.

Prior Action

A proposal to extend the current credit for 5 years was included in the President's fiscal year 1999 budget proposal. 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 Items 1–6

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.[80] When the social costs of consumption exceed the private costs of consumption, a negative exter-

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

nality 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 over consumption of the good causing the negative externality relative to what would be socially optimal. When positive externalities exist, there will be under consumption or production of the good producing the positive externality. The reason for the over consumption or under consumption is that private actors will in general not take into account the effect of their consumption on others, but only weigh their personal cost and benefits in their decisions. Thus, they will consume goods up to the point where their marginal benefit of more consumption is equal to the marginal cost that they face. But from a social perspective, consumption should occur up to the point where the marginal social cost is equal to the marginal social benefit. Only when there are no externalities will the private actions lead to the socially optimal level of consumption or production, because in this case private costs and benefits will be equal to social costs and benefits.

Pollution is an example of a negative externality, because the costs of pollution are borne by society as a whole rather than solely by the polluters themselves. In the case of pollution, there are two possible government interventions that could produce a more socially desirable level of pollution. One such approach would be to set a tax on the polluting activity that is equal to the social cost of the pollution. Thus, if burning a gallon of gasoline results in pollution that represents a cost to society as a whole of 20 cents, it would be economically efficient to tax gasoline at 20 cents a gallon. By so doing, the externality is said to be internalized, because now the private polluter faces a private cost equal to the social cost, and the socially optimal amount of consumption will take place. An alternative approach would be to employ a system of payments, such as perhaps tax credits, to essentially pay polluters to reduce pollution. If the payments can be set in such a way as to yield the right amount of reduction (that is, without paying for reduction more than the reduction is valued, or failing to pay for a reduction where the payment would be less than the value of the pollution reduction), the socially desirable level of pollution will result.[81] 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

[81] 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.

benefits, leading to the socially optimal level of consumption or production.

Targeted investment tax credits

Five 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.[82] The following general analysis of targeted investment tax credits is applicable to these proposals.

As a general matter of economic efficiency, tax credits designed to influence investment choices should be used only when it is acknowledged that market-based pricing signals have led to a lower level of investment in a good than would be socially optimal. In general, this can occur in a market-based economy when private investors do not capture the full value of an investment—that is, when there are positive externalities to the investment that accrue to third parties who did not bear any of the costs of the investments.[83] For example, if an individual or corporation can borrow funds at 10 percent and make an investment that will return 15 percent, they will generally make that investment. However, if the return were 15 percent, but only 8 percent of that return went to the investor, and 7 percent to third parties, the investment will generally not take place, even though the social return (the sum of the return to the investor and other parties) would indicate that the investment should be made. In such a situation, it may be desirable to subsidize the return to the investor through tax credits or other mechanisms in order that the investor's return is sufficient to cause the socially desirable investment to be made. In this example, a credit that raised the return to the investor to at least 10 percent would be necessary. Even if the cost of the credit led to tax increases for the third parties, they would 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).[84]

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

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

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

[84] The actual calculation as to whether the credit would improve economic efficiency should also consider the economic costs imposed to raise the necessary tax revenues to pay for the credit. Unless taxation is perfectly efficient (i.e., no distortions are imposed in raising tax revenue), the costs to society of raising a dollar in public funds will exceed a dollar. For a discussion of this issue, see Charles Ballard, John Shoven, and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," *American Economic Review,* March 1985, pp. 128–38; and Charles Ballard, John Shoven, and John Whalley, "The Total Welfare Cost of the United States Tax System: A General Equilibrium Approach," *National Tax Journal,* June 1985, pp. 125–40.

approach of targeted tax credits for certain technologies. By this approach, the establishment of the economically efficient prices on pollutants, through taxes, would result in the socially optimal level of pollution. This would indirectly lead to the adoption of the technologies favored in the President's budget, but only if they were in fact the most socially efficient technologies. In many cases, however, establishing the right prices on pollution-causing activities through taxes could be administratively infeasible, and other solutions such as targeted credits may be more appropriate.

A second potential inefficiency of investment tax credits is one of budgetary inefficiency, in the sense that their budgetary costs could be large relative to the incremental investment in the targeted activities. The reason for this is that there will generally have been investment in the activities eligible for the credit even in the absence of the credit. Thus, for example, if investors planned to invest a million dollars in an activity before a 10-percent credit, and the credit caused the investment to rise $100,000 to $1.1 million because of the credit, then only $100,000 in additional investment can be attributed to the credit. However, all $1.1 million in investments will be eligible for the 10-percent credit, at a budgetary cost of $110,000 (10 percent of 1.1 million). Thus, only $100,000 in additional investment would be undertaken, at a budgetary cost of $110,000. Because there is a large aggregate amount of investment undertaken without general investment credits, introducing a general credit would subsidize much activity that would have taken place anyway.[85]

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.[86] 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 reduce costs and encourage investment in the favored activity.

A final limitation on the efficiency of the proposed credits is their restricted availability. The proposed tax credits come with several limitations beyond their stipulated dollar limitation. Specifically, they are all nonrefundable and cannot offset tax liability determined under the AMT. Certain of the proposals, such as the credit for rooftop solar equipment and the credits for certain energy-efficient building equipment, have a cap on the dollar amount of the credit, and thus after the cap is reached the marginal cost of further investment becomes equal to the market price again, which is

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[85] 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.

[86] 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.

presumed to be inefficient.[87] 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 to the investments.[88] 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.[89] 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.

[87] The cap on the credit for rooftop solar equipment is a per-taxpayer cap. The cap for the energy efficient building equipment is a per-unit cap, which could encourage an economically inefficient proliferation of units, rather than use of a single larger unit, in order to take advantage of the credits.

[88] 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.

[89] 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.

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 be considered an economically inefficient outcome unless there are positive externalities to the production of the good that exceed the value of the credit.[90] If it is presumed that the electricity produced from wind or biomass substitutes for electricity produced from the burning of fossil fuels, economic efficiency will be improved so long as the credit does not have to be set so high in order to encourage the alternative production that it exceeds the value of the positive externality. On the other hand, by making some production of electricity cheaper, it is possible that the credit could encourage more electricity consumption. On net, however, there would be less electricity produced from fossil fuels.

With respect to the expansion of the biomass materials eligible for the credit, the basic issues are the same as those outlined above for any tax benefit for energy conservation or pollution abatement. To justify the credit on economic grounds, the positive externalities from the burning of biomass for the production of electricity must outweigh the costs of the tax subsidy. With respect to the waste materials that are proposed to be made eligible for the credit, one positive externality is similar to that of wind power production, namely the reduction in electricity production from the more envi-

[90] 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.

ronmentally damaging coal. Another consideration with the waste products is whether their current disposal is harmful to the environment. If so, an additional positive externality may exist from discouraging such disposal. If the disposal is harmful to the environment and is a partial justification for the credit, then ideally the credit amount should vary for each biomass waste product if their present disposal varies in its harm to the environment. A single credit rate would be justified if the negative externalities are of a similar magnitude, or if administrative considerations would make multiple credit rates problematic.

With respect to the special credit rate for biomass that is co-fired in coal plants, it is unclear why the rate should be lower. A possible rationale is that a higher rate is necessary for facilities that plan to exclusively burn biomass in order that more of such facilities get built. However, if the primary rationale for the credit is that biomass of a given Btu content substitutes for a given amount of coal that would otherwise be burned, then it would appear that coal plants should be given the same incentives to reduce coal burning as are facilities that exclusively burn biomass.

F. Retirement Savings Provisions

1. IRA contributions through payroll deduction

Present Law

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

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

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

Description of Proposal

Under the proposal, contributions of up to $2,000 made to an IRA through payroll deduction generally would be excluded from an employee's income and, accordingly, would not be reported as income on the employee's Form W–2. However, the amounts would be subject to employment taxes (FICA and FUTA), and would be reported as a contributions to an IRA on the employee's W–2. If the full amount of the payroll deduction IRA contributions would not have been deductible had the employee contributed directly to an IRA, the employee would be required to include the amount that would not have been deductible in income.

Effective Date

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

Prior Action

A similar proposal was included in the President's fiscal year 1999 budget proposal.

Analysis

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

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

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

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

2. Small business tax credit for new retirement plan 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 be eligible for 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 after 1997 and on or before December 31, 2001. For example, if an eligible employer adopted a plan in the year 2000, the credit would be available for the years 2000, 2001, and 2002.

Prior Action

A similar proposal was included in the President's budget proposal for fiscal year 1999.

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

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

Description of Proposal

In general

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

Employer and employee eligibility and vesting

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

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

Benefits and funding

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

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

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

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

Distributions

No distributions would be allowed from a SMART Plan prior to the employee's attainment of age 65, except in the event of death or disability, or if the account balance of a terminated employee does not exceed $5,000. However, an employer could allow a terminated employee who has not yet attained age 65 to directly transfer the individual's account balance from a SMART Trust to either a SMART Annuity or a special individual retirement account ("SMART Account") that is subject to the same distribution restrictions as the SMART Trust. If a terminated employee's account balance did not exceed $5,000, the SMART Plan would be allowed to make a cashout of the account balance. The employee would be allowed to transfer such distribution tax-free to a SMART Annuity, a SMART Account, or a regular IRA.

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

Distributions from SMART Plans would be subject to tax under the present-law rules applicable to qualified plans. A 20-percent additional tax would be imposed for violating the pre-age 65 distribution restrictions under a SMART Annuity or SMART Account.

PBGC guarantee and premiums

The minimum guaranteed benefit under the SMART Trust would be guaranteed by the Pension Benefit Guarantee Corporation ("PBGC"). Reduced PBGC premiums would apply to the SMART Trust. Neither the PBGC guarantee, nor PBGC premiums, would apply to the SMART Annuity or SMART Account.

Nondiscrimination requirements and benefit limitations

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

Other rules

Other plans maintained by the employer.—An employer that maintained a SMART Plan could not maintain additional tax-qualified plans, other than a SIMPLE plan, a 401(k) plan, or a 403(b) tax-sheltered annuity plan under which the only contributions that are permitted are elective contributions and 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. Employers would not be required to use the IRS models.

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

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

Effective Date

The proposal would be effective for calendar years beginning after 1999.

Prior Action

A similar proposal was included in the President's fiscal year 1999 budget proposal.[91]

Analysis

Under present law, small businesses have many options available for providing retirement benefits for their employees, including SIMPLE plans and SEPs not available to larger employers. Nevertheless, retirement plan coverage is lower among smaller employers. There may be a number of reasons for such lower coverage. Some believe the retirement plan coverage for small business employers continues to be inadequate. They argue that the limits on qualified plan benefits are not sufficient to induce owners to establish a plan because the owners will not be able to receive as high a retirement benefit as they would like. Others point out that the limits are high enough to allow significant retirement benefits (the lesser of $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.

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

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

4. Faster vesting of 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

[91] A similar proposal was included in H.R. 1656 (105th Cong.), introduced by Mrs. Johnson and others, and S. 2339 (105th Cong.), introduced by Senator Graham, Senator Grassley, and others.

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 are generally subject to these vesting rules. However, employer matching contributions that are used to satisfy the special nondiscrimination test under section 401(k) must be fully vested immediately.

Description of Proposal

Under the proposal, employer matching contributions 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) special nondiscrimination 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, 1999, with an (unspecified) extended effective date for plans maintained pursuant to a collective bargaining agreement.

Prior Action

A similar provision was included in the President's fiscal year 1999 budget proposal.

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 generally used by employers to reduce the contributions of the employer in subsequent years, employers may find that the shorter vesting period increases their plan costs. This could cause employers to eliminate or reduce 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 to balance any increased costs associated with accelerated vesting.

5. Count FMLA leave for retirement plan eligibility and vesting purposes

Present Law

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

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

Description of Proposal

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

Effective Date

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

Prior Action

No prior action.

Analysis

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

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

6. Require joint and 75-percent survivor annuity option for pension plans

Present Law

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

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

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

Description of Proposal

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

Effective Date

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

Analysis

A joint and survivor annuity is generally the actuarial equivalent of an annuity payable over the life of the participant (a single life annuity). Under a joint and survivor annuity, the amount payable during the lifetime of the participant is generally less than the amount that would be paid if the benefit were paid as a single life annuity. Thus, while a joint and survivor annuity offers a survivor benefit, it typically pays a lower benefit during the participant's lifetime. Plans may, but are not required to, provide a fully subsidized joint and survivor annuity that pays the same amount during the participant's lifetime as would have been paid under a single life annuity. Under present law, a plan may provide for a more generous survivor benefit than the 50-percent joint and survivor annuity. In addition, a plan may provide for an optional joint and survivor benefit, e.g., a 50-percent QJSA and a 75-percent or 100-percent joint and survivor annuity option.

The stated rationale for the proposal is that many couples may prefer an option that pays a somewhat smaller benefit to the couple while both are alive but a larger benefit than the present-law 50-percent survivor benefit. It is also argued that a surviving spouse typically has retirement needs that exceed half the retirement needs of a couple. For example, the poverty threshold for an aged individual is almost 80 percent of the threshold for an aged couple. Proponents of the proposal argue that the option would be especially helpful to women, because they tend to live longer than men, and many aged widows have income below the poverty level.

Some plans may already provide options that satisfy the proposal. Other plans, however, would need to be modified to comply. Some employers may wish to restrict the options offered under the plan in order to minimize administrative costs. If an employer wishes to offer only one joint and survivor annuity option, it would have to provide a 75-percent joint and survivor annuity. Some participants prefer the 50-percent joint and survivor annuity, because they do not wish to receive lower benefits during the participant's lifetime. For such participants, the proposal may have the effect of causing the participant to elect a nonannuity form of benefit (if one is available) or a single life annuity.[92]

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[92] Present law prohibits plan amendments that eliminate an optional form of benefit with respect to benefits attributable to service before the amendment (sec. 411(d)(6)). It is not clear whether the proposal would modify section 411(d)(6) so that a plan could eliminate existing forms of joint and survivor annuities when adopting the option required under the proposal.

7. Pension disclosure

Present Law

Spouse's right to know distribution information

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

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

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

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 does not have to apply the ADP or ACP tests of employee elective contributions and employer matching contributions. There are similar safe-harbor designs under a SIMPLE plan. Under SIMPLE plans, employees must be provided annual 60-day election periods and notification tied to those election periods. Unlike SIMPLE plans, 401(k) plans using the design-based safe harbor are not subject to specific requirements that prescribe the length and frequency of the election period or that tie the timing of the notice describing employee rights and obligations under the plan to the election period.

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 a participant, 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 could be provided in a single mailing addressed to the participant and his or her spouse.

Election periods and right to know employer contribution formula

The proposal would require employers who use one of the design-based safe harbors in lieu of 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 contribution formula the employer is currently using (in order to notify employees of their rights and obligations) would be modified to require the notice within a reasonable period of time before the 60-day periods begin rather than before the beginning of the year.

Effective Date

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

Prior Action

A similar proposal was included in the President's fiscal year 1999 budget proposal.

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.

8. Benefits of nonhighly compensated employees under section 401(k) safe harbor plans

Present Law

Under present law, special nondiscrimination tests apply to contributions made to 401(k) plans. In general, the actual deferral percentage ("ADP") test applies to the elective contributions of all employees under the plan and the average contribution percentage ("ACP") test applies to employer matching and after-tax employee contributions. The ADP test is satisfied if the average percentage of elective contributions for highly compensated employees does not exceed the average percentage of elective contributions for nonhighly compensated employees by more than a specified percentage. The ACP test is similar but it tests the average contribution percentages (i.e., employer matching and after-tax employee contributions) of the highly compensated employees and nonhighly compensated employees.

As an alternative to annual testing under the ADP and ACP tests, the Small Business Job Protection Act of 1996 provides two alternative "design-based" 401(k) safe harbors, effective beginning in 1999. Under the safe harbor, if the employees are provided a specified matching or nonelective contribution, ADP and ACP testing of employee elective contributions and employer matching contributions is not required. Under the matching contribution safe harbor, the employer must make nonelective contributions of at least 3 percent of compensation for each nonhighly compensated employee eligible to participate in the plan. Alternatively, under the other safe harbor, the employer must make a 100 percent matching contribution on an employee's elective contributions up to the first 3 percent of compensation and a matching contribution of at least 50 percent on the employee's elective contributions up to the next 2 percent of compensation.

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 plan years beginning after December 31, 1999.

Prior Action

A similar proposal was included in the President's budget proposal for fiscal year 1999.

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.

9. Modify definition of highly compensated employee

Present Law

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

Description of Proposal

The proposal would eliminate the top-paid group election from the definition of highly compensated employee. Under the new definition, an employee would be treated as a highly compensated employee if the employee (1) was a 5-percent owner of the employer at any time during the year or the preceding year, or (2) for the preceding year, had compensation in excess of $80,000 (indexed for inflation).

Effective Date

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

Prior Action

A similar proposal was included in the President's fiscal year 1999 budget proposal.

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.

10. Modify 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 1999) 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, 1999.

Prior Action

The proposal was included in the Administration's 1995 Pension Simplification Proposal,[93] in the Small Business Job Protection Act of 1996 as passed by the Senate, in the Taxpayer Relief Act of 1997 as passed by the Senate, and in the President's fiscal year 1999 budget proposal.

Analysis

The limits on benefits under qualified plans were designed to limit the tax benefits and revenue loss associated with such plans, while still ensuring that adequate retirement benefits could be provided. The 100-percent-of-compensation limitation reflects Congressional judgment that a replacement rate of 100-percent-of-compensation is an adequate retirement benefit.

The stated rationale for the proposal is that the qualified plan limitations present significant administrative problems for many multiemployer plans which base benefits on years of credited service rather than compensation. In addition, it is argued that 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 ar-

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

gued 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.

11. Modify full funding limit for multiemployer plans

Present Law

Under present law, employer deductions for contributions to a defined benefit pension plan cannot exceed the full funding limit. In general, the full funding limit is the lesser of a plan's accrued liability and 155-percent of current liability. The 155-percent of current liability limit is scheduled to increase gradually, until it is 170 percent in 2005 and thereafter.

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

Description of Proposal

Under the proposal, the current liability full funding limit would not apply to multiemployer plans. In addition, such plans would be required to have an actuarial valuation at least once every three years. Changes would be made to the corresponding provisions of title I of the Employee Retirement Income Security Act of 1974, as amended.

Effective Date

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

Prior Action

The proposal was included in the Administration's 1995 Pension Simplification Proposal[94] and in the President's fiscal year 1999 budget proposal.

Analysis

The current liability full funding limit was enacted as a balance between differing policy objectives. On one hand is the concern that defined benefit pension plans should be funded so as to provide adequate benefit security for plan participants. On the other hand is the concern that employers should not be entitled to make excessive contributions to a defined benefit pension plan to fund liabilities that it has not yet incurred. Such use of a defined benefit plan was believed to be equivalent to a tax-free savings account for future liabilities, and inconsistent generally with the treatment of unaccrued liabilities under the Internal Revenue Code. The current liability full funding limit as initially enacted was 150 percent of current liability. It was increased to the present-law level by the Taxpayer Relief Act of 1997 because the Congress believed that the

[94] *Ibid.*

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.

12. 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, 1999.

Prior Action

The proposal was included in the Administration's 1995 Pension Simplification Proposal,[95] in the Taxpayer Relief Act of 1997 as

[95] *Ibid.*

passed by the Senate, and in the President's fiscal year 1999 budget proposal.

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 of a plan.

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 other employer participating in the plan.

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

13. Allow rollovers between qualified retirement plans and section 403(b) tax-sheltered annuities

Present Law

Present law permits the rollover of funds from a tax-favored retirement vehicle to another tax-favored retirement vehicle. The rules that apply depend on the type of plan involved.

Under present law, an "eligible rollover distribution" from a tax-qualified employer-sponsored retirement plan (a "qualified plan") may be rolled over tax free to a traditional individual retirement arrangement ("IRA")[96] or another qualified plan.[97]

An "eligible rollover distribution" means any distribution to an employee of all or any portion of the balance to the credit of the employee, except the term does not include (1) any distribution which is one of a series of substantially equal periodic payments made (a) for the life (or life expectancy) of the employee or the joint lives) or joint life expectancies) of the employee and the employee's designated beneficiary, or (b) for a specified period of 10 years or more, and (2) any distribution to the extent such distribution is required under the section 401(a)(9) minimum distribution rules. The portion of a distribution that is nontaxable cannot be rolled over.

Distributions from a tax-sheltered annuity ("section 403(b) annuity") may be rolled over into a traditional IRA or another section

[96] A "traditional" IRA refers to an IRA other than a Roth IRA.

[97] An eligible rollover distribution may either be rolled over by the distributee within 60 days of the date of the distribution or directly rolled over by the distributing plan.

403(b) annuity. Distributions from a section 403(b) annuity cannot be rolled over into a qualified plan.

Distributions from a traditional IRA can be rolled over into another traditional IRA. In general, distributions from an IRA cannot be rolled over into a qualified plan or section 403(b) annuity. An exception to this rule applies in the case of so-called "conduit IRAs." Under the conduit IRA rule, amounts can be rolled from a qualified plan into a traditional IRA and then subsequently rolled back to another qualified plan if the amounts in the IRA are attributable solely to rollovers from a qualified plan. Similarly, an amount may be rolled over from a section 403(b) annuity to a traditional IRA and subsequently rolled back into a section 403(b) annuity if the amounts in the IRA are attributable solely to rollovers from a section 403(b) annuity.

Under present law, amounts distributed from a qualified plan, section 403(b) annuity, or traditional IRA are generally includible in gross income. Capital gain treatment and income averaging may apply to certain distributions from qualified retirement plans. Capital gains treatment may be available for a lump-sum distribution that contains amounts attributable to participation in a plan before 1974. Five or 10-year averaging may be available for a lump-sum distribution in the case of individuals who were at least 50 years old by January 1, 1986, in 1986 (i.e., born before 1936). Five year averaging may be available in the case of a lump-sum distribution before 2000.

Description of Proposal

The proposal would provide that eligible rollover distributions from qualified plans could be rolled over to another qualified plan, section 403(b) annuity, or traditional IRA. Similarly, an eligible rollover distribution from a section 403(b) annuity could be rolled over to another 403(b) annuity, qualified plan, or traditional IRA.

A special rule would prevent individuals from receiving special capital gains and income averaging treatment available to qualified plan distributions if the individual's account includes any amounts previously held under a section 403(b) annuity.

Effective Date

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

Prior Action

No prior action.[98]

Analysis

Some individuals may accumulate retirement savings in more than one different type of tax-favored retirement saving vehicle. Allowing rollovers between different types of plans will allow individuals to combine their retirement savings in one vehicle. The ability

[98] A similar proposal was included in H.R. 3788 (105th Cong.), introduced by Mr. Portman and Mr. Cardin, and S. 2339 (105th Cong.), introduced by Senator Graham, Senator Grassley, and others.

to combine savings may be administratively easier for individuals, and may also affect investment choices and returns.

In general, the rationale for not permitting rollovers between qualified plans and section 403(b) annuities has been that benefits under such plans are taxed differently. The key difference is the availability of capital gains and income averaging treatment for certain qualified retirement plan distributions. These special rules have been repealed so that, after the expiration of certain transition rules, these differences in tax treatment between qualified plans and section 403(b) annuities will no longer remain.

The proposal addresses the current differences in tax treatment by providing that the special rules will not apply to section 403(b) annuity amounts.[99] In order to preserve the availability of averaging or capital gains treatment, it may be necessary for individuals to separately keep track of amounts attributable to section 403(b) annuities. Individuals may make mistakes, which can result in claiming averaging or capital gains treatment when the individual is not eligible to do so, or in losing the ability to claim such treatment when it is available.

14. Allow rollovers from deductible IRAs to qualified plans or section 403(b) tax-sheltered annuities

Present Law

In general, amounts in an individual retirement arrangement (“IRA”) cannot be rolled over into a tax-qualified retirement plan or a section 403(b) tax-sheltered annuity.[100]

Description of Proposal

Under the proposal, amounts in a deductible IRA could be transferred to a qualified defined contribution plan or section 403(b) tax-sheltered annuity, provided that the retirement plan trustee meets the same standards as an IRA trustee.[101]

Effective Date

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

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[99] The details of this rule have not yet been specified.

[100] An exception to this rule applies in the case of a “conduit IRA.” Under the conduit IRA rule, amounts can be rolled from a qualified retirement plan into a traditional IRA and then subsequently rolled back to another qualified plan if the amounts in the IRA are attributable solely to rollovers from qualified retirement plans. A similar rule applies to conduit IRAs with respect to section 403(b) annuities.

[101] Under present law, an IRA trustee must either be a bank or another person who demonstrates to the satisfaction of the Secretary that such other person will administer the trust in a manner consistent with the IRA rules. Persons wishing to be IRA trustees must make application to the Secretary. Among other things, the applicant must demonstrate in detail its ability to act within the accepted rules of fiduciary conduct, its experience and competence with respect to accounting for the interests of a large number of individuals, and its experience and competence with respect to other activities normally associated with the handling of retirement funds.

Prior Action

No prior action.[102]

Analysis

Like the proposal relating to rollovers between qualified plans and section 403(b) annuities, allowing rollovers from IRAs into qualified plans or section 403(b) annuities will allow individuals to combine their retirement savings in one vehicle. The ability to combine savings may be administratively easier for individuals, and may also affect investment choices and returns.

As discussed above under the preceding rollover proposal, qualified plan distributions may be eligible for special tax treatment that is not available with respect to distributions from IRAs. Rules would need to be developed, similar to those contemplated under the preceding proposal so that this special treatment is not inadvertently applied to IRA balances rolled into a qualified plan.

15. Allow rollovers of after-tax contributions

Present Law

Under present law, a qualified plan may permit individuals to make after-tax contributions to the plan. Present law provides that the maximum amount that can be rolled over to another qualified plan or an IRA is the amount of the distribution that is taxable. That is, employee after-tax contributions cannot be rolled over to another retirement plan or an IRA.

Description of Proposal

The proposal would provide that employee after-tax contributions could be rolled over to another qualified retirement plan or a traditional IRA, provided that the plan or IRA provider agrees to track and report the after-tax portion of the rollover for the individual.[103]

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[102] A similar proposal was included in H.R. 3788 (105th Cong.), introduced by Mr. Portman and Mr. Cardin, and S. 2339 (105th Cong.), introduced by Senator Graham, Senator Grassley, and others.

[103] Under the proposal, it is not clear what tax consequences result when an individual rolls over some, but not all, of a distribution that consists of both taxable and nontaxable amounts. Ordering rules are necessary to determine which amounts are considered to be rolled over. A number of rules are possible. For example, the individual could be permitted to designate which amounts are treated as being rolled over. Under such a rule, the individual could roll over all taxable amounts, and retain the nontaxable amounts. This would allow an individual to in effect withdraw after-tax contributions from a plan, as occurs under present law. Under another possible rule, the individual could be deemed to roll over taxable amounts first. This would generally have the same effect as the first rule, assuming that taxpayers would generally wish to retain the nontaxable portion of the distribution in order to avoid paying tax currently. Under another possible rule, a pro rata rule could be applied. That is, the amount rolled over could consist in part of taxable amounts and in part of nontaxable amounts. This rule is more consistent with the present-law rules regarding taxation of distributions, which generally apply a pro rata rule. On the other hand, some individuals may not want to roll over their own contributions. Resolution of this issue is relevant not only in determining the tax consequences to the individual, but also could affect the plan's withholding obligations.

Under present law, distributions that can be rolled over are subject to 20 percent withholding unless the distribution is directly rolled over into another qualified plan or IRA. This rule is intended to encourage direct rollovers. The proposal does not indicate whether this rule would apply to distributions of after-tax employee contributions.

Effective Date

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

Prior Action

No prior action.[104]

Analysis

The primary rationale for not permitting after-tax contributions to be rolled over has generally been that the record keeping involved is too complex. An individual who rolls over such contributions will need to keep accurate records in order to determine the taxable amount of any subsequent distribution from the IRA or plan. Maintaining such records may be difficult, because they may have to be kept for a long time. In addition, keeping track of the after-tax contributions may be more difficult if new contributions are made to the plan or IRA or amounts are subsequently transferred to another IRA or plan. The proposal addresses this issue by placing the burden of keeping track of such amounts on the financial institution offering the IRA or the plan. However, financial institutions and plans may not want the responsibility of keeping track of such contributions. It is unclear how many plans will not accept such contributions because they do not want the record keeping burdens.

The proposal may help individuals to save for retirement. By increasing the opportunities to retain after-tax contributions in a tax-favored vehicle, it may help increase retirement security.

16. Allow rollovers of contributions from nonqualified deferred compensation plans of State and local governments to IRAs

Present Law

Benefits under an eligible deferred compensation plan of tax-exempt and State and local governmental employers (a "section 457 plan") cannot be rolled over into an individual retirement arrangement ("IRA").

Description of Proposal

Under the proposal, distributions from a governmental section 457 plan could be rolled over to a traditional IRA.[105]

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[104] A similar proposal was included in H.R. 3788 (105th Cong.), introduced by Mr. Portman and Mr. Cardin, and S. 2339 (105th Cong.), introduced by Senator Graham, Senator Grassley, and others.

[105] Although the proposal is not clear on this point, presumably the definition under present law of an eligible rollover distribution would apply to rollovers from a section 457 plan. For example, certain periodic distributions are not considered eligible rollover distributions under present law. It is also not clear whether the direct rollover rules would apply; i.e., whether the plan would be required to withhold if a distribution that could be rolled over is not directly rolled over.

Effective Date

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

Prior Action

No prior action.[106]

Analysis

Section 457 imposes rules on certain deferred compensation arrangements of tax-exempt and State and local governmental employers. Section 457 plans are not qualified retirement plans; rather such plans have traditionally been more like unfunded, nonqualified deferred compensation arrangements of private, taxable employers. Present law does not limit the amount of deferred compensation payable under nonqualified deferred compensation plans of taxable employers because there is tension between the employer and the employee-employers generally want a current deduction for compensation, whereas deferred compensation is not deductible until includible in employees' income. This tension is not present in the case of deferred compensation plans of tax-exempt and governmental employers. Thus, section 457 limits the amount that can be deferred under such plans and provides other rules regarding such plans. The tax rules applicable to section 457 plans are similar to those applicable to nonqualified deferred compensation arrangements of taxable employers.

Section 457 plans have not received the same tax treatment as qualified retirement plans, because section 457 plans generally have not been subject to all of the same restrictions and rules as qualified plans. However, recent changes in the rules relating to section 457 plans of governmental employers have blurred the distinction between governmental section 457 plans and governmental qualified plans. In particular, assets of governmental section 457 plans must now be held in trust, and governmental qualified plans are not subject to nondiscrimination rules. Given then narrowing of the differences between such plans, the reasons for prohibiting roll over governmental section 457 plans become less clear.

Allowing distributions from governmental section 457 plans to be rolled over into an IRA will enable participants in such plans to continue to receive the benefits of tax deferral, and may help such individuals increase retirement savings. Individuals who roll over distributions from a section 457 plan into an IRA will need, however, to be aware that the tax consequences of a distribution from an IRA may be different than the tax consequences of a distribution from a section 457 plan. For example, the withdrawal restrictions applicable to section 457 plans do not apply to IRAs; however, early distributions from an IRA are subject to a 10-percent early withdrawal tax.

[106] A similar proposal was included in H.R. 3788 (105th Cong.), introduced by Mr. Portman and Mr. Cardin, and S. 2339 (105th Cong.), introduced by Senator Graham, Senator Grassley, and others.

17. Purchase of service credits in governmental defined benefit plans

Present Law

Under present law, limits are imposed on the contributions and benefits under qualified pension plans (Code sec. 415). In the case of a defined contribution plan, the limit on annual additions is the lesser of $30,000 (for 1999) or 25 percent of compensation. Annual additions include employer contributions, as well as after-tax employee contributions. In the case of a defined benefit pension plan, the limit on the annual retirement benefit is the lesser of (1) 100 percent of compensation or (2) $130,000 (for 1999). The 100 percent of compensation limitation does not apply in the case of State and local governmental pension plans.

Present law provides special rules with respect to contributions by a participant in a State or local governmental plan to purchase permissive service credits under a governmental defined benefit plan. Such contributions are subject to one of two limits. Either (1) the accrued benefit derived from all contributions to purchase permissive service credit must be taken into account in determining whether the defined benefit pension plan limit is satisfied, or (2) all such contributions must be taken into account in determining whether the $30,000 limit on annual additions is met for the year (taking into account any other annual additions of the participant). These limits may be applied on a participant-by-participant basis. That is, contributions to purchase permissive service credits by all participants in the same plan do not have to satisfy the same limit.

Permissive service credit means credit for a period of service recognized by the governmental plan only if the employee voluntarily contributes to the plan an amount (as determined by the plan) which does not exceed the amount necessary to fund the benefit attributable to the period of service and which is in addition to the regular employee contributions, if any, under the plan. Section 415 is violated if more than 5 years of permissive service credit is purchased for "nonqualified service". In addition, section 415 is violated if nonqualified service is taken into account for an employee who has less than 5 years of participation under the plan. Nonqualified service is service other than service (1) as a Federal, State, or local government employee, (2) as an employee of an association representing Federal, State or local government employees, (3) as an employee of an educational institution which provides elementary or secondary education, or (4) for military service. Service under (1), (2) or (3) is not qualified if it enables a participant to receive a retirement benefit for the same service under more than one plan.

Under present law, benefits in a section 403(b) tax-sheltered annuity or under a governmental section 457 plan cannot be rolled over or transferred in a tax-free transfer to a governmental defined benefit plan.

Benefits under section 403(b) annuities and section 457 plans are subject to certain distribution restrictions. Benefits under a section 403(b) annuity cannot be distributed prior to age 59½, separation from service, hardship, death or disability. Benefits under a section

457 plan cannot be distributed prior to the earliest of age 70½, hardship, or separation from service.

Description of Proposal

Under the proposal, governmental employees would be able to transfer funds from a section 403(b) plan or a section 457 plan in a tax-free transfer in order to purchase permissive service credits under a governmental defined benefit plan. A transfer could be made even if the individual could not take a distribution from the transferree plan. Transferred funds would be subject to the present-law rules regarding permissive service credit.

Effective Date

The proposal would be effective with respect to transfers made after December 31, 1999.

Prior Action

No prior action.[107]

Analysis

Permitting tax-free transfers as under the proposal will make it easier for State and local government employees to purchase permissive service credit, thereby allowing such employees to increase their retirement benefits. Some question whether it is appropriate to provide such special rules only for employers of certain types of entities.

G. Extend Certain Expiring Tax Provisions

1. Extend minimum tax relief for individuals

Present Law

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, and the D.C. homebuyer's credit[108]). Generally, these credits are reduced or eliminated for individuals with adjusted gross incomes above specified amounts. Except for taxable years beginning during 1998, these credits are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the AMT foreign tax credit ("the sec. 26(a) limitation"). For taxable years beginning during 1998, these credits are allowed to the extent of the full amount of the individual's regular tax (without regard to the tentative minimum tax).

An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married

[107] A similar proposal was included in H.R. 3788 (105th Cong.), introduced by Mr. Portman and Mr. Cardin, and S. 2339 (105th Cong.), introduced by Senator Graham, Senator Grassley, and others.

[108] The President's fiscal year 2000 budget proposal also includes personal tax credits for long-term care and for disabled workers.

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

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

Description of Proposal

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

The provision that reduces the refundable child credit by the amount of an individual's AMT would not apply for taxable years beginning during 1999 and 2000.

Effective Date

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

Prior Action

The Taxpayer Relief Act of 1997, as passed by both the House and the Senate, provided for increases in the AMT exemption amounts. The conference agreement on that Act retained the present-law exemption amounts.

The Tax and Trade Relief Extension Act of 1998 allowed the personal credits to offset the full regular tax, and provided that the refundable child credit would not be reduced by the amount of the individual's AMT for taxable years beginning during 1998.

Analysis

The alternative minimum tax was enacted by Congress to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits.[109] In 1998, the Congress determined that allowing middle-income families to use the nonrefundable personal tax credits to offset the regular tax in full would not undermine the policy of the minimum tax, and would promote the important social policies underlying each of the credits. The Congress thus allowed taxpayers to use the credits to offset the regular tax in full for taxable years beginning during 1998.

It is estimated that under present law the number of individuals who will receive zero or less than the full nonrefundable personal credits due to the AMT limitations will be 1 million in 1999 and 1.2 million in 2000.

Allowing the personal credits to offset the regular tax in full results in significant simplification. Substantially fewer taxpayers need to complete the minimum tax form (Form 6251) and the worksheets accompanying the credits can be greatly simplified. For example, the child credit worksheet proposed by the IRS under the legislation in effect before the changes made by the 1998 Act would have required any individual claiming the child credit who filed a schedule C (business income), schedule D (capital gains), schedule E (rents and royalties) or schedule F (farm income) to file a minimum tax form (Form 6251). Form 6251 contains 28 lines for those individuals without any net capital gain and an additional 22 lines for individuals with a net capital gain. In addition, many individuals with only wage, dividend and interest income would have been required to compute their tentative minimum tax using a shorter schedule. Also, the additional child credit form (Form 8812) would have contained two additional lines to adjust for the minium tax.

The following examples compare present law with the Administration proposal extending the minimum tax relief of the 1998 Act:

Example 1.—Assume in 1999 a married couple has an adjusted gross income of $65,800, they do not itemize deductions, and they have four dependent children. Also assume they are entitled to an $1,000 child credit for two of the children, a $3,000 HOPE scholarship credit with respect to the other two children, and a $960 dependent care tax credit—for a total amount of tax credits of $4,960. The couple's net tax liability under present law and under the proposal are computed as follows:

	Present law	Proposal
Adjusted gross income	$65,800	$65,800
Less standard deduction	7,200	7,200
Less personal exemptions (6 @ $2,750)	16,500	16,500
Taxable income	42,100	42,100
Regular tax (15% of $42,100)	6,315	6,315
Tentative minimum tax (26% of $20,800)	5,408	5,408
Pre-limitation credits ($1,000+$3,000+$960)	4,960	4,960

[109] See H. Rept. 99–426, pp. 305–306, and S. Rept. 99–313, p. 518.

	Present law	Proposal
Section 26(a) limit on nonrefundable credits:		
Regular tax	6,315	6,315
Less tentative minimum tax for sec. 26(a)(2)	5,408	0
Maximum nonrefundable credits allowable	907	6,315
Total credits allowed	907	4,960
Net tax	5,408	1,355
Net tax reduction	....	4,053

Example 2.—Assume the same facts as Example 1, except the couple has five dependent children, three of whom qualify for the child tax credit, and their adjusted gross income is $68,550. Thus, the couple is eligible for tax credits totaling $5,460. Also assume the couple paid $5,000 in social security taxes for purposes of determining the refundable child tax credit for three or more qualifying children. The couple's net tax liability under present law and under the proposal are computed as follows:

	Present law	Proposal
Adjusted gross income	$68,550	$68,550
Less standard deduction	7,200	7,200
Less personal exemptions (7 @ $2,750)	19,250	19,250
Taxable income	42,100	42,100
Regular tax (15% of $42,100)	6,315	6,315
Tentative minimum tax (26% of $23,550)	6,123	6,123
Pre-limitation credits ($1,500+$3,000+$960)	5,460	5,460
Section 26(a) limit on nonrefundable credits:		
Regular tax	6,315	6,315
Less tentative minimum tax for sec. 26(a)(2)	6,123	0
Maximum nonrefundable credits allowable	192	6,315
Total nonrefundable credits allowed	192	5,460
Section 24(d) refundable child credit [110]	1,500	0
Total credits allowed	1,692	5,460
Net tax	4,623	855

[110] Section 24(d) provides for a refundable child credit for families with three or more eligible children. The section 24(d) credit is the lesser of (1) the amount by which allowable credits would increase if the social security taxes were added to the section 26(a) limit or (2) the amount of the child tax credit, determined without regard to the section 26(a) limitation. Under present law, the section 24(d) child credit would be $1,500 (the lesser of $1,500 or the amount that the total credits would be increased if the section 26(a) limit is increased by the $5,000 social security taxes paid). Because the credits would be allowed in full under the proposal, the couple's section 24(d) child credit would be zero under the proposal.

	Present law	Proposal
Net tax reduction	....	3,768

Under the proposal, in addition to the tax savings, the couple would no longer be required to compute the tentative minimum tax or the section 24(d) refundable child credit to determine their net tax liability.

Example 3.—Assume the same facts as Example 2, except the couple has six dependent children, four of whom are eligible for the child credit, and their adjusted gross income is $71,300. Thus, the couple is eligible for tax credits totaling $5,960. The couple's net tax liability under present law and under the proposal are computed as follows:

	Present law	Proposal
Adjusted gross income	$71,300	$71,300
Less standard deduction	7,200	7,200
Less personal exemptions (8 @ $2,750)	22,000	22,000
Taxable income	42,100	42,100
Regular tax (15% of $42,100)	6,315	6,315
Tentative minimum tax (26% of $26,300)	6,838	6,838
Minimum tax ($6,838 less $6,315)	523	523
Pre-limitation credits ($2,000+$3,000+$960)	5,960	5,960
Section 26(a) limit on nonrefundable credits:		
Regular tax	6,315	6,315
Less tentative minimum tax for sec. 26(a)(2)	6,838	0
Maximum nonrefundable credits allowable	0	6,315
Total nonrefundable credits allowed	0	5,960
Section 24(d) refundable child credit [111]	1,477	0
Total credits allowed	1,477	5,960
Net tax	5,361	878
Net tax reduction	....	4,483

Under the proposal, in addition to the tax savings, the couple would no longer be required to compute the tentative minimum tax or the section 24(d) refundable child credit to determine their net tax liability.

Example 4.—Assume in 1999 a married couple has an adjusted gross income of $63,050, they do not itemize deductions, and they have three dependent children who qualify for the child tax credit. Also assume the couple is entitled to a dependent care credit of

[111] Under present law, the $1,477 section 24(d) refundable child credit is $2,000 less the $523 minimum tax liability. Because the credits would be allowed in full under the proposal, the couple's section 24(d) child credit would be zero under the proposal.

$960. Thus, the couple is eligible for $2,460 of credits. Also, assume the couple paid $4,000 in social security taxes for purposes of determining the refundable child credit for three or more qualifying children. The couple's net tax liability under present law and under the proposal are computed as follows:

	Present law	Proposal
Adjusted gross income	$63,050	$63,050
Less standard deduction	7,200	7,200
Less personal exemptions (5 @ $2,750)	13,750	13,750
Taxable income	42,100	42,100
Regular tax (15% of $42,100)	6,315	6,315
Tentative minimum tax (26% of $18,050)	4,693	4,693
Pre-limitation credits ($1,500+$960)	2,460	2,460
Section 26(a) limit on nonrefundable credits:		
Regular tax	6,315	6,315
Less tentative minimum tax for sec. 26(a)(2)	4,693	0
Maximum nonrefundable credits allowable	1,622	6,315
Total nonrefundable credits allowed	1,622	2,460
Section 24(d) refundable child credit [112]	838	0
Total credits allowed	2,460	2,460
Net tax	3,855	3,855
Net tax reduction	....	0

Although there would be no net tax reduction under the proposal, the couple would no longer be required to compute the tentative minimum tax or the section 24(d) refundable child credit to determine their net tax liability.

2. Extend the work opportunity tax credit

Present Law

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

Generally, no more than $6,000 of wages during the first year of employment is permitted to be taken into account with respect to

[112] Under present law, this is the amount (not in excess of the $1,500 child tax credit) by which the nonrefundable credits would have been increased if the social security taxes were added to the section 26(a) limitation ($2,460 total credits less $1,622 credits otherwise allowable).

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, 1999.

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

Description of Proposal

The proposal would extend the WOTC for one year (through June 30, 2000). The proposal would also clarify the coordination of the WOTC and the welfare-to-work tax credit with respect to an individual whose first year of employment does not coincide with the employer's taxable year.

Effective Date

Generally, 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, 1999, and before July 1, 2000. The clarification of the coordination of WOTC and the welfare-to-work tax credit would be effective for taxable years beginning on or after the date of first committee action.

Prior Action

A 22-month extension of the WOTC was included in the President's fiscal year 1999 budget proposal.

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.[113]

The 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

[113] 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).

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 35-percent corporate income tax rate, the cost of hiring the credit-eligible worker is lower than the cost of hiring a credit-ineligible worker for 2,000 hours at the same hourly wage *w* by 2,400 (1 − .35) = $1,560.[114] This $1,560 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,

[114] The after-tax cost of hiring this credit eligible worker would be ((2,000)(w) − 2,400)(1 − .35) 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.

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").[115]

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 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.[116]

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.[117] In these latter cases, the TJTC provided a cash benefit to the firm, without affecting the decision to hire a particular worker.

3. 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

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[115] 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.

[116] 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.

[117] 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.

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 two 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 the health care continuation rules (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 June 30, 1999.

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 July 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 June 30, 1999 and before July 1, 2000.

Prior Action

A one-year extension of the welfare-to-work tax credit was included in the President's fiscal year 1999 budget proposal.

Analysis

Proponents argue that an extension of the welfare-to-work tax credit will encourage employers to hire, train, 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.G.2., above, of this pamphlet.)

4. 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,[118] 1999.

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

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984–1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.[119]

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

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[118] 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.

[119] 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)).

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 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").[120]

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

[120] 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.

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 particular, expenditures undertaken in the Commonwealth of Puerto Rico are not eligible for the research credit. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

Relation to deduction

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, 1999, through June 30, 2000.

The proposal also would make expenditures on qualified research activities undertaken in the Commonwealth of Puerto Rico eligible for the research tax credit.

Effective Date

The proposal would be effective for qualified research expenditures paid or incurred during the period July 1, 1999, through June 30, 2000. With respect to qualifying activities undertaken in Puerto Rico the provision would be effective for taxable years beginning on or after the date of enactment.

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). The Tax and Trade Relief Extension Act of 1998 extended the research credit for 12 months, i.e., through June 30, 1999.

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.[121] However, this does not mean that increased tax benefits or more government spending for research always will improve economic efficiency. It is possible 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 evidence that the current level of research undertaken in the United States, and worldwide, is too little to maximize society's well-being.[122]

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

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

[122] See Zvi Griliches, "The Search for R&D Spillovers," *Scandinavian Journal of Economics*, XCIV, (1992) 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. Griliches concludes, "In spite of [many] difficulties, there has been a significant number of reasonably well-done studies all pointing in the same direction: R&D spillovers are present, their magnitude may be quite large, and social rates of return remain significantly above private rates." (p. S43)

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 1999. The related tax expenditure for expensing of research and development expenditures is estimated to be $1.9 billion for 1999 growing to $3.0 billion for 2003.[123] As noted above, the Federal Government also directly subsidizes research activities. For example, in fiscal 1998 the National Science Foundation made $2.4 billion in grants, subsidies, and contributions to research activities, the Department of Defense financed $2.1 billion in advanced technology development, and the Department of Energy financed $250 million in fuels research and clean/efficient power systems research.[124]

Tables 2 and 3 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 3 documents, a large number of small firms are engaged in research and are able to claim the research tax credit.

Table 2.—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 staff calculations from Internal Revenue Service, *Statistics of Income* data.

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[123] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1999–2003* (JCS–7–98), December 14, 1998, p.15.

[124] Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2000: Appendix*, pp. 1062, 291, and 400.

Table 3.—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: Joint Committee on Taxation staff 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.[125] Unfortunately, it is nearly impossible as a practical matter to determine which particular projects would be undertaken

[125] 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.

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 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.[126] 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.[127]

Despite the central role of the measurement of the price elasticity of research activities, there is little empirical evidence on this

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[126] 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.

[127] 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.

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.[128]

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.[129] 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

[128] 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.

[129] 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, 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.

Other research suggests that many of the elasticity studies may overstate the efficiency of subsidies to research. Most R&D spending is for wages and the supply of qualified scientists is small, particularly in the short run. Subsidies may raise the wages of scientists, and hence research spending, without increasing actual research. See Austan Goolsbee, "Does Government R&D Policy Mainly Benefit Scientists and Engineers?" National Bureau of Economic Research Working Paper #6532, April 1998.

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.[130]

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.[131]

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

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[130] 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.

[131] 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.

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.[132]

Under present law, research activities conducted in U.S. territories are not eligible for the research credit. Some have advocated that, to help foster economic development in the territories, it might be appropriate to extend credit eligibility to research undertaken in U.S. territories. Proponents note that incomes in the territories, and particularly in Puerto Rico, lag behind those of the States.[133]

Permitting the research credit to be claimed for activities in the territories may encourage businesses to expand in the territories and encourage the growth of technology industries in the territories. Technology industries generally pay higher wages. It is unclear whether, and in what manner, the research credit would apply to active businesses located in the territories that are subsidiaries of a U.S. business. If an active business in a U.S. territory is a branch of a domestic corporation, the taxation of its activity in the territory, including any qualified research activities, would be equivalent to the taxation of the same activities carried out in the States. However, in this circumstance, the corporation may be able to claim the economic activity credit permitted under section 30A. Coordination of the research credit with the economic activity credit may be appropriate under such circumstances.[134]

5. Make permanent the expensing of brownfields remediation costs

Present Law

Code section 162 allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Treasury regulations provide that the cost of incidental repairs which neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. Section 263(a)(1) limits the scope of section 162 by prohibiting a

[132] 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.

[133] The 1990 Census reported that in 1989 the median family income in the United States was $35,225, while in Puerto Rico it was $9,988, in the Virgin Islands it was $24,036, in Guam it was $31,178, in American Samoa it was $15,979, and in the Northern Mariana Islands it was $21,275. Bureau of the Census, U.S. Department of Commerce, *Statistical Abstract of the United States*, 1997, p. 813.

[134] The Administration proposes extending and modifying the section 30A credit. See Part I.I.1 of this pamphlet for a description and discussion of that proposal.

current deduction for certain capital expenditures. Treasury regulations define "capital expenditures" as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Under Code section 198, taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property, which would otherwise be allocated to the site under the principles set forth in *Commissioner* v. *Idaho Power Co.*[135] 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[136] (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

[135] *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)).

[136] 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.

within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use.

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

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

An identical proposal was included in the President's fiscal year 1999 budget proposal. 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.[137] 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.

6. Extend tax credit for first-time D.C. homebuyers

Present Law

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

The credit is scheduled to expire for residences purchased after December 31, 2000.

Description of Proposal

The D.C. first-time homebuyer tax credit would be extended for 12 months, from January 1, 2001, through December 31, 2001.

Effective Date

The proposal would be effective on the date of enactment.

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

Prior Action

No prior action.

Analysis

The District of Columbia has experienced a long-term decline in the number of residents, though there are some signs that this trend may be slowing down or reversing.[138] Between 1990 and 1998, the District of Columbia population fell by 83,776, from 606,900 to 523,124.[139] The D.C. first-time homebuyer credit aims to encourage eligible homebuyers to buy in the District of Columbia rather than in the outlying suburbs in Virginia and Maryland. The aim is to encourage home ownership in the District of Columbia to stabilize or increase its population and thus to improve its tax base.

Recently, home sales in the District of Columbia have reached record levels, and sales prices have increased. From 1996 to 1998, home sales have increased 90 percent, and average prices have risen 6.5 percent. However, the market has been strong across the entire metropolitan region, with home sales up 45 percent and prices up 6 percent from 1996 to 1998.[140] It is thus difficult to know the extent to which the D.C. homebuyer credit may have been a factor in the surge in home sales.

A number of policy issues are raised with respect to whether the D.C. homebuyer credit should be extended. One concern is whether it is the proper role of the Federal government to distort local housing markets by favoring the choice of home ownership in one jurisdiction over another. Favoring home ownership in one area can only come at the expense of home ownership in adjacent areas. Thus, if the credit stimulates demand in the District of Columbia, this can only come at the expense of demand in other portions of the relevant housing market, namely the nearby suburbs of Virginia and Maryland.

To the extent that local jurisdictions vary in their tax rates and services, individuals purchasing a home will choose to buy in the jurisdiction that offers them the combination of tax rates and services and other amenities that they desire. If a jurisdiction has a low tax rate, some might choose it on that basis. If a jurisdiction has a high tax rate but offers a high level of services, some will decide that the high tax rate is worth the services and will choose to buy in that jurisdiction. If tax rates are high but services are not correspondingly high, individuals may avoid such jurisdictions. It is in part this individual freedom to choose where to live that can promote competition in the provision of local public services, helping to assure that such services are provided at reasonable tax rates. If a jurisdiction fails at providing reasonable services at reasonable tax rates, individuals might choose to move to other jurisdictions. This may cause property values in the jurisdiction to fall, and, together with taxpayer departures, may put pressure on the

[138] See "Population Loss Eases Again in District," *The Washington Post*, December 31, 1998, p. A1.

[139] See "State Population Estimates and Demographic Components of Population Change: April 1, 1990 to July 1, 1998," Department of Commerce, Bureau of the Census.

[140] See "SOLD! It's a Hot Market as Sales and Prices Rise Across the Region," *The Washington Post*, January 30, 1999, p. G 1.

local government to change its behavior and improve its services. If the Federal government were to intervene in this market by encouraging the purchase of a home in one local market over another, competition among local jurisdictions in the provision of public services may be undermined.

In the above scenario, however, a dwindling tax base may make it financially difficult to improve government services. Many would argue that the District of Columbia has found itself in this position and that it needs Federal assistance to reverse the downward spiral of poor services leading to a smaller tax base, which then leads to even poorer services. The tax credit may help reverse this process by improving the District's revenue base. An alternative view is that the tax credit could take some of the pressure off the local government to make necessary improvements. By improving the local government's tax base without a commensurate improvement in government services, the Federal expenditure could encourage a slower transition to good governance.

Some argue that the credit is appropriate because a number of factors distinguish the District of Columbia from other cities or jurisdictions and that competition among the District and neighboring jurisdictions is constrained by outside factors. For example, some argue that the credit is a means of compensating the District for an artificially restricted tax base. While many residents of the suburbs work in the District and benefit from certain of its services, the Federal government precludes the imposition of a "commuter tax," which is used by some other jurisdictions to tax income earned within the jurisdiction by workers who reside elsewhere. In addition, some argue that the District has artificially reduced property, sales, and income tax revenues because the Federal government is headquartered in the District. The Federal government makes a payment to the District to compensate for the forgone revenues, but some argue that the payment is insufficient. Some also argue that to the extent migration from the District is a result of a high tax rate and poor services, it is not entirely within the control of the District to fix such problems, because the District government is not autonomous, but is subject to the control of Congress.

Another issue regarding the D.C. homebuyer credit is how effectively it achieves its objective. Several factors might diminish its effectiveness. First, the $5,000 will not reduce the net cost of homes by $5,000. Some of the $5,000 is likely to be captured by sellers, as eligible buyers entering the market with effectively an additional $5,000 to spend will push prices to levels higher than would otherwise attain. If the supply of homes for sale is relatively fixed, and potential buyers relatively plentiful, then the credit will largely evaporate into sellers' hands through higher prices for homes.

A second reason the credit might not be very effective at boosting the residential base of the District is that it applies to existing homes as well as any new homes that are built. Thus, the family that sells its D.C. home to a credit-eligible buyer must move elsewhere. To the extent that they sell in order to move outside of the District of Columbia, there is no gain in D.C. residences. And to the extent that the credit caused home prices to rise, the credit can be seen as an encouragement to sell a home in the District as much as an encouragement to buy.

Finally, the income restrictions on the credit might lead to a lower level of average incomes in the District of Columbia than would have otherwise been the case in the absence of the credit. Such lower average incomes would reduce the D.C. income tax base, thus potentially undermining an objective of the credit, if the lower average income is not outweighed by an increase in the number of residents. To see how this could be so, consider two families, each seeking housing in the D.C. area, one with an income of $100,000 who is eligible for the full credit and one with an income of $130,000 and thus not eligible. Now consider two homes, one in Virginia and one in the District of Columbia, that each can objectively be said to be worth $300,000 in the absence of the credit. The credit-eligible family with the lower income has a much greater incentive to buy the D.C. home, as the net cost to them would be only $295,000, assuming the price did not increase as a result of the credit. The credit-ineligible family would be indifferent. Because of the credit, credit-eligible families would be willing to pay up to $305,000 for the home in the District, at which point they would be indifferent between the D.C. home and the $300,000 Virginia home. Because of demand induced by the cedit, the price of the D.C. home might thus increase to, perhaps, $302,000, yielding a net cost to the credit-eligible buyer of $297,000. To the credit-eligible buyers, the $302,000 price for the D.C. home has a lower net cost than the $300,000 Virginia home, and thus they would prefer the D.C. home at the higher gross price. The credit-ineligible buyers would not partake in bidding up the price of the D.C. home because they would bear the full cost of the higher sales price, and would thus prefer the similar Virginia home at the $300,000 price to any price above $300,000 for the D.C. home. The outcome might be that some upper middle class families get "pushed-out" to the suburbs as a result of the credit, which would actually undermine the District's income tax base because average incomes would fall as a result.

H. 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 ($72,600 for OASDI taxes in 1999 and indexed annually, and without limit for the Hospital Insurance tax). Special rules allow certain self-employed individuals to continue to maintain social security coverage during a period of low income. The method applicable to farmers is slightly more favorable than the method applicable to other self-employed 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, 1999.

Prior Action

The proposal was included in the Administration's 1997 tax simplification proposals [141] and the President's budget proposal for fiscal year 1999. A similar proposal was also included in the Taxpayer Relief Act of 1997, as passed by the House. However, that provision also would have initially increased the $2,400 limit to the amount that would provide for four quarters of coverage in 1998, and increased the limit thereafter as the earnings requirement for quarters of coverage increases under the Social Security Act. That provision also would have provided that the optional method could not be elected retroactively on an amended return.

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

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 securities or commodities trader or dealer that is 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).

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 generally would 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.

Effective Date

The proposal generally would be effective 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

This proposal is substantially identical to a proposal made in the President's budget proposals for fiscal years 1998 and 1999.

Analysis

Overview

The basic thrust of the Administration proposal is (1) to codify certain positions taken in regulations that deal with hedging transactions in light of the U.S. Supreme Court's decision in the *Arkansas Best* case and (2) to broaden those rules so that they apply to transactions that are intended to "manage" risk, not just those transactions that "reduce" risk.

The Administration proposal would codify the following positions taken by IRS regulations: (1) add supplies to the list of ordinary assets (e.g., jet fuel); (2) validate the IRS rule of the regulations that identification is necessary to get ordinary treatment of hedge gains and losses and that inaccurate identifications result in ordinary income and capital loss; (3) validate the IRS rule of the regulations that hedge gain and losses on short positions and options can be ordinary; and (4) validate the IRS rule of the regulations that the clear reflection of income standard of section 446 requires matching of hedging gains and losses to income from hedged positions.

Additional ordinary income assets

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.[142] 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.

Broaden definition of hedging

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

[142] The disparity between commodities dealers and dealers in other derivative contracts was reduced somewhat by the Taxpayer Relief Act of 1997, which added Code section 475(e) allowing commodities dealers to elect section 475 treatment.

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.

Timing rules

The proposal generally would codify the Treasury regulations' timing rules for hedges, with the advantages of codification described above. The hedge timing rules 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 also would 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.

3. Clarify rules relating to certain disclaimers

Present Law

There must be acceptance of a gift in order for the gift to be completed under State law, and there is no taxable gift for Federal gift tax purposes unless there is a completed gift. Most States have rules which provide that, when there is a disclaimer of a gift, the property passes to the person who would be entitled to the property had the disclaiming party died before the purported transfer.

In the Tax Reform Act of 1976, Congress provided a uniform disclaimer rule (sec. 2518) that specified how and when a disclaimer must be made in order to be effective for Federal transfer tax purposes. Under section 2518, a disclaimer is effective for Federal transfer tax purposes if it is an irrevocable and unqualified refusal to accept an interest in property and certain other requirements are satisfied. One of the requirements is that the disclaimer generally must be made in writing not later than nine months after the transfer creating the interest occurs. In order to be a qualified disclaimer, the disclaiming person must not have accepted the disclaimed interest or any of its benefits. Section 2518 currently is effective only for Federal transfer tax purposes (e.g., it is not effective for Federal income tax purposes).

In 1981, Congress added a rule to section 2518 that allowed certain transfers of property to be treated as a qualified disclaimer, even if not a qualified disclaimer under State law. In order to qualify, these transfer-type disclaimers must be a written transfer of the disclaimant's "entire interest in the property" to persons who would have received the property had there been a valid disclaimer under State law (sec. 2518(c)(3)). Like other disclaimers, the transfer-type disclaimer generally must be made within nine months of the transfer creating the interest.

Under present-law assignment of income principles, an individual can avoid tax on the income from property only after the individual has made a gift of the income-producing property, rather than simply assigning the income from the property.

Description of Proposal

The proposal would allow a transfer-type disclaimer of an "undivided portion" of the disclaimant transferor's interest in property to qualify under section 2518. Also, the proposal would allow a spouse to make a qualified transfer-type disclaimer where the disclaimed property is transferred to a trust in which the disclaimant spouse has an interest (e.g., a credit shelter trust). Further, the proposal would provide that a qualified disclaimer for transfer tax purposes under section 2518 also would be effective for Federal income tax purposes (e.g., disclaimers of interests in annuities and income in respect of a decedent).

Effective Date

The proposal would apply to disclaimers made after the date of enactment.

Prior Action

The proposal is identical to a provision contained in the House version of the Taxpayer Relief Act of 1997 and in the President's budget proposal for fiscal year 1999.

Analysis

Under present law, a State-law disclaimer can be a qualified disclaimer even (1) when it is only a partial disclaimer of the property interest, or (2) when the disclaimant spouse retains an interest in the property. It is currently unclear, however, whether a transfer-type disclaimer described in section 2518(c)(3) can qualify under similar circumstances. Thus, in order to equalize the treatment of State-law disclaimers and transfer-type disclaimers, it may be appropriate to allow a transfer-type disclaimer of an undivided portion of property or a transfer-type disclaimer where the disclaimant spouse has retained an interest in the property to be treated as a qualified disclaimer for transfer tax purposes.

The present-law rules pertaining to qualified disclaimers, as set forth in section 2518, are effective for Federal transfer tax purposes but not Federal income tax purposes. If a disclaimer satisfies the requirements for a qualified disclaimer under present law, it may be appropriate to allow the disclaimer to be effective for Federal income tax purposes as well as Federal transfer tax purposes. It should be noted, however, that allowing disclaimers to be effective for Federal income tax purposes would override the general assignment of income concepts in that area.

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").[143] 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

[143] A controlled foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote is treated as a 10/50 company with respect to any distribution out of earnings and profits for periods when it was not a controlled foreign corporation.

years beginning after December 31, 2002, out of earnings and profits accumulated in taxable years beginning before January 1, 2003, are subject to a single foreign tax credit limitation for all 10/50 companies (other than passive foreign investment companies). Dividends paid by a 10/50 company that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, continue to be subject to a separate foreign tax credit limitation for each such 10/50 company. Dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, out of earnings and profits accumulated in taxable years after December 31, 2002, are treated as income in a foreign tax credit limitation category in proportion to the ratio of the earnings and profits attributable to income in such foreign tax credit limitation category to the total earnings and profits (a so-called "look-through" approach). For these purposes, distributions are treated as made from the most recently accumulated earnings and profits. Regulatory authority is granted to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

Description of Proposal

The proposal would simplify the application of the foreign tax credit limitation by applying the look-through approach immediately to all dividends paid by a 10/50 company, regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated. The proposal would broaden the regulatory authority to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of the stock, 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, 1998.

Prior Action

The proposal was included in the President's fiscal year 1999 budget proposal. 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 includable in income by its shareholders as dividends, but the character of certain income items of the RIC may be passed through to shareholders receiving the dividend. A RIC generally may pass through to its shareholders the character of its long-term capital gains by designating a dividend it pays as a capital gain dividend to the extent that the RIC has net capital gain. A RIC generally also can pass through to its shareholders the character of its tax-exempt interest from State and municipal bonds, but only if, at the close of each quarter of its taxable year, at least 50 percent of the value of the total assets of the RIC consists of these obligations.

Under the Code, a 30-percent tax, collected by withholding, generally is imposed on the gross amount of certain U.S.-source income, such as interest and dividends, of nonresident alien individuals and foreign corporations (collectively, "foreign persons"). Dividends paid by a RIC generally are treated as dividends for withholding tax purposes, subject to the exceptions noted above. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable income tax treaty. In the case of dividends on portfolio investments, U.S. income tax treaties commonly provide for a withholding tax at a rate of at least 15 percent.

An exception from the U.S. 30-percent withholding tax is provided for so-called "portfolio interest." Portfolio interest is interest (including original issue discount) which would be subject to the U.S. withholding tax but for the fact that specified requirements are met with respect to the obligation on which the interest is paid and with respect to the interest recipient. Pursuant to these requirements, in the case of an obligation that is in registered form, the U.S. person who otherwise would be required to withhold tax must receive a statement that the beneficial owner of the obligation is not a United States person. Alternatively, if the obligation is not in registered form, it must be "foreign targeted." If the obligation is issued by a corporation or a partnership, the recipient of the interest must not have 10 percent or more of the voting power of the corporation or 10 percent or more of the capital or profits interest in the partnership. A corporate recipient of the interest must be neither a controlled foreign corporation receiving interest from a related person, nor (unless the obligor is the United States) a bank receiving the interest on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business. Finally, certain contingent interest does not qualify as portfolio interest.

Description of Proposal

In the case of a RIC that invests substantially all of its assets in certain debt instruments or cash, the proposal would treat all dividends paid by the RIC to shareholders who are foreign persons as interest that qualifies for the "portfolio interest" exception from the U.S. withholding tax. Under the proposal, the debt instruments taken into account to satisfy this "substantially all" test generally would be limited to debt instruments of U.S. issuers that would themselves qualify for the "portfolio interest" exception if held by a foreign person. However, under the proposal, some amount of foreign debt instruments that are free from foreign tax (pursuant to the laws of the relevant foreign country) also would be treated as debt instruments that count toward the "substantially all" test.

Effective Date

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

Prior Action

The proposal was included in the President's fiscal year 1999 budget proposal.

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.

6. Expand declaratory judgment remedy for non-charitable organizations seeking determinations of tax-exempt status

Present Law

In order for an organization to be granted tax exemption as a charitable entity described in section 501(c)(3), it generally must file an application for recognition of exemption with the IRS and receive a favorable determination of its status. Similarly, for most organizations, a charitable organization's eligibility to receive tax-deductible contributions is dependent upon its receipt of a favorable determination from the IRS. In general, a section 501(c)(3) organization can rely on a determination letter or ruling from the IRS regarding its tax-exempt status, unless there is a material change in its character, purposes, or methods of operation. In cases where an organization violates one or more of the requirements for tax exemption under section 501(c)(3), the IRS is authorized to revoke an organization's tax exemption, notwithstanding an earlier favorable determination.

In situations where the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or where the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax status. Specifically, section 7428 provides a remedy in the case of a dispute involving a determination by the IRS with respect to: (1) the initial qualification or continuing qualification of an organization as a charitable organization for tax exemption purposes or for charitable contribution deduction purposes, (2) the initial classification or continuing classification of an organization as a private foundation, (3) the initial classification or continuing classification of an organization as a private operating foundation, or (4) the failure of the IRS to make a determination with respect to (1), (2), or (3). A determination in this context generally is a final decision by the IRS affecting the tax qualification of a charitable organization, although it also can include a proposed revocation of an organization's tax-exempt status or public charity classification. Section 7428 vests jurisdiction over controversies involving such a determination in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the U.S. Tax Court.

Prior to utilizing the declaratory judgment procedure, an organization must have exhausted all administrative remedies available to it within the IRS. For the first 270 days after a request for a determination is made, an organization is deemed to not have exhausted its administrative remedies. Provided that no determination is made during the 270-day period, the organization may initiate an action for declaratory judgment after the period has elapsed. If, however, the IRS makes an adverse determination during the 270-day period, an organization may initiate a declaratory judgment immediately. The 270-day period does not begin with respect to applications for recognition of tax-exempt status until the date a substantially completed application is submitted.

In contrast to the rules governing charities, it is a disputed issue as to whether non-charities (i.e., organizations not described in section 501(c)(3), including trade associations, social welfare organizations, social clubs, labor and agricultural organizations, and fraternal organizations) are required to file an application with the IRS to obtain a determination of their tax-exempt status. If an organization voluntarily files an application for recognition of exemption and receives a favorable determination from the IRS, the determination of tax-exempt status is usually effective as of the date of formation of the organization if its purposes and activities during the period prior to the date of the determination letter were consistent with the requirements for exemption. However, if the organization later receives an adverse determination from the IRS, the IRS may assert that the organization is subject to tax on some or all of its income for open taxable years. Furthermore, as with charitable organizations, the IRS may revoke or modify an earlier favorable determination regarding an organization's tax-exempt status.

Under present law, a non-charity (i.e., an organization not described in section 501(c)(3)) may not seek a declaratory judgment with respect to an IRS determination regarding its tax-exempt status. The only remedies available to such an organization are to petition the U.S. Tax Court for relief following the issuance of a notice of deficiency or to pay any tax owed and sue for refund in federal district court or the U.S. Court of Federal Claims.

Description of Proposal

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

Effective Date

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

Prior Action

No prior action.

Analysis

The declaratory judgment procedures are designed to provide a relatively simple and prompt means (as compared to deficiency or refund proceedings) of judicial review of certain issues relating to the tax-exempt status of organizations. The primary benefit of permitting tax-exempt organizations other than those described in section 501(c)(3) to use the declaratory judgment procedures would be to provide a remedy in cases where the IRS delays action on an application for recognition of tax-exempt status filed by such an organization and, consequently, the organization is left uncertain about its status and any potential tax liability for an extended period of time. While section 501(c)(3) organizations that are eligible to receive tax-deductible contributions arguably require faster judicial resolution of issues related to their tax-exempt status in order to protect their ability to receive deductible contributions, it is unlikely that allowing non-charities access to the declaratory judgment procedures would impede this objective.

The proposal does not specify whether non-charities would be permitted to use the declaratory judgment procedures in situations other than an initial denial of tax-exempt status (e.g., a proposed revocation of exemption after the IRS previously had issued a favorable determination or a determination by the IRS that an organization should be reclassified from section 501(c)(4) to 501(c)(19)).

The proposal would limit jurisdiction over declaratory judgments for non-charities to the United States Tax Court.[144] The United States Tax Court is the only one of the three possible jurisdictions for present-law section 7428 declaratory judgment actions to have adopted formal procedural rules for such actions.[145] The most significant feature of these rules is that, in the case of a denial by the IRS for an initial determination of exemption, they generally confine the Court to a review based solely on the facts contained in the administrative record. Thus, the parties are not permitted to submit new evidence while the case is pending before the Court.

7. Simplify the active trade or business requirement for tax-free spin-offs

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if such property had been sold for its fair market value. An exception to this rule is where the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. Among the requirements that must be satisfied in order to qualify for tax-free treatment under section 355 is that, immediately after the distribution, both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business (sec. 355(b)(1)).[146] For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) if the corporation is not directly engaged in an active trade or business, then substantially all of its assets consist of stock and securities of a corporation it controls that is engaged in the active conduct of a trade or business (sec. 355(b)(2)(A)).

In determining whether a corporation satisfies the active trade or business requirement, the Internal Revenue Service's position for advance ruling purposes is that the value of the gross assets of the trade or business being relied on must constitute at least five percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[147] However, if the corporation is not directly engaged in an active trade or business, then the "substantially all" test requires that at least 90 percent of the value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.[148]

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[144] This limitation currently applies to declaratory judgments relating to tax qualification for certain employee retirement plans (sec. 7476).

[145] Rules of Practice and Procedure, U.S. Tax Court, Title XXI. Many of the U.S. Tax Court procedures have been adopted on a case-by-case basis by the U.S. District Court for the District of Columbia and the U.S. Court of Federal Claims.

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

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

[148] Rev. Proc. 86–41, sec. 4.03(4), 1986–2 C.B. 716; Rev. Proc. 77–37, sec. 3.04, 1977–2 C.B. 568.

Description of Proposal

The Administration proposes to simplify the active trade or business requirement by eliminating the "substantially all" test, and instead, applying the active business requirement on an affiliated group basis. In applying the active business requirement to an affiliated group, each relevant affiliated group (immediately after the distribution) must satisfy the requirement. For the distributing corporation, the relevant affiliated group would consist of the distributing corporation as the common parent and all corporations connected with the distributing corporation through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under sec. 1504(b)). The relevant affiliated group for a controlled corporation would be determined in a similar manner (with the controlled corporation as the common parent).

Effective Date

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

Prior Action

No prior action. However, a similar proposal (S. 2538) was introduced in the 105th Congress by Senator John Breaux.

Analysis

The proposal would make it easier for affiliated groups that operate active businesses using a holding company structure to engage in transactions that qualify for tax-free treatment under section 355. It is not uncommon for a holding company, in contemplation of a tax-free spin-off, to undergo a series of internal restructurings which serve little purpose other than to satisfy the active trade or business test. Applying the active trade or business requirement on a limited affiliated group basis is also consistent with the treatment accorded to affiliated groups for other purposes of section 355(b)(2).[149]

It is unclear whether section 355(b)(2)(A), which was enacted in 1954, was intended to impose different active trade or business tests depending on the corporate structure. Indeed, Treasury Regulations issued a year earlier had provided that a corporation would be treated as engaged in an active trade or business if it was engaged in the trade or business directly or indirectly through another corporation (the policies of which were directed by the corporate parent).[150] It is conceivable that the "substantially all" test was only intended to override that aspect of the regulations.

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

[150] Treas. Reg. sec. 29.112(b)(11)–2, 1953–1 C.B. 143.

I. Miscellaneous Provisions

1. 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 10-year transition period. Such credits apply to possession business income, which is derived from the active conduct of a trade or business within a U.S. possession or from the sale or exchange of substantially all of the assets that were used in such a trade or business. In contrast to the foreign tax credit, the Puerto Rico and possession tax credit is granted whether or not the corporation pays income tax to the possession.

One of two alternative limitations is applicable to the amount of the credit attributable to possession business income. Under the economic activity limit, the amount of the credit with respect to such income cannot exceed the sum of a portion of the taxpayer's wage and fringe benefit expenses and depreciation allowances (plus, in certain cases, possession income taxes); beginning in 2002, the income eligible for the credit computed under this limit generally is subject to a cap based on the corporation's pre-1996 possession business income. Under the alternative limit, the amount of the credit is limited to the applicable percentage (40 percent for 1998 and thereafter) of the credit that would otherwise be allowable with respect to possession business income; beginning in 1998, the income eligible for the credit computed under this limit generally is subject to a cap based on the corporation's pre-1996 possession business income. Special rules apply in computing the credit with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. The credit is eliminated for taxable years beginning after December 31, 2005.

Description of Proposal

The proposal would modify the credit computed under the economic activity limit with respect to operations in Puerto Rico only. First, the proposal would extend the December 31, 2005 termination date with respect to such credit to December 31, 2008. Second, the proposal would eliminate the limitation that applies the credit only to certain corporations with pre-existing operations in Puerto Rico. Accordingly, under the proposal, the credit computed under the economic activity limit would be available with respect to corporations with new operations in Puerto Rico.[151] 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.

[151] An operation would be defined as "new" if established after October 13, 1995, the end of the base period established by the Small Business Job Protection Act of 1996.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1998.

Prior Action

Similar proposals were included in the President's fiscal year 1998 and 1999 budget proposals.

Analysis

When the Puerto Rico and possession tax credit was repealed in 1996, the Congress expressed its concern that the tax benefits provided by the credit were enjoyed by only the relatively small number of large U.S. corporations that operate in the possessions and that the tax cost of the benefits provided to these possessions corporations was borne by all U.S. taxpayers. In light of the then current budget constraints, the Congress believed that the continuation of the tax exemption provided to corporations pursuant to the Puerto Rico and possession tax credit was no longer appropriate.

The proposal to extend and modify the credit computed under the economic activity limit is intended to provide an incentive for job creation and economic activity in Puerto Rico. In this regard, it should be noted that the Puerto Rican government itself has enacted a package of incentives effective January 1, 1998, designed to attract business investment in Puerto Rico. This proposal should be analyzed in light of these local initiatives which 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.[152] 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.[153] In 1996, per capita GDP in Puerto Rico was $8,104, while per capita GDP for the United States was $28,784.[154] Puerto Rico has long lagged the mainland by such measures of economic performance. (See Tables 4 and 5 below.) It has been these, or comparable, facts that have

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[152] 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*.

[153] *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.

[154] *Ibid*.

motivated efforts to encourage economic development in Puerto Rico.

Table 4.—Unemployment Rate in the United States and Puerto Rico, Selected Years, 1970–1997

	1970	1980	1985	1990	1995	1996	Dec. 1997
United States	4.9	7.1	7.2	5.6	5.6	5.4	4.7
Puerto Rico	10.0	17.0	21.0	14.0	14.0	14.0	14.5

Source: U.S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States, 1997*. December 1997 figures are preliminary data from the Bureau of Labor Statistics.

Table 5.—Per Capita Gross Domestic Product for the United States and Puerto Rico, Selected Years, 1980–1995

[Current year dollars]

	1980	1985	1990	1995
United States	12,226	17,529	22,979	27,571
Puerto Rico	3,475	4,441	6,130	7,640

Source: U.S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States, 1997.*

The credit computed under the economic activity limit as provided in section 30A reduces the Federal income tax burden on economic activity located in Puerto Rico. By reducing the Federal income tax burden, the credit may make it attractive for a business to locate in Puerto Rico, even if the costs of operation or transportation to or from the United States would otherwise make such an undertaking unprofitable. As such, the credit is a deliberate attempt to distort taxpayer behavior. Generally, distortions of taxpayer behavior, such as those that distort decisions regarding investment, labor choice, or choice of business location reduce overall well-being by not putting labor and capital resources to their highest and best use. However, proponents of the credit argue that such a distortion of choice may increase aggregate economic welfare because Puerto Rico has so many underutilized resources, as evidenced by its chronic high unemployment rate.

Some also have suggested that the credit may offset partially certain other distortions that exist in the Puerto Rican economy. For example, some have suggested that the application of the Federal minimum wage, which generally has been chosen based on the circumstances of the States, to Puerto Rico may contribute to Puerto Rico's relatively high unemployment rate. Others have suggested that the cost of investment funds to Puerto Rican businesses may be higher than is dictated by the actual risk of those investments. If this is the case, there may be an imperfect capital market. The credit, as it applies to wages and capital, may partially offset a distortion created by the minimum wage or a capital market imperfection.

The proposal would extend the credit computed under the economic activity limit with respect to operations in Puerto Rico to new business operations in Puerto Rico. The credit computed under the economic activity limit is based loosely on the value added by a business that occurs within a qualifying Puerto Rican facility. That is, the credit is based upon compensation paid to employees in Puerto Rico and upon tangible personal property located in Puerto Rico. Proponents of the credit note that this design does not bias a business's choice of production between more labor intensive or more capital intensive methods, and thus should not promote an inefficient use of resources in production.[155] 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 are left to the private sector rather than being made by government officials.

2. Exempt first $2,000 of severance pay from income tax

Present Law

Under present law, severance payments are includible in gross income.

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[155] 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.

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 at least 95 percent of the compensation the individual received before the separation from service. The exclusion would not apply if the total severance payments received by the individual exceed $75,000.

Effective Date

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

Prior Action

A similar proposal was included in the President's fiscal year 1999 budget proposal.

Analysis

The proposal lacks specificity in certain respects. For example, the proposal does not define a "reduction in the employer's work force." Without an adequate definition, almost any termination of employment could be construed as in connection with a reduction in the employer's work force, meaning that up to $2,000 of any payments made upon termination of employment would be excludable from income. While the proposal was not intended to be interpreted so broadly, additional details would be necessary to 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 $75,000 cap is exceeded.

It is also not clear from the proposal whether the exclusion is a one-time exclusion, an annual exclusion, or whether it applies separately to each qualifying separation from service of the individual.

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 do not exceed $75,000, is one way of addressing this concern, as is the restriction that the exclusion does not apply if comparable employment is attained within 6 months. Other methods would also be possible, but would also add complexity to the proposal. The 6-month rule may itself add some complexity, because the new employment may occur in a tax year other than the one in which the payments were received and after the individual's tax return for the year of payment had been filed. An individual may need to file an amended return in such cases.

3. Extend carryback period for NOLs of steel companies

Present Law

The net operating loss ("NOL") of a taxpayer (generally, the amount by which the business deductions of a taxpayer exceeds its gross income) may be carried back two years and carried forward 20 years to offset taxable income in such years. A taxpayer may elect to forgo the carryback of an NOL. In the case of NOLs arising from (1) casualty or theft losses of individual taxpayers, or (2) losses incurred in a Presidentially declared disaster area by small business taxpayers, such NOLs can be carried back three years. NOLs attributable to a farming business may be carried back 5 years, whether or not incurred in a Presidentially declared disaster area. Other special rules apply to real estate investment trusts (REITs) (no carrybacks), specified liability losses (10-year carryback), and excess interest losses (no carrybacks).

Description of Proposal

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

Effective Date

The proposal would be effective for taxable years ending after the date of enactment, regardless of when the NOL arose. The proposal would not apply to taxable years ending 5 years or more after the date of enactment.

Prior Action

No prior action.

Analysis

The NOL carryback and carryforward rules allow taxpayers to smooth out swings in business income (and Federal income taxes thereon) that result from business cycle fluctuations and unexpected financial losses. Some argue that the steel industry is particularly vulnerable to such fluctuations and losses because foreign governments subsidize or otherwise encourage the export of steel in order to preserve their domestic steel industry.

On the other hand, Congress has determined that a two-year carryback of NOLs is sufficient in all but extraordinary situations. Many industries face the challenge of subsidized foreign competition. It is argued that it is not appropriate to provide a special set of rules for the steel industry and not for other industries.

J. Electricity Restructuring

1. Tax-exempt bonds for electric facilities of public power entities

Present Law

In general

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (Code sec. 103). Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person ("private activity bonds") is taxable unless the purpose of the borrowing is approved specifically in the Code or in another provision of a revenue Act. The provision of electric service (generation, transmission, distribution, and retailing) is an activity eligible for financing with governmental tax-exempt bonds when the financed facilities are used by or paid for by a State or local government ("public power"). Except as described below, public power is subject to the same limits on private business use that apply to other governmental functions. Exempt-facility private activity tax-exempt bonds for the provision of electric service (*e.g.*, bonds for investor-owned utilities) may be issued only for facilities used in the local furnishing of electricity.[156]

The general structure of the rules for determining whether a tax-exempt bond is a governmental or a private activity bond was enacted in 1968, at which time State or local government bonds were classified as "industrial development bonds" if private business use and security for debt repayment exceeded 25 percent of the proceeds and debt service.[157] The Tax Reform Act of 1986 (the "1986 Act") further restricted the amount of private business use that may be financed before a State or local government bond is classi-

[156] Local furnishing is limited to private facilities serving no more than two counties (or a city and a contiguous county). Further, these tax-exempt bonds may only be issued for the benefit of persons engaged in that activity on January 1, 1997, and in general only for areas served on that date.

[157] Industrial development bonds were subsumed into the category of "private activity bonds" by the 1986 Act.

fied as a private activity bond (and therefore in the case of bonds for the provision of electric service, generally lose their tax-exempt status). The principal present-law test for determining whether a State or local government bond is in substance a private activity bond consists of two parts:

(1) More than 10 percent of the bond proceeds is to be used (directly or indirectly) by a private business; and

(2) More than 10 percent of the debt service on the bonds is secured by an interest in property to be used in a private business use or to is be derived from payments in respect of such property.[158]

In the case of public power bonds, the maximum amount of private business use is limited to the *lesser* of 10 percent *of the bond proceeds* or $15 million *per facility*. All outstanding bonds are included in calculating the $15 million limit. This per-facility limit is more restrictive than the general per-bond-issue limit on private business use for bonds for other governmental activities. Because power facilities such as generating plants are costly, the substantive effect of the $15 million limit is to reduce the otherwise permitted amount of private business use of those facilities.

The Statement of Managers accompanying the 1986 Act states that ". . . trade or business use by all persons on a basis different from the general public is aggregated in determining if the 10-percent threshold for being a private activity bond is satisfied." See, H. Rept. 99–841, p. II–688. The *General Explanation of the Tax Reform Act of 1986*[159] further amplified this rule, as follows:

> The determination of who uses bond proceeds or bond-financed property generally is made by reference to the ultimate user of the proceeds or property. . . . [B]ond proceeds used to satisfy contractual obligations undertaken in connection with general governmental operations, such as payment of government salaries, or to pay legal judgments against a governmental unit, are not treated as used in the business of the payee. This is to be contrasted with the indirect nongovernmental use of bond proceeds that occurs when a government contracts with a nongovernmental person to supply that person's trade or business with a service (*e.g.,* electric energy) on a basis different from that on which the service is provided to the public generally or to finance property used in that person's business (*e.g.,* a manufacturing plant). In both of these instances a nongovernmental person is considered to use the bond proceeds other than as a member of the general public.

The 1986 Act included only four relevant exceptions to the general rule that all business use by a private person on a basis different from that available to other members of the general public is counted under the private business use test. First, a general exception for all governmental bonds provides that management of governmental facilities by private businesses is disregarded if the

[158] The 10-percent private use and payment limits are reduced to an amount equal to the lesser of 5 percent or $5 million in the case of loans. Present law further includes a more restrictive rule limiting the amount of governmental bond proceeds that may be used to finance private business activities that are unrelated to governmental activities also being financed with a bond.

[159] Joint Committee on Taxation (JCS–10–87), May 4, 1987, p. 1160.

management is pursuant to contracts having specified terms limiting the duration of the arrangement and the fees paid to the private business. Second, the legislative history to the 1986 Act provided three exceptions that are unique to public power. These exceptions allow spot sales of excess power capacity for temporary periods not exceeding 30 days, and disregard the presence of a nongovernmental person acting solely as a conduit for power-sharing among governmentally owned and operated utilities. They further allow "power-swapping" arrangements between public power and privately owned electric utilities if (1) the arrangements are designed to enable the respective utilities to satisfy differing peak load demands or to accommodate temporary outages, (2) the swapped power between the parties is approximately equivalent determined over periods of one year or less, and (3) no output-type contracts are involved.

The determination of whether interest on State or local government bonds is tax-exempt initially is made when the bonds are issued. That is, the determination is made by reference to how the bond proceeds are "to be used." Deliberate acts within the control of the issuer that are taken after the date of issuance to use bond-financed facilities (indirectly a use of bond proceeds) in a manner not qualifying for tax exemption may render interest on the bonds taxable, retroactive to the date of issuance (the "change in use rules"). A transaction giving rise to a prohibited change in use may be illustrated by a post-bond-issuance sale of public power electric output to private businesses in a manner not qualifying for tax-exemption (*e.g.*, an output-type contract with a private business for a period in excess of the 30 days provided for in the 1986 Act legislative history).

Both before and after 1986, the Treasury Department administratively has provided alternative sanctions to retroactive loss of tax-exemption for post-issuance changes in use in certain cases when the change was not reasonably expected at the time the bonds were issued. These alternative sanctions require immediate surrender of the benefits of tax-exempt financing by redemption of outstanding bonds, or if immediate redemption is precluded by pre-existing bond terms, by immediate defeasance of the bonds through establishment of an escrow account funded with taxable debt, and generally after 1993, accompanied by redemption on the first possible date.

Temporary and proposed treasury regulations affecting public power bonds

On January 21, 1998, the Treasury Department issued temporary and proposed regulations (T.D. 8757) affecting tax-exempt bonds of public power entities that participate in electric industry open access arrangements. These regulations are scheduled to expire three years after they were issued. The regulations include a general rule that, if an arrangement provides a private business user with rights to bond-financed property that are different from rights of the general public (i.e., transfers the benefits and burdens with respect to the property), the private use is counted under the 10-percent (and $15 million) limits described above. However, in the case of public power bonds, the regulations create special exceptions pursuant to which certain transactions entered into to facilitate an issuer's participation in open access arrangements are not treated as giving rise to private business use or as deliberate actions increasing the amount of private business use beyond that allowed under the Code.

The first such exception provides that contracts of up to three years duration for the sale to a nongovernmental person of excess electric output resulting from participation in an open access arrangement are not treated as private business use under certain circumstances. (Treas. Reg. sec. 1.141–7T(f)(4).) The purpose of the sale must be to mitigate costs of existing generating plants that the utilities no longer can recover as a result of competition ("stranded costs"). Issuers benefiting from the rule may not make tax-exempt-bond-financed expenditures to increase the generating capacity of their systems during the term of the contract; however, they may continue to benefit both from all of their outstanding tax-exempt bonds and newly issued bonds if the newly issued bonds are not used to increase capacity. Further conditions of this output contract exception are that issuers must offer non-discriminatory open access transmission tariffs for the use of their system under Federal Energy Regulatory Commission ("FERC") rules, and they must use any stranded cost recovery under the contracts to redeem bonds "as promptly as is reasonably practical."

The regulations also create two new exceptions under which private business use of public power transmission facilities is disregarded in determining whether a prohibited change in use has occurred. The first of these provides that the use of public power transmission facilities pursuant to contracts entered into in response to wheeling required (or expected to be required) under sections 211 and 212 of the Federal Power Act or comparable State laws is not treated as a post-issuance deliberate action violating the private business tests. (Treas. Reg. sec. 1.141–7T(f)(5)(i).) This regulatory exception mirrors a separate, statutory provision in Code section 142(f)(2). The statutory provision, enacted as part of the Energy Policy Act of 1992 (P.L. 102–486), applies only to private activity tax-exempt bonds for the local furnishing of electricity. The second exception for transmission facility bonds provides that other actions taken by public power entities to implement non-discriminatory, open access plans of FERC or a State are not treated as deliberate actions in determining whether the private business tests are violated with regard to outstanding tax-exempt bonds. (Treas. Reg. sec. 1.141–7T(f)(5)(ii).) There is no requirement in the second exception that the action be taken in response to or in anticipation of a requirement by the Federal Government or a State government.

In addition to preserving tax-exemption for previously issued public power transmission bonds under the circumstances described, the regulations permit public power to refund that debt with new bonds, notwithstanding violation of the general tax-exempt bond rule that tax-exempt refunding bonds may only be issued if the private business tests (and all other requirements for tax exemption) are satisfied on the date the refunding occurs. (Treas. Reg. sec. 1.141–7T(f)(5)(iii).)

Finally, the regulations provide that a "wholesale requirements" contract may violate the private business tests if the contract substantively results in private business use in excess of that allowed under the Code. (Treas. Reg. sec. 1.141–7T(c)(4).) A wholesale requirements contract is a contract under which the purchaser agrees to purchase all or a portion of its requirements from the seller. The regulations provide three primary factors that are to be used to establish whether requirements contracts violate the private business tests. Two of these factors describe attributes of investor-owned utilities (i.e., diverse customer base (including residential customers) and historical as opposed to projected requirements). Most proposed electric restructuring arrangements anticipate significant sales of electricity by independent power brokers (much like stock or commodities traders). These traders would not be expected to have customer bases similar to those of traditional electric utilities. The regulations specifically provide that use of property by a power broker is treated as private business use under the 1986 Act exception for power-swapping arrangements (Treas. Reg. sec. 1.141–7T(f)(6)).

Description of Proposal

In conjunction with legislative consideration of the Administration's Comprehensive Electricity Competition Plan,[160] the Administration would propose that tax-exempt bonds be allowed to be used in certain cases by public power entities participating in open access arrangements to finance new distribution facilities (including functionally related and subordinate property). No new electric generation or new transmission facilities could be financed with tax-exempt bonds by such entities. Distribution facilities would be defined as facilities operating at 69 kilovolts or less (including functionally related and subordinate property).

The proposal also would provide that bonds outstanding on the date of enactment would not lose their tax-exempt status if the bonds were used to finance: (1) transmission facilities the private use of which results from action pursuant to a FERC order requiring non-discriminatory open access to those facilities; or (2) generation or distribution facilities the private use of which results from retail competition or from the issuer entering into a contract for the sale of electricity or the use of its distribution property that will become effective after implementation of retail competition.

Sales of facilities financed with tax-exempt bonds to private entities would continue to constitute a change of use.

The proposal would permit current refunding, but not advance refunding, of bonds issued before the date of enactment.

Effective Date

The proposal would be effective on the date of enactment of the Administration's Comprehensive Electricity Competition Plan.

[160] The Comprehensive Electricity Competition Plan was announced on March 24, 1998 by the Department of Energy.

Prior Action

No prior action.

Analysis

The ability to finance capital and operating costs with tax-exempt bonds may substantially reduce the cost of debt finance. To illustrate, assume the interest rate on taxable debt is 10 percent. If an investor in the 36-percent marginal income tax bracket purchased a taxable debt instrument, his after-tax rate of return would be the 10-percent interest less a tax of 36 percent on the interest received for a net return of 6.4 percent. If as an alternative this investor could purchase a tax-exempt bond, all other things such as credit-worthiness being equal, he would earn a better after-tax return by accepting any yield greater than 6.4 percent.[161] In the market, the yield spread between a tax-exempt bond and comparable taxable bond is determined by the marginal buyer of the bonds; in today's market, yield spreads are generally less than 28 percent.[162] Because the yield spread arises from forgone tax revenue, economists say that tax-exempt finance creates an implicit subsidy to the issuer. However, with many investors in different tax brackets, the loss of Federal receipts is greater than the reduction in the tax-exempt issuers' interest saving.[163] The difference accrues to investors in tax brackets higher than those that would be implied by the yield spread between taxable and tax-exempt bonds.

Electric industry restructuring might have two distinct effects on public power and investor-owned utilities ("IOUs") that qualify for tax-exempt financing as local furnishers. First, if these utilities must use taxable bonds to finance generation facilities, their cost of capital is likely to rise.[164] Because competitors attempt to price their services to recover their capital costs, in the long run, prices of electricity provided by these generators might rise. In addition, because tax-exempt financing lowers the cost of debt capital, electric service providers that receive tax-exempt bond financing may rely more heavily on debt finance than other providers. Loss of the

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[161] More generally, if the investor's marginal tax rate is t and the taxable bond yields r, the investor is indifferent between a tax-exempt yield, r_e, and $(1-t)r$.

[162] For example, while not comparable in security, market trading recently has priced 30-year U.S. Treasuries to have a yield to maturity of approximately 5.4 percent. Prices for an index of long-term tax-exempt bonds have produced a yield to maturity of approximately 5.0 percent. See, *The Bond Buyer,* 327, February 12, 1999, p. 39. Again ignoring differences in risk or other non-tax characteristics of the securities, the yield spread implies that an investor with a marginal tax rate of 10 percent would be indifferent between the Treasury bond and the average high-yield tax-exempt bond.

[163] The Federal income tax has graduated marginal tax rates. Thus, $100 of interest income forgone to a taxpayer in the 31-percent bracket costs the Federal Government $31, while the same amount of interest income forgone to a taxpayer in the 28-percent bracket costs the Federal Government $28. If a taxpayer in the 28-percent bracket finds it profitable to hold a tax-exempt security, a taxpayer in the 31-percent bracket will find it even more profitable. This conclusion implies that the Federal Government will lose more in revenue than the tax-exempt issuer gains in reduced interest payments.

[164] Restructuring could cause outstanding bonds to lose their tax exemption. In practice, when an outstanding tax-exempt bond becomes taxable the issuer typically pays the Federal Government a negotiated settlement amount. Such payments would not raise the total interest expense to that incurred by an issuer who has issued taxable bonds unless the negotiated settlement amount equals the yield spread between the formerly tax-exempt bond and a comparable taxable bond. Moreover, even in such case, the "tax" recovered when an outstanding tax-exempt bond becomes taxable is less than the amount of tax that would have been paid had the bond initially been sold as a taxable bond offering taxable interest for the reasons explained in the preceding footnote.

ability to use tax-exempt financing may cause the affected entities to adjust their financial structure in the long run. In the short run, investors may view such providers as riskier investments than others because of their higher leverage ratios.

On the other hand, if these electric service providers were permitted to retain their ability to receive tax-exempt financing, they might have a considerable cost advantage over other generators in a deregulated market for generated power. The market share of such generators would expand and the implicit Federal subsidy to electric generation and certain investors might increase. In order to keep these providers from exploiting their capital cost advantage, the scope of restructuring may have to be smaller, perhaps by not permitting such generators to interconnect with the IOUs. Limiting interconnection, however, would limit the scope for exploiting system rationalization, inter-regional power sales, and efficiency gains.

A second effect that restructuring could have on current electric power industry beneficiaries of tax-exempt bonds is the so-called stranded cost problem. Analysts usually refer to the stranded cost problem in the context of privately owned facilities, but the problem can arise for public power as well. Bonds outstanding today have financed facilities. The prices charged for the electricity produced by these facilities is based on a non-competitive market in which the price is sufficient to meet the debt service demands of the bond. Under restructuring, the wholesale price of electricity may generate revenues insufficient to meet the debt service requirements of the facilities. In such a situation, to avoid possible default on the bonds, the utility may have to draw down reserves or devise some method to recover the original investment in the facilities.

Advocates of the President's proposal may argue that it ameliorates the stranded costs transition problem by allowing much currently outstanding tax-exempt debt to retain its status but does not give public power the unfair advantage of tax-exempt financing in any expansion. Also, they may argue that, the benefit is limited in duration because the refinancing may not extend the term of the debt beyond 120 percent of the economic life of the property being refinanced. Others may respond that this transition relief gives public power an unfair advantage in the market place by retaining the lower cost of capital resulting from their outstanding tax-exempt debt. They continue that even the limited duration of this financing perpetuates an unequal cost of capital which undermines fair competition On a prospective basis, some may argue, that the President's proposal correctly allows tax-exempt financing for distribution facilities (including functionally related and subordinate property). They believe that these facilities are less likely to be the subject of increased competition so there is no unfair competitive advantage as a result of this limited tax-exemption. Others believe that market competition and the public are the best served by eliminating tax-exemption for all new bond issues.

2. Modify treatment of contributions to nuclear decommissioning funds

Present Law

Special rules dealing with nuclear decommissioning reserve funds were adopted by Congress in the Deficit Reduction Act of 1984 ("1984 Act") when tax issues regarding the time value of money were addressed generally. Under general tax accounting rules, a deduction for accrual basis taxpayers generally is deferred until there is economic performance for the item for which the deduction is claimed. However, the 1984 Act contains an exception to those rules under which a taxpayer responsible for nuclear power plant decommissioning may elect to deduct contributions made to a qualified nuclear decommissioning fund for future payment costs. Taxpayers who do not elect this provision are subject to the general rules in the 1984 Act.

A qualified decommissioning fund is a segregated fund established by the taxpayer that is used exclusively for the payment of decommissioning costs, taxes on fund income, payment of management costs of the fund, and making investments. The fund is prohibited from dealing with the taxpayer that established the fund. The income of the fund is taxed at a reduced rate of 20 percent [165] for taxable years beginning after December 31, 1995.

Contributions to the fund are deductible in the year made to the extent that these amounts were collected as part of the cost of service to ratepayers. Withdrawal of funds by the taxpayer to pay for decommissioning expenses are included in income at that time, but the taxpayer also is entitled to a deduction at that time for decommissioning expenses as economic performance for those costs occurs.

A taxpayer's contributions to the fund may not exceed the amount of nuclear decommissioning costs included in the taxpayer's cost of service for ratemaking purposes for the taxable year. Additionally, in order to prevent accumulations of funds over the remaining life of a nuclear power plant in excess of those required to pay future decommissioning costs and to ensure that contributions to the funds are not deducted more rapidly than level funding, taxpayers must obtain a ruling from the IRS to establish the maximum contribution that may be made to the fund.

If the decommissioning fund fails to comply with the qualification requirements or when the decommissioning is substantially completed, the fund's qualification may be terminated, in which case the amounts in the fund must be included in income of the taxpayer.

Description of Proposal

The cost of service requirement for deductible contributions to nuclear decommissioning funds would be repealed. Thus, tax-

[165] As originally enacted in 1984, the fund paid tax on its earnings at the top corporate rate and, as a result, there would be no present-value tax benefit of making deductible contributions to the fund. Also, as originally enacted, the funds in the trust could be invested only in certain low risk investments. Subsequent amendments to the provision have reduced the rate of tax on the fund to 20 percent, and removed the restrictions on the types of permitted investments that the fund can make.

payers, including unregulated taxpayers, would be allowed a deduction for amounts contributed to a qualified nuclear decommissioning fund. As under current law, however, the maximum contribution and deduction for a taxable year could not exceed the IRS ruling amount for that year.

Effective Date

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

Prior Action

No prior action.

Analysis

The rationale for the present-law treatment of nuclear decommissioning costs is to assure that there is adequate funding available for the high cost of decommissioning these plants at the end of their useful life. This tax treatment also helps to spread the costs of the decommissioning over the life of the plant, rather than burdening future ratepayers with the entire expense.

The requirement of present law that the amount deducted cannot exceed the amount of nuclear decommissioning costs included in the taxpayer's cost of service for rate making purposes would imply that no amounts would be deductible for a utility that, in a deregulated electric power market, is no longer subject to cost of service rate regulation. If the rationale for the present-law treatment of nuclear decommissioning remains in a competitive environment, it would arguably be appropriate to drop the present-law cost of service requirement. Thus, regulated and unregulated owners of nuclear power plants would be treated equally.[166]

[166] See Joint Committee on Taxation, *Federal Income Tax Issues Arising in Connection with Proposal to Restructure the Electric Power Industry* (JCS–20–97), October 17, 1997.

II. PROVISIONS INCREASING REVENUES

A. Corporate Tax Shelters

1. Modify the substantial understatement penalty for corporate tax shelters

Present Law

Substantial understatement penalty

The accuracy-related penalty,[167] which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement.

The substantial understatement penalty applies in the following manner. If the correct income tax liability of a taxpayer for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there was a reasonable basis for the tax treatment of the item. In no event does a corporation have a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction if such treatment does not clearly reflect the income of the corporation.[168]

Special rules apply to tax shelters. With respect to tax shelter items of non-corporate taxpayers, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for his position, he reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters. The reduction in the understatement for items disclosed on the return is inapplicable to both corporate and non-corporate tax shelters. For this purpose, a tax shelter is a partnership or other entity, plan, or arrangement a significant purpose[169] of which is the avoidance or evasion of Federal income tax.

[167] Section 6662.
[168] This provision was enacted in section 1028 of the Taxpayer Relief Act of 1997.
[169] The standard of "a significant" purpose was enacted in section 1028 of the Taxpayer Relief Act of 1997. Previously, the standard was "the principal" purpose.

The penalty is not imposed if the taxpayer establishes with respect to any item reasonable cause for his treatment of the item and that he acted in good faith.

Tax shelter registration

The Code [170] requires a promoter of a corporate tax shelter to register the shelter with the Secretary. Registration is required not later than the next business day after the day when the tax shelter is first offered to potential users. If the promoter is not a U.S. person, or if a required registration is not otherwise made, then any U.S. participant is required to register the shelter. An exception to this special rule provides that registration would not be required if the U.S. participant notifies the promoter in writing not later than 90 days after discussions began that the U.S. participant will not participate in the shelter and the U.S. person does not in fact participate in the shelter.

A corporate tax shelter is any investment, plan, arrangement or transaction (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant, (2) that is offered to any potential participant under conditions of confidentiality, and (3) for which the tax shelter promoters may receive total fees in excess of $100,000.

A transaction is offered under conditions of confidentiality if: (1) an offeree (or any person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to restrict or limit its disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows or has reason to know (or the promoter causes another person to claim or otherwise knows or has reason to know that a party other than the potential offeree claims) that the transaction (or one or more aspects of its structure) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use. The promoter includes specified related parties.

Registration will require the submission of information identifying and describing the tax shelter and the tax benefits of the tax shelter, as well as such other information as the Treasury Department may require.

Tax shelter promoters are required to maintain lists of those who have signed confidentiality agreements, or otherwise have been subjected to nondisclosure requirements, with respect to particular tax shelters. In addition, promoters must retain lists of those paying fees with respect to plans or arrangements that have previously been registered (even though the particular party may not have been subject to confidentiality restrictions).

All registrations are treated as taxpayer information under the provisions of section 6103 and are therefore not subject to any public disclosure.

The penalty for failing to timely register a corporate tax shelter is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration (i.e., this part of the penalty does not apply to fee payments with respect to offerings after late registration). A similar penalty

[170] Section 6111(d).

is applicable to actual participants in any corporate tax shelter who were required to register the tax shelter but did not. With respect to participants, however, the 50-percent penalty is based only on fees paid by that participant. Intentional disregard of the requirement to register by either a promoter or a participant increases the 50-percent penalty to 75 percent of the applicable fees.

The tax shelter registration provision applies to any tax shelter offered to potential participants after the date the Treasury Department issues guidance with respect to the filing requirements. As of February 18, 1999, the requisite guidance has not yet been issued; accordingly, this new tax shelter registration provision is not yet effective.

Description of Proposal

The proposal would make three modifications to the substantial understatement penalty as it applies to corporate tax shelters. First, the rate of the penalty would be increased from 20 percent to 40 percent with respect to any item attributable to a corporate tax shelter. Second, that 40 percent rate would be reduced to 20 percent if the corporation fulfilled specified disclosure requirements. Third, the reasonable cause exception from the substantial understatement penalty would be unavailable with respect to any item attributable to a corporate tax shelter.

To fulfill the specified disclosure requirements, the corporate taxpayer must: (1) disclose (within 30 days of closing the transaction) to the National office of the IRS appropriate documents describing the transaction; (2) file a statement with the corporation's tax return verifying that this disclosure has been made; and (3) provide adequate disclosure on the corporation's tax returns as to the book/tax differences resulting from the corporate tax shelter item for all taxable years in which the tax shelter transaction applies.

The proposal would also provide a new statutory definition of a corporate tax shelter. A corporate tax shelter would be any entity, plan, or arrangement (to be determined based on all facts and circumstances) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction. A tax benefit would be defined to include a reduction, exclusion, avoidance, or deferral of tax, or an increase in a refund, but would not include a tax benefit clearly contemplated by the applicable provision (taking into account the Congressional purpose for such provision and the interaction of such provision with other provisions of the Code).[171]

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

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[171] This proposal is intended to interact with the proposal expanding section 269 through the denial of certain tax benefits to persons avoiding income tax as a result of tax avoidance transactions in the following manner. The section 269 proposal would expand the range of transactions where tax benefits are denied because it is a tax avoidance transaction. Consequently, the range of prohibited transactions subject to this penalty proposal would also be expanded.

a tax avoidance transaction would be defined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income.

The proposal would give the Secretary the authority to prescribe regulations necessary to carry out the purposes of the provision.

Effective Date

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

Prior Action

No prior action, except that the abolition of the reasonable cause exception may be contrasted with a 1997 Administration proposal to provide a uniform reasonable cause exception for penalties.[172]

Analysis

Some observers have noted that there appears to be a substantial increase in corporate tax shelter activity recently. These observers are concerned about serious, adverse consequences to the income tax from this activity. One adverse consequence could be the erosion of the corporate tax base. Another adverse consequence could be a decrease in voluntary compliance by many taxpayers (whether individuals or corporations), who could view the tax system as fundamentally unfair if large, well-advised corporations are able to substantially reduce or eliminate their tax liability through techniques unavailable to the general public. A third adverse consequence could be an increase in inefficiency in the economy generally through the diversion of capital (both intellectual and real) into nonproductive activities. Accordingly, some observers believe that it is appropriate to undertake significant initiatives to slow the spread of corporate tax shelters generally.

Some commentators have noted that the present-law rule that makes disclosure inapplicable in obtaining a reduction in the penalty with respect to tax shelter items may give taxpayers who engage in these transactions no reason not to conceal the transactions in their tax returns, which in turn may make it significantly more difficult for the IRS to audit the transaction. Some may question, however, whether doubling the penalty and then reducing it back to present-law levels with disclosure is the most appropriate mechanism to encourage greater disclosure and accordingly remedy this perceived defect in present law.

On the other hand, this concern may be less relevant if the intent of the proposal is to deter corporate tax shelter transactions from occurring, rather than just encouraging more disclosure. Those who are troubled by the recent growth of corporate tax shelters may expect the proposal to stop abusive transactions from occurring at all, rather than increasing disclosure.

Some observers have questioned whether the proposal's definition of a corporate tax shelter is too broad and fails to provide sufficient specificity for taxpayers to be on notice as to which trans-

[172] See page 1 of Department of the Treasury, *Taxpayer Bill of Rights 3 and Tax Simplification Proposals*, April 1997. This proposal was enacted as section 1281 of the Taxpayer Relief Act of 1997.

actions may be subject to these rules. Proponents might respond that the definition is intended to correlate with current case law, and so is not wholly new.[173] To the extent the proposal's definition of tax shelter is vague, some transactions for which disclosure is desirable may not be disclosed, while other transactions for which disclosure is not useful may be subject to disclosure. This could impose an unnecessary burden on taxpayers and could distract the IRS from pursuing the most significant transactions. In addition, it is unclear how the proposal's definition of a tax shelter would apply to certain corporate restructuring transactions where there is no profit motive, or to multi-step transactions, which can be viewed as separate transactions that may not have sufficient pre-tax profits unless viewed in the aggregate.

On the other hand, new types of transactions are continuously being created and marketed as corporate tax shelters. This continuing innovation may make it difficult to craft a definition of a corporate tax shelter that is sufficiently specific and that at the same time retains long-term viability. The proposal could be viewed as a first step towards a more workable definition of a corporate tax shelter.

There may be significant overlap between the proposal's disclosure provisions and the tax shelter registration provisions enacted in 1997. The proposal does not address possible resolutions of this overlap. Some have observed that the tax shelter registration provision is not yet effective because Treasury has not yet issued the guidance required by the statute before the provision is to become effective. Accordingly, it may be premature to propose new measures to deal with corporate tax shelters when provisions have already been enacted that are intended to do that, but where there has been no opportunity to evaluate the effectiveness of those already-enacted provisions because they have not yet become effective because of the lack of the required guidance.

Proponents of the proposal might respond in two ways. First, they believe that the proposal may be more narrowly targeted at inappropriate transactions than was the registration proposal, which may make it more efficacious at eliminating undesired behavior. Second, they believe that the apparently unabated level of corporate tax shelter activity requires additional legislative action beyond that already enacted.

The proposal would eliminate the reasonable cause exception with respect to corporate tax shelters. All of the major civil penalties in the Code contain a reasonable cause exception.[174] Accordingly, some might question whether it is appropriate to eliminate this reasonable cause exception, in light of the Code's complexity and the significant areas of uncertainty in its interpretation. On the other hand, the taxpayers involved in corporate tax shelters may be well equipped to deal with the complexity and uncertainty in the Code; in fact, many corporate tax shelter transactions are designed to take advantage of complex or uncertain provisions, as

[173] See, e.g., *ACM v. Commissioner*, 157 F. 3d 231 (1998).

[174] The estimated tax penalties (secs. 6654 and 6655) do not contain reasonable cause exceptions, but these penalties are very similar to an interest charge, in that they are computed by applying the generally applicable underpayment interest rate to the amount of the underpayment for the period of the underpayment.

well as aggressive interpretations of the reasonable cause exception.

It is also possible that eliminating the reasonable cause exception could have unintended consequences, in that the reasonable cause exception provides a "relief valve" for the penalty administration system (in addition to other functions) by permitting the elimination of the penalty in instances where the Service believes that it is reasonable and appropriate to do so. Accordingly, eliminating the explicit reasonable cause exception may cause Service personnel to in effect provide one through less formal means (such as negotiating a lower total amount due) where the Service believes that imposition of the penalty is not reasonable. Causing Service personnel to provide relief they believe to be appropriate through nonstatutory, less formal mechanisms may decrease uniformity in the administration of this penalty. However, it may be less difficult to provide uniformity when dealing with a relatively small universe of corporations that engage in tax shelter transactions and with a penalty that is subject to the routine deficiency procedures of the Code.

In addition, if the Service does not believe that it is reasonable and appropriate to eliminate the penalty, the presence of the reasonable cause exception does not require the Service to do so. Accordingly, some might infer that elimination of the reasonable cause exception is designed to relieve individual IRS personnel of the burden of exercising sound judgment in penalty cases involving corporate tax shelters. Proponents of the proposal might argue that eliminating the reasonable cause exception is appropriate, in that, by definition, there can be no reasonable cause for entering into transactions that satisfy the definition of a corporate tax shelter and that sound judgment will still be essential to the administration of the penalty. The force of this argument may be dependent upon the relative specificity, clarity, and objectivity contained in that definition.

2. Deny certain tax benefits to persons avoiding income tax as a result of tax avoidance transactions

Present Law

Generally on a complete liquidation of a controlled subsidiary, the acquiring corporation succeeds to its tax attributes, including net operating loss carryovers and other carryover items. When control of a corporation is acquired, or a corporation acquires property with a carryover basis from another corporation not controlled by the acquiring corporation or its shareholders, carryovers and other tax benefits may be disallowed if the principal purpose of the acquisition is tax avoidance or evasion (sec. 269). This disallowance provision also applies when a purchased subsidiary corporation with unexpired carryforward items is liquidated into the acquiring corporation, by authorizing the disallowance of carryover and other tax benefits of the subsidiary corporation acquired in a qualified stock purchase with respect to which an election of asset acquisition treatment is not made, if the subsidiary corporation is liquidated pursuant to a plan adopted within two years of the acquisition date and the principal purpose of the liquidation is tax avoidance or evasion.

Description of Proposal

The proposal would expand this anti-avoidance provision by authorizing the Secretary to disallow a deduction, credit, exclusion, or other allowance obtained in a tax avoidance transaction. The definition of a tax avoidance transaction for purposes of this proposal would be the same as the definition proposed as part of the 40-percent substantial understatement penalty. No inference is intended as to the treatment of these transactions under present law.

Effective Date

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

Prior Action

No prior action.

Analysis

Section 269 of present law was primarily directed at a relatively narrow range of situations involving corporate combinations or acquisitions where one corporation acquires losses, credits, or other benefits of another corporation as "the principal purpose" of the acquisition. The standard requiring that "the principal purpose" be to avoid tax has been difficult to administer as there is often a showing of some business or non-tax avoidance purpose. Furthermore, allowing the Secretary to disallow a tax benefit is not always a self-enforcing standard, since some taxpayers may decide to take a contrary position and play the "audit lottery." Other later-enacted Code sections, such as section 382, utilize a more objective standard to limit losses and credits of corporations following certain ownership changes. Consequently, those provisions are more administrable by the IRS and their impact on taxpayers is more certain. However, provisions that involve "bright line" rules may be subject to potential manipulation by taxpayers who aggressively interpret those rules.

The proposal explicitly expands the scope of present-law section 269 to any type of tax-avoidance transaction involving a corporation, not merely corporate acquisitions. It also expands the types of "tax avoidance transactions" with respect to which the Secretary is given the authority to disallow any tax benefits. Some have argued that this expanded authority is needed to address inappropriate corporate tax shelter activity. On the other hand, the definition proposed by the Administration is both broad and subjective (although proponents might argue that the definition is neither broader nor more subjective that either present-law section 269 or case law) . Some would argue that it is not appropriate to provide such broad authority to the Secretary in the absence of clearer, more objective standards. This is the case in part because this may be an inappropriate delegation of authority to the Secretary and in part because the definition may lead to substantial uncertainty on the part of taxpayers as to the eventual tax treatment of transactions that they are contemplating. Some fear that this broad power could be abused, such as by being used to threaten taxpayers to settle unrelated tax issues that may arise during an IRS audit.

3. Deny deductions for certain tax advice and impose an excise tax on certain fees received

Present Law

In general, taxpayers may deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Accordingly, fees paid for advice in connection with a corporate tax shelter are generally deductible.

No Federal excise tax is imposed on fees received in connection with the purchase or implementation of corporate tax shelters. Few such excise taxes exist in other areas of the Internal Revenue Code for similar payments (see, however, Code section 5881, which imposes a 50-percent excise tax on a person who receives greenmail).

Description of Proposal

The proposal would deny a deduction to a corporation for fees paid or incurred in connection with the purchase and implementation, as well as the rendering of tax advice related to, a corporate tax shelter. The proposal would also impose a 25-percent excise tax on fees (such as underwriting fees) paid or incurred in connection with the purchase and implementation, as well as the rendering of tax advice related to, a corporate tax shelter.

Several special rules would apply. First, the proposal would not apply to expenses incurred to represent the taxpayer before the IRS or a court. Second, if a taxpayer claimed a deduction that would otherwise be denied under the proposal, the deduction would be considered to be in connection with a corporate tax shelter for purposes of the proposed 40-percent substantial understatement penalty. Third, the definition of corporate tax shelter for purposes of this proposal would be the same as the definition proposed as part of the 40-percent substantial understatement penalty.

Effective Date

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

Prior Action

No prior action.

Analysis

Some observers are troubled by the apparent recent increase in corporate tax shelter activity. One element of this appears to be the rise in the marketing of these transactions by parties with no prior connections with the taxpayer involved. These observers may believe that this may be an indicia of tax motivation for these transactions. Accordingly, denying a deduction and imposing an excise tax may be a way to lessen behavior that may be viewed as undesirable. Opponents of the proposal might respond that denying a deduction for what have heretofore been considered ordinary and necessary business expenses may be viewed as a disproportionate response to corporate tax shelters.

The effective date proposed could, if enacted, cause this proposal to apply to fees in connection with transactions that have already occurred. Some might view this aspect of the proposal as retroactive in its impact. Proponents of the proposal might respond that it is not retroactive in that it applies only to fees paid, incurred, or received after the date of first committee action.

Some might argue that it is unclear what incremental impact the proposal would have beyond that of the other proposals related to corporate tax shelters, particularly the substantial understatement penalty modifications. It does not appear that there are any corporate tax shelters that would be subject to this proposal that would not be subject to the substantial understatement proposal.[175] Accordingly, it may be more efficacious to accomplish the intended policy goal through one proposal rather than through two. On the other hand, proponents of the proposal might note that, although there is substantial overlap among the transactions covered by the two proposals, this proposal affects entirely different types of participants in those transactions than does the proposal related to the substantial understatement penalty. The penalty proposal affects the parties to the transaction, while this proposal affects persons who are not parties to the transaction but who are giving advice with respect to the transaction. Proponents might argue that it is appropriate to subject promoters of corporate tax shelters to an excise tax in order to provide a front-end disincentive to the development of corporate tax shelters by such persons.

It may not be clear under the proposal upon which party the excise tax is actually imposed: upon the corporation when it makes a payment, or upon the recipient of the payment. If it is imposed upon the recipient of the payment, that person may have no legal standing to enter into disputes between the actual taxpayer and the IRS as to the substance of the transaction, such as whether a transaction is or is not a tax shelter. If it is imposed on the corporation when it makes a payment, there may be, from an economic standpoint, no substantive difference between denying the deduction to the corporation and imposing an excise tax (aside from the higher rate). If the excise tax is imposed on the corporation and if this proposal is considered in conjunction with the substantial understatement penalty proposal (discussed above), the net tax effect on the corporation could exceed the value of tax benefits that might be derived from these transactions.

4. Impose excise tax on certain rescission provisions and provisions guaranteeing tax benefits

Present Law

Corporations that contemplate entering into tax shelter transactions may employ several mechanisms to minimize their losses if

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[175] There are, however, corporate tax shelters (such as those developed in-house, without the participation of outside advisors) that would be subject to the substantial understatement proposal that would not be subject to this proposal.

the transaction cannot be successfully implemented. One mechanism is to provide for unwinding the entire transaction through a rescission clause. Another mechanism is to require a guarantee of the legal basis of the tax benefits. Another is to obtain insurance from a third party.

The Code does not impose an excise tax on any of these types of mechanisms. Few such excise taxes exist in other areas of the Internal Revenue Code for similar payments (see, however, Code section 5881, which imposes a 50-percent excise tax on a person who receives greenmail).

Description of Proposal

The proposal would impose an excise tax of 25 percent on the maximum payment that might be made under a tax benefit protection arrangement. The excise tax is imposed at the time the benefit protection arrangement is entered into, regardless of whether benefits may actually be paid in the future or not. A tax benefit protection arrangement would include a rescission clause, a guarantee of the legal basis of the benefits, insurance, or any other arrangement that has the same economic effect. The definition of corporate tax shelter for purposes of this proposal would be the same as the definition proposed as part of the 40-percent substantial understatement penalty. The Secretary would have the authority to provide that specified transactions would not be subject to the proposal.

Effective Date

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

Prior Action

No prior action.

Analysis

An increasingly common feature of recent corporate tax shelter activity has been the utilization of rescission or guarantee mechanisms that apply if the transaction cannot be successfully implemented. Although guarantees as to the factual basis of a transaction have long been a part of routine transactions, guarantees as to a specific legal outcome have been less common. Some observers are troubled by the increased utilization of these mechanisms, in that they may reflect a lack of independent economic viability apart from the tax aspects of the transaction. An excise tax is one mechanism that has been used in the past to deter specific types of activities that are disfavored (such as greenmail payments under section 5881).

Some might argue that it is unclear what incremental impact the proposal would have beyond that of the other proposals related to corporate tax shelters, particularly the substantial understatement penalty modifications. It does not appear that there are any corporate tax shelters that would be subject to this proposal that would not be subject to the substantial understatement proposal.[176] Accordingly, it may be more efficacious to accomplish the intended policy goal through one proposal rather than through two.

Under some benefit protection arrangements, such as rescission clauses, it may be difficult for the taxpayer to determine, at the point the arrangement is entered into, the maximum payment that might ultimately be made under the arrangement. This could lead to factual disputes between taxpayers and the IRS. Opponents of the proposal have questioned whether the excise tax should only apply at the point (if ever) when the arrangement ultimately becomes effective. Otherwise, the proposal could be considered to be penalizing activities that may never occur. Similarly, applying the excise tax to the maximum payment possible under the arrangement (as contrasted with the actual amount of any ultimate payment) could lead to a penalty that exceeds the amount of the transaction itself. Proponents of the proposal might respond that the proposal is intended to discourage benefit protection arrangements, whether or not they are ultimately utilized, because the mere existence of those arrangements may call into question the independent economic viability of the transaction.

It could also be questioned whether the proposed excise tax should apply in circumstances where a taxpayer has applied for a private letter ruling and includes a benefit protection arrangement in a transaction while the taxpayer awaits an answer from the IRS. Some might consider it inappropriate to apply the excise tax in situations like this where there is significant uncertainty as the proper application of the tax law to specific transactions. On the other hand, it may be argued that few (if any) taxpayers request a private letter ruling from the IRS with respect to a corporate tax shelter.

5. Preclude taxpayers from taking tax positions inconsistent with the form of their transactions

Present Law

Taxpayers may enter into transactions and then assert that the form of the transaction should be disregarded because its economic substance is not reflected by the form of the transaction. In light of the fact that in general taxpayers control the form in which the transaction occurs, the IRS generally opposes attempts by taxpayers to disregard the form the taxpayers themselves chose for a transaction. The IRS may, however, seek to disregard the form of a transaction that taxpayers wish to defend if the IRS believes that the form of the transaction does not reflect the transaction's economic substance.

There are two provisions in the Code that restrict the ability of taxpayers to take positions inconsistent with the form of their transactions. Section 385(c) provides that the characterization (as of the time of issuance) of a corporate instrument as stock or debt by the corporate issuer is binding on the issuer and on all holders. This characterization, however, is not binding on the Secretary of

[176] There are, however, corporate tax shelters (such as those without a rescission (or similar) clause) that would be subject to the substantial understatement proposal that would not be subject to this proposal.

the Treasury. Except as provided in regulations, a holder who treats such instrument in a manner inconsistent with such characterization must disclose the inconsistent treatment on such holder's tax return. Section 1060(a) provides that a written agreement regarding the allocation of consideration to, or the fair market value of, any of the assets in an applicable asset acquisition will be binding on both parties for tax purposes, unless the Secretary determines that such allocation (or fair market value) is not appropriate.

Aside from these two provisions, the legal standard that taxpayers must meet in order to overturn successfully the form of a transaction is not specified in the Code; rather, it has been judicially established. Accordingly, there has been some variation among the courts that have considered this issue as to the precise contours of this legal standard.

One important delineation of this legal standard is in *Danielson v. Commissioner*.[177] That standard is:

> a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.[178]

There have been two fundamental issues that court cases have discussed regarding the *Danielson* rule. The first is whether to adopt it at all. While the majority of circuit courts of appeal that have considered this issue have adopted the *Danielson* rule, some have not.[179] Also, the Tax Court has not adopted the *Danielson* rule, but has instead adopted a "strong proof" standard that is somewhat easier for taxpayers to meet than the *Danielson* rule.[180] The second fundamental issue is under what circumstances is adoption of the rule appropriate. The *Danielson* rule originated "with respect to agreed allocations of the sales price in contracts for the sale of a going business or the stock of an incorporated enterprise, when accompanied by a covenant not to compete."[181] Additionally, the contract must be written unambiguously with respect to this issue. The policy reasons underlying this higher burden of proof are: "(1) reducing uncertainty about tax effects of contracts; (2) the tax polarity of the parties; (3) the possibility of denying a bargained-for tax advantage to the taxpayer's opposite number; (4) the administrative burden imposed on the IRS, which may have to litigate with both taxpayers and may be whipsawed by inconsistent decisions; and (5) the difficulty of placing separate values on items that would not have been sold in isolation."[182] These factors may apply in many other situations. Accordingly, some commentators

[177] 378 F.2d 771 (3d Cir. 1967); *cert. denied*, 389 U.S. 858 (l967).
[178] 378 F.2d 771, 775.
[179] See Bailoff, "When (and Where) Does the Danielson Rule Limit Taxpayers Arguing 'Substance Over Form'?," 82 *J. Taxation* 362 (June 1995) for a detailed discussion of this issue.
[180] *Schmitz v. Commissioner*, 51 T.C. 306 (1968), aff'd. 457 F.2d 1022 (9th Cir., 1972).
[181] Bittker and Lokken, *Federal Taxation of Income, Estates, and Gifts* (Third Ed.) 4.4.6 (1999).
[182] *Id.*

have argued for extending this rule to all contracts.[183] Others are more cautious about whether extension is appropriate.[184]

Description of Proposal

The proposal would preclude a corporate taxpayer from taking any position on a return or claim for refund that the income tax treatment of a transaction is different from that required by its form if a tax indifferent party has a direct or indirect interest in the transaction. Several exceptions would apply. First, this rule would not apply if the taxpayer discloses the inconsistent position on its timely filed, original tax return for the taxable year that includes the date on which the transaction was entered into. Second, this rule would not apply if reporting the substance of the transaction more clearly reflects the income of the taxpayer (to the extent this exception is permitted in regulations). Third, this rule would not apply to transactions that are identified in regulations.

Several special rules and definitions would apply. First, the form of a transaction is to be determined based on all facts and circumstances, including the treatment that would be given the transaction for regulatory or foreign law purposes. Second, a tax indifferent party would be defined as a foreign person, a Native American tribal organization, a tax-exempt organization, or a domestic corporation with expiring loss or credit carryforwards.[185] Third, the Secretary would have the authority to prescribe regulations to carry out the purposes of the rule, including a definition of the "form" of a transaction. Fourth, nothing in the proposal is intended to prevent the Secretary from asserting the substance-over-form doctrine or imposing any applicable penalties. Fifth, no inference is intended as to the extent to which a corporate taxpayer can disavow the form of its transactions under present law.

Effective Date

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

Prior Action

No prior action.

Analysis

Some might observe that the lengthy development of judicial principles to deal with this issue, as well as the continuing controversies between taxpayers and the IRS on this issue, make it ripe for additional legislative resolution. Others might counter that the judicial principles are sufficiently developed at this point that additional legislative action might (at least in the short term) increase, rather than decrease, uncertainty in this area.

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[183] *Id.*; also, see Lozich, "The Continuing Application of the Danielson Rule," 49 *Tax Lawyer* 769 (1996).

[184] Smith, "Substance and Form," 44 *Tax Lawyer* 137 (1990); Blatt, "Lost on a One-Way Street: The Taxpayer's Ability to Disavow Form," 70 *Oregon L. Rev.* no. 2 (1991).

[185] Loss and credit carryforwards would generally be treated as expiring if the carryforward is more than three years old.

Proponents of codification of the *Danielson* rule would argue that it is a clear, easily applicable rule of long standing that has been widely adopted. Opponents of codification of the *Danielson* rule would argue that *Danielson* has not been universally adopted, both because of its rigid nature and because it imposes a more difficult standard for taxpayers to meet than any of the competing alternative rules.

The proposal essentially codifies the *Danielson* rule, but with several important modifications. First, the proposal does not codify the *Danielson* exceptions for fraud or duress (except indirectly, through either the disclosure rule or a possible regulatory exception). It is not clear whether omission of the explicit fraud or duress exception was necessary to achieve a policy goal or was inadvertent.

The second important way in which the proposal differs from *Danielson* is that the proposal limits codification of this rule to situations where a tax indifferent party has a direct or indirect interest in the transaction. Several of the rationales underlying the *Danielson* rule presuppose that both parties to a transaction are taxable. Some might argue that so limiting this codification of the *Danielson* rule is inappropriate.

6. Tax income from corporate tax shelters involving tax-indifferent parties

Present Law

The United States imposes tax on nonresident alien individuals and foreign corporations (collectively, foreign persons) only on income that has a sufficient nexus to the United States. Foreign persons are subject to U.S. tax on income that is effectively connected with the conduct of a trade or business within the United States (secs. 871(b) and 882). Such income generally is taxed in the same manner and at the same rates as income of a U.S. person.

Foreign persons also are subject to a 30-percent gross basis tax, collected by withholding, on certain U.S.-source income, such as interest, dividends and other fixed or determinable annual or periodical (“FDAP”) income, that is not effectively connected with a U.S. trade or business. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable tax treaty. Foreign persons generally are not subject to U.S. tax on foreign-source income that is not effectively connected with a U.S. trade or business.

Tax-exempt organizations (such as sec. 501(c) nonprofit organizations and pension plans) generally are not subject to Federal income tax, for example, on dues and contributions they receive from their members, as well as other income from activities that are substantially related to the purpose of their tax exemption. However, tax-exempt organizations are subject to the unrelated business income tax (“UBIT”) on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization’s tax-exempt functions (secs. 511–514). In addition, Native American Indian tribes, as well as wholly owned tribal corporations chartered under Federal law, generally are not subject to Federal income taxes.[186]

Specific rules apply for purposes of allowing U.S. corporations to carryback or carryforward losses or credits. For example, net operating losses may be carried back two years and forward twenty years (sec. 172). Capital losses in excess of capital gains for a year may be carried back three years and forward five years (sec. 1212(a)). Business credits may be carried back one year and forward twenty years (sec. 39). Foreign tax credits may be carried back two years and forward five years (sec. 904(c)). Detailed rules apply to limit the use of such loss and credit carrybacks and carryforwards (secs. 381 through 384).

Description of Proposal

The proposal would provide that any income allocable to a tax-indifferent party with respect to a corporate tax shelter is taxable to such tax-indifferent party. The U.S. tax imposed on the income allocable to the tax-indifferent party would be determined without regard to any statutory, regulatory, or treaty exclusion or exception. The proposal also would provide that any other participants in the corporate tax shelter (i.e., any participant other than the tax-indifferent party in question) would be jointly and severally liable with the tax-indifferent party for taxes imposed.

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

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

The proposal would define a "tax-indifferent party" as a foreign person (i.e., a nonresident alien individual or a foreign corporation), a Native American tribal organization, a tax-exempt organization, and U.S. corporations with expiring loss or credit carryforwards. For these purposes, loss and credit carryforwards generally would

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[186] See Rev. Rul. 94–65, 1994–2 C.B. 14; Rev. Rul. 94–16, 1994–1 C.B. 19; Rev. Rul. 81–295, 1981–2 C.B. 15; Rev. Rul. 67–284, 1967–2 C.B. 55. The Internal Revenue Service recently clarified that tribal corporations chartered under tribal law also can qualify for exemption as section 501(c)(3) organizations. See General Information Letter to First Nations Development Institute (September 8, 1998).

be treated as expiring if the carryforward is more than three years old.

In the case of a foreign person, U.S. tax on the income or gain allocable to such person would be determined without regard to any exclusion or exception, provided in a treaty or otherwise. Any such income or gain that is not U.S.-source FDAP income would be treated as effectively connected with a U.S. trade or business without regard to whether such income is U.S.- or foreign-source. If the foreign person properly claims the benefit of an income tax treaty, the U.S. tax otherwise owed by such foreign person would be collected from the other participants in the corporate tax shelter transaction who are not exempt from U.S. tax. It is understood that present-law standards (e.g., under sec. 6114) would apply in determining whether a foreign person "properly claims" the benefit of a treaty for these purposes. It also is understood that in no event would such foreign person be liable for taxes with respect to such transaction in excess of U.S. taxes (if any) not reduced or eliminated pursuant to the applicable income tax treaty for which relief is claimed.

In the case of a Native American tribal organization, the tax on the income allocable to such person would be determined without regard to any exclusion or exception. However, the tax would be collected only from participants of the corporate tax shelter transaction who are not exempt from U.S. tax.

In the case of a tax-exempt organization, the income would be characterized as income that is subject to UBIT. In the case of a U.S. corporation with expiring loss or credit carryovers, the tax on the income allocable to such corporation would be computed without regard to such losses or credits.

Effective Date

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

Prior Action

No prior action.

Analysis

The proposal is intended to address corporate tax shelter transactions involving a timing mismatch, or separation of income or gains from deductions or losses, through the use of tax-indifferent parties. The Administration's proposal does not contain specific examples of such transactions, but generally describes the transactions as involving the absorption of income or gain generated in the transaction by a tax-indifferent party, leaving a corresponding deduction or loss to taxable corporate entities. Tax-indifferent parties may agree to engage in such transactions in exchange for an enhanced return on their investment or for an accommodation fee.

Some argue that taxable U.S. corporations should not be permitted to "purchase" the special tax status of tax-indifferent parties in order to generate U.S. tax benefits. Imposing tax on income allocated to tax-indifferent parties is expected to limit their participation in corporate tax shelter transactions and, thus, limit the "sale" of their special tax status. In addition, requiring the other participants in such transactions to be jointly and severally liable for the tax would create further disincentives for participation in such transactions, as well as facilitating the collection of the tax.

On the other hand, the proposal would represent a significant departure from the manner in which the United States taxes foreign persons and certain other tax-exempt entities. For example, in the case of foreign persons, the proposal would expand the scope of the U.S. taxing jurisdiction to allow the United States to tax foreign persons on foreign-source income that has no economic nexus to the United States. This approach could result in, among other things, potential double taxation with respect to such income, because the United States generally does not allow foreign persons to claim foreign tax credits (although double taxation could be mitigated under an applicable tax treaty). In addition, because the proposal would treat foreign-source income allocable to a foreign person in a corporate tax shelter transaction as income effectively connected with a U.S. trade or business, foreign persons with no connection to the United States would be required to file a U.S. tax return to report income and pay tax with respect such transactions; however, requiring such reporting and collecting the tax from such foreign persons may be difficult to enforce in practice. The proposal could lead to retaliation from other foreign countries (perhaps through the enactment of similar rules that would tax U.S. persons on certain income having no economic nexus to that country).

The proposal would provide that tax on income or gain allocable to a foreign person would be determined without regard to applicable treaties, raising treaty override issues. However, the proposal would provide that if the foreign person properly claims the benefit of a treaty, the tax otherwise owing by such foreign person would be collected from the other parties participating in the corporate tax shelter transaction, and not such foreign person. It is understood that foreign persons would not be liable for taxes with respect to such transaction in excess of any U.S. taxes not reduced or eliminated pursuant to the applicable income tax treaty for which relief is claimed. Thus, it is asserted that a foreign person should not be denied treaty benefits as a result of the proposal.

The proposal would treat as a tax-indifferent party U.S. corporations with expiring loss or credit carryforwards, generally defined to mean loss or credit carryforwards that are more than three years old. Some have observed that this three-year threshold is arbitrary and perhaps unduly harsh, particularly in the case of losses or credits that may be carried forward twenty years (e.g., net operating losses and business credits). Some also might argue that U.S. corporations with expiring losses or credits should be distinguished from tax-exempt entities.

Some have observed that the definition of "corporate tax shelter" and other defined terms in the proposal may be viewed as being too vague or overly broad, and may not provide sufficient specificity for taxable or tax-indifferent parties to be on notice as to which transactions may be subject to these rules. This approach could be criticized as creating an environment of uncertainty for such parties in making business and investment decisions.

7. Require accrual of time value element on forward sale of corporate stock

Present Law

A corporation generally recognizes no gain or loss on the receipt of money or other property in exchange for its own stock (including treasury stock) (sec. 1032). Furthermore, a corporation does not recognize gain or loss when it redeems its stock, with cash, for less or more than it received when the stock was issued.

In general, a forward contract means a contract to deliver at a set future date (the "settlement date") a substantially fixed amount of property (such as stock) for a substantially fixed price. Gains or losses from forward contracts generally are not taxed until the forward contract is closed. A corporation does not recognize gain or loss with respect to a forward contract for the sale of its own stock. A corporation does, however, recognize interest income upon the current sale of its stock for a deferred payment.

With respect to certain "conversion transactions" (transactions generally consisting of two or more positions taken with regard to the same or similar property, where substantially all of the taxpayer's return is attributable to the time value of the taxpayer's net investment in the transaction), gain recognized that would otherwise be treated as capital gain may be recharacterized as ordinary income (sec. 1258).

Description of Proposal

The proposal would require a corporation that enters into a forward contract for the sale of its own stock to treat a portion of the payment received with respect to the forward contract as a payment of interest.

Effective Date

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

Prior Action

No prior action.

Analysis

Under a traditional forward contract, the purchase price generally is determined by reference to the value of the underlying property on the contract date and is adjusted (1) upward to reflect a time value of money component to the seller for the deferred payment (i.e. for holding the property) from the contract date until the settlement date and (2) downward to reflect the current yield on the property that will remain with the seller until the settlement date. Strategies have been developed whereby a corporation can obtain favorable tax results through entering into a forward sale of its own stock, which results could not be achieved if the corporation merely sold its stock for a deferred payment. One such strategy that might be used to exaggerate a corporation's interest deductions could involve a corporation borrowing funds (producing an interest deduction) to repurchase its own stock, which it immediately sells in a forward contract at a price equal to the principal and interest on the debt for settlement on the date that the debt matures. Although the interest would be deductible on the debt, any gain from the forward contract (including any interest component) would not be taxable to the corporation (sec. 1032).

Advocates of the proposal argue that there is little substantive difference between a corporation's current sale of its own stock for deferred payment (upon which the corporate issuer would accrue interest) and the corporation's forward sale of the same stock. The primary difference between the two transactions is the timing of the stock issuance. In a current sale, the stock is issued at the inception of the transaction, while in a forward sale, the stock is issued at the time the deferred payment is received. In both cases, a portion of the deferred payment economically compensates the corporation for the time value of the deferred payment. Proponents of the proposal argue that these two transactions should be treated the same. Additionally, some would argue that the proposal is a logical extension of the conversion rules of section 1258 which treat as ordinary income the time-value component of the return from certain conversion transactions.

Opponents of the proposal argue that there is a substantive difference between a corporation's forward sale of its stock and a current sale. Under a forward sale, the stock is not outstanding until it is issued on the settlement date. The purchaser has no current dividend rights, voting rights or rights in liquidation. Additionally, any forward sale by its very nature has a time value component: that feature is not unique to a corporate issuer of its own stock. The time value component should compensate the holder for its carrying costs with respect to the property. The proposal would treat differently a forward sale of stock and an issuance in the future of stock for the same price on the same date as the settlement date.

Some also might argue that the policy rationale underlying the conversion rules is not present with respect to the issuance of corporate stock because there is no conversion of ordinary income to capital gain. For example, assume a taxpayer buys gold today for $100 and immediately enters into a forward contract to sell that gold in the future for $110 ($10 of which represents the time value of money). Upon closing of the forward sale, the taxpayer (and its shareholders if it is a corporation) would recognize an economic gain of $10. Absent the conversion rules (sec. 1258), the $10 gain on that transaction may be treated as capital gain notwithstanding that substantially all of the taxpayer's return is with respect to the time value of money. The taxpayer is in the economic position of a lender with an expectation of a return from the transaction that is in the nature of interest and with no significant risks other than those typical of a lender. That arguably is not the case (at least with respect to the economic position of the existing shareholders) with respect to a corporation that enters into a forward sale of its own stock. A corporation's ownership of its own stock arguably has no economic significance to the corporation or its shareholders. The purchase or issuance by a corporation of its own stock at fair market value does not affect the value of the shareholders' interests in the corporation. The economic gain or loss, if any, to the existing shareholders of the corporation on the forward sale of its stock would depend on the fair market value of the corporation's stock on the settlement date. If the fair market value of the corporation's stock on the settlement date equals the contract price under the forward sale, then there is no economic gain or loss to the corporation or its shareholders.

Finally, some would argue that the provision narrowly focuses on one type of derivative contract with respect to a corporation's own stock and that a broader approach addressing the treatment under section 1032 of derivative contracts and other techniques for using a corporation's own stock would be more appropriate.

8. Modify treatment of built-in losses and other attribute trafficking

Present Law

U.S. persons are subject to U.S. tax on their worldwide income. Foreign persons are subject to U.S. tax, calculated in the same manner and at the same graduated rates as the U.S. tax on U.S. persons, on income that is effectively connected with the conduct of a U.S. trade or business ("U.S.-effectively connected income"). Foreign persons also are subject to a U.S. 30-percent withholding tax on the gross amount of certain U.S.-source income that is not U.S.-effectively connected income.

Tax-exempt organizations (such as sec. 501(c) nonprofit organizations and pension plans) generally are not subject to Federal income tax, for example, on dues and contributions they receive from their members, as well as other income from activities that are substantially related to the purpose of their tax exemption. However, tax-exempt organizations are subject to the unrelated business income tax ("UBIT") on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions (secs. 511–514). In addition, Native American Indian tribes, as well as wholly owned tribal corporations chartered under Federal law, generally are not subject to Federal income taxes.[187]

Detailed rules apply to limit a taxpayer's ability to use certain tax attributes, such as net operating losses, built-in losses and various credit items (secs. 269 and 381 through 384). In addition, in determining U.S. taxable income, various rules are aimed at preventing U.S. taxpayers from transferring appreciated property outside the U.S. taxing jurisdiction to escape U.S. tax on the built-in gain with respect to such property. Section 367(a) limits the application of nonrecognition provisions to corporate reorganizations and transfers involving foreign corporations. In addition, under section 864(c)(7), the gain with respect to property that was used in connection with a U.S. trade or business may be considered to be effectively connected with a U.S. trade or business, and therefore sub-

[187] See Rev. Rul. 94–65, 1994–2 C.B. 14; Rev. Rul. 94–16, 1994–1 C.B. 19; Rev. Rul. 81–295, 1981–2 C.B. 15; Rev. Rul. 67–284, 1967–2 C.B. 55. The Internal Revenue Service recently clarified that tribal corporations chartered under tribal law also can qualify for exemption as section 501(c)(3) organizations. See General Information Letter to First Nations Development Institute (September 8, 1998).

ject to U.S. tax, even though the property is no longer so used at the time of its disposition. Moreover, section 877 includes rules to limit the ability of former U.S. citizens to avoid U.S. tax on appreciated property.

The Code does not include analogous provisions specifically aimed at preventing taxpayers from transferring property with built-in losses, or transferring other favorable tax attributes such as deficits in earnings and profits and foreign tax credits, into the U.S. taxing jurisdiction. Such built-in losses or other tax attributes could be used to offset income or gain that otherwise would be subject to U.S. tax.

Taxpayers also may transfer property with built-in gains or other unfavorable tax attributes into the U.S. taxing jurisdiction. Such transfers could result in the imposition of U.S. taxes. However, many taxpayers can trigger recognition of built-in gain assets in a manner that is not subject to U.S. or foreign tax, or can obtain a step-up in basis in all of its assets through a section 338 election, when such election is beneficial and available.

Description of Proposal

The proposal would provide a new regime for assets, entities, and attributes that are brought into the U.S. taxing jurisdiction. In this regard, the proposal would provide that assets would be marked to fair market value and other tax attributes would be eliminated, as may be applicable, when assets or entities become "relevant" for U.S. tax purposes (so-called "fresh start" rules). An entity would become "relevant" for U.S. tax purposes in two general situations. First, an entity would become relevant when a "tax-exempt entity" becomes a "taxable U.S. entity" (as defined). Second, an entity would become relevant when a foreign corporation that is not a controlled foreign corporation ("CFC"), but is a "taxable U.S. entity," becomes a CFC or a U.S. person.

For these purposes, a "tax-exempt entity" would include an entity that is exempt from tax under section 501, a Native American tribal organization, a nonresident alien individual, and a foreign corporation that is not a member of a qualified group under section 902(b)(2) (i.e., a foreign corporation in which there is no U.S. shareholder who would be entitled to indirect foreign tax credits). A "taxable U.S. entity" would be a U.S. person (e.g., a U.S. citizen or resident, a U.S. corporation, and a U.S. partnership, but not a section 501 tax-exempt organization), a foreign corporation that is a member of a qualified group under section 902(b)(2) (i.e., a foreign corporation in which a U.S. shareholder would be entitled to indirect foreign tax credits), and a CFC.

The proposal thus would apply in several cases where a tax-exempt entity becomes a taxable U.S. entity, including where: (1) a U.S. corporation acquires a 10-percent or greater voting interest in the stock of a foreign corporation with no U.S. shareholders, (2) a foreign corporation with no U.S. shareholders domesticates in an F reorganization, (3) a nonresident alien individual becomes a U.S. resident, and (4) a section 501 tax-exempt organization loses its tax-exempt status. In addition, the proposal would apply where a noncontrolled section 902 corporation (a "10/50 company") becomes a CFC or a U.S. corporation (e.g., through stock acquisitions by U.S. persons or through reorganization transactions).

The proposal also would apply to the transfer of assets and liabilities by tax-exempt entities to taxable U.S. entities or operations. For example, assets or liabilities that are transferred by a foreign person to a U.S. corporation (such as in a section 351 transaction), or to a business unit that generates UBIT or U.S.-effectively connected income, would be marked to market at the time of transfer. In addition, the proposal would apply to the transfer of assets and liabilities by a 10/50 company to a CFC, U.S. resident, or a business unit that generates UBIT or U.S.-effectively connected income.

Several special rules would apply. First, special valuation rules would be provided with respect to the transfer of intangible assets. Second, the proposal generally would not apply to assets or other attributes held by a tax-exempt entity to the extent such items were or would be subject to net U.S. income tax. Thus, a special rule would be provided to exclude from the fresh start rules items that are related to UBIT or U.S.-effectively connected income prior to the time an asset or its owner becomes relevant for U.S. tax purposes, as well as for personal assets in the case of a nonresident alien who becomes a U.S. resident.

Third, special rules would be provided to preserve the tax attributes of certain U.S. shareholders who held an interest in a foreign corporation before and after a fresh start event. In this regard, the proposal would require 10-percent or greater (determined by voting power) U.S. shareholders of a foreign corporation to maintain a shareholder-level suspense account that contains such shareholder's pro rata share of the corporation's tax attributes (e.g., earnings and profits and foreign taxes) immediately after the marking of assets, but prior to the elimination of the tax attributes of the corporation. These rules would not affect the attributes of other shareholders of the foreign corporation.

For example, assume that in year one a U.S. corporation ("US1") acquires 20 percent of the stock of a foreign corporation with no U.S. shareholders. The acquisition would trigger the fresh start rules, causing all of the foreign corporation's assets and liabilities to be marked to fair market value, and all of such corporation's tax attributes (e.g., earnings and profits and taxes) to be eliminated for U.S. tax purposes. Assume that in year five an unrelated U.S. corporation ("US2") acquires the remaining 80 percent of the foreign corporation's stock from its non-U.S. shareholders. This stock acquisition would cause the foreign corporation to become a CFC, which would trigger a second fresh start event. In year five, all of the foreign corporation's assets and liabilities would again be marked to fair market value, and all of its tax attributes would be eliminated. However, because US1 was a 10-percent or greater shareholder in the foreign corporation after this fresh start event, a shareholder-level suspense account would be created with respect to US1 that would reflect US1's pro rata share (i.e., 20 percent) of the foreign corporation's earnings and profits (including earnings and profits created by the second fresh start) and related foreign taxes.

The proposal would provide the Secretary with authority to prescribe regulations to carry out the purposes of the proposal, including regulations governing the proper treatment of deficits that existed in an entity prior to the elimination of attributes and related foreign tax credits, and the proposal's interaction with section 367(b) (and the regulations thereunder) and the passive foreign investment company regime. The proposal also would provide the Secretary with authority to prescribe regulations necessary to prevent trafficking in favorable tax attributes involving foreign corporations to the extent not specifically addressed by the proposal. This would include, for example, trafficking in favorable tax attributes among CFCs. The proposal further would provide the Secretary with authority to identify the circumstances under which transfers to partnerships and transfers of partnership interests would be subject to these rules. Moreover, the proposal would provide the Secretary with authority to prescribe regulations in cases in which certain tax-exempt entities would not be subject to these rules, such as in the case of a section 501(c)(12) corporation that changes between taxable and tax-exempt status from year-to-year based on income earned.

No inference would be intended as to the treatment under present law of transactions that result in the use for U.S. tax purposes of tax attributes arising outside the U.S. taxing jurisdiction.

Effective Date

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

Prior Action

The President's fiscal year 1999 budget proposal would have directed the Secretary of the Treasury to prescribe regulations to determine the basis of assets held directly or indirectly by a foreign person and the amount of built-in deductions with respect to a foreign person or an entity held directly or indirectly by a foreign person as may be necessary or appropriate to prevent the avoidance of tax.

Analysis

The proposal would represent a fundamental change in the manner in which the United States treats assets or entities that are brought into the U.S. taxing jurisdiction. In this regard, the proposal would apply a mandatory set of rules to mark assets to fair market value, and eliminate tax attributes, as applicable, upon the occurrence of certain defined events, such as when a tax-exempt entity becomes a taxable U.S. entity.

Some argue that legislative rules are needed to address the use of built-in losses and other tax attributes which economically accrue outside the U.S. taxing jurisdiction, in order to prevent purposeful tax avoidance by U.S. and foreign persons. For example, foreign persons investing in the United States may reduce U.S. tax on U.S. operations (e.g., U.S. subsidiary operations or U.S. branch operations giving rise to U.S.-effectively connected income), by importing built-in loss assets and other tax attributes, and triggering, for example, recognition of losses and deductions to offset U.S. income. Similar issues may arise in transactions involving tax-exempt organizations or other tax-exempt entities. Taxpayers can obtain mark-to-market treatment if desired (e.g., in the case of appreciated assets) such that present law can offer, in certain cases, selectivity as between gain and loss assets.

Some also argue that tax attributes which accrue outside the U.S. taxing jurisdiction, whether favorable or unfavorable, should not affect U.S. tax liability. There also is administrative complexity for taxpayers and the government in attempting to track tax attributes for U.S. tax purposes that accrue outside the U.S. taxing jurisdiction. This includes recreating records reflecting tax attributes such as earnings and profits under U.S. tax principles that may span several years, which could be costly and of questionable accuracy. Limiting the use of such tax attributes could reduce administrative and compliance burdens under present law.

On the other hand, the rules would not be limited to abusive tax avoidance transactions, but would apply equally to legitimate business transactions. In addition, the proposal would significantly differ from present-law rules addressing trafficking in tax attributes (such as net operating losses under secs. 381 through 384), which generally operate to defer the use of such attributes for U.S. tax purposes. The proposal would eliminate tax attributes altogether in certain cases (e.g., in the case of certain entity transfers). Some argue that rules addressing trafficking in various tax attributes should be similar.

The proposal would mandate the application of the fresh start rules, for example, upon the acquisition by a U.S. corporation of at least 10 percent of the voting stock of a foreign corporation. Ten percent may be viewed as a relatively low threshold for purposes of requiring assets to be marked to market and tax attributes to be eliminated. Under present law, taxpayers generally can mark to market assets and eliminate tax attributes, at the taxpayer's election, only when, among other things, 80 percent of the stock of a corporation is acquired (sec. 338). On the other hand, some might argue that a 10-percent threshold is appropriate to identify the first time there is meaningful U.S. ownership.

The proposal would introduce considerable complexity and compliance burdens. For example, the fresh start rules would be invoked when a 10/50 company becomes either a CFC or a U.S. person, resulting potentially in a second separate fresh start event (i.e., the first fresh start event occurring when a foreign corporation becomes a 10/50 company, and a second fresh start event occurring when such 10/50 company becomes either a CFC or a U.S. person). In addition, the requirement of maintaining shareholder-level suspense accounts to preserve tax attributes (whether favorable or unfavorable) for certain 10-percent or greater U.S. shareholders would introduce further complexity.

Some have observed that mark-to-market events mandated by the proposal could give rise to potential adverse consequences, such as potential current inclusions to U.S. persons (e.g., under the passive foreign investment company rules), or causing a foreign corporation to become a passive foreign investment company. The proposal would grant regulatory authority to address such types of issues. Some argue that these types of issues would need to be addressed as part of any proposed legislative rules and not through regulatory authority.

9. Modify treatment of ESOP as S corporation shareholder

Present Law

The Small Business and Job Protection Act of 1996 ("1996 Act") allowed qualified retirement plan trusts described in Code section 401(a) to own stock in an S corporation. The 1996 Act treated the plan's share of the S corporation's income (and gain on the disposition of the stock) as includible in full in the trust's unrelated business taxable income ("UBTI"). The provision was effective for taxable years beginning after December 31, 1997.

The Tax Relief Act of 1997 ("1997 Act") repealed the provision treating items of income or loss of an S corporation as unrelated business taxable income in the case of an employee stock ownership plan ("ESOP"), effective for taxable years to which the 1996 legislation applied. Thus, the income of an S corporation allocable to an ESOP is not subject to current taxation. Distributions made to the participants of the ESOP are generally taxable.

Description of Proposal

The proposal would repeal the provision of the 1997 Act eliminating the inclusion of S corporation income of an ESOP as UBTI. Thus, all items of income or loss of an S corporation would flowthrough to an ESOP as UBTI. In addition, gain or loss on the sale or other disposition (including any distribution to a participant) of stock of an S corporation by an ESOP would be treated as UBTI.

An ESOP would be allowed a deduction in computing its UBTI from an S corporation for the amount of distributions made to participants. The deduction would be allowed only to the extent that the ESOP's total distributions after the effective date of the proposal exceed the amount of income that was not subject to tax by reason of the 1997 Act provision. The deduction would be taken into account in computing the ESOP's net operating loss so that an ESOP would be allowed a refund or reduction of tax when the previously taxed income is distributed to participants.

Effective Date

The proposal would be effective for taxable years beginning on or after the date of the first committee action. The proposal would also be effective with respect to the acquisition of S corporation stock or an S corporation election made on or after that date.

Prior Action

Prior Congressional action is described under *Present Law*, above.

Analysis

The 1996 Act permitted ESOPs (and certain other tax-exempt entities) to hold stock in an S corporation. That Act provided that the

S corporation income was taxable to the tax-exempt shareholders in keeping with the underlying premise of subchapter S that all income is subject to tax.[188]

Under the 1996 Act, the income of an ESOP attributable to S corporation stock would have been subject to tax in the hands of an ESOP when earned by the S corporation and again in the hands of the participants when distributions were made from the ESOP. This method of taxation generally would have meant that ESOPs holding S corporation stock would have been subject to a similar tax burden as ESOPs holding C corporation stock—a business tax would have been imposed when income was earned by the corporation and another tax would have been imposed on participants when distributions were made by the ESOP. This would have denied the ESOP and its participants the advantages of an S corporation election.[189] However, the taxable shareholders of the S corporation would have retained the benefits of subchapter S, allowing more corporations to establish ESOPs.

The 1997 Act eliminated the tax on the income when earned by the S corporation in order to reduce the tax burden on the ESOP's share of the S corporation's income. However, the elimination of the tax on the ESOP has resulted in the ability to attain tax deferral unlike that available to other taxable income of an S corporation or a C corporation. For example, some S corporations may be wholly owned by an ESOP, so that none of the S corporation's income is subject to current tax. For companies with just one or two employees, transactions using the ESOP/S corporation provisions have been described as "just a way to take advantage of the law".[190] It is also possible that the taxable shareholders of the S corporation may deflect income to the ESOP and thus reduce their tax by using stock options or restricted stock. Transactions have been described as providing for a "five-year tax holiday" using these techniques.[191] The 1997 Act provision encouraged more corporations to establish ESOPs. However, commentators have pointed out that the provision may have opened up unwarranted tax breaks.

The Administration proposal is a middle ground between the provision originally enacted in the 1996 Act and the provision in the 1997 Act. It would provide a single tax on the earnings of the S corporation that are eventually distributed to the ESOP participants. Unlike present law, the tax would be paid currently by the ESOP as the S corporation earns income rather than deferred until benefits are paid to participants. When it made a distribution, the ESOP would be allowed a deduction which may allow for a refund of the previously paid tax. The participant would include the distribution in income as under present law.

The proposal may restrict the establishment of ESOPs by S corporations, by denying the additional deferral incentive available

[188] See H. Rept. 104–281, p. 61.

[189] To the extent the employer securities are distributed to participants, any untaxed appreciation may be taxed as long-term capital gain.

[190] Employee Ownership Report, November/December 1998, p. 11. The article was set forth under the title "Outrages".

[191] See, for example, Ginsburg, "The Taxpayer Relief Act of 1997: Worse Than You Think" 76 *Tax Notes* 1790 (September 29, 1997). The article describes how tax planning can convert the ESOP provision of the 1997 Act into a long-term tax holiday for the S corporation's taxable shareholders.

under present law. However, there may be a need to balance the advantages of establishing additional ESOPs against the need to eliminate the tax planning opportunities available under present law.

10. Limit tax-free liquidations of U.S. subsidiaries of foreign corporations

Present Law

A U.S. corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, when dividends are paid to the corporation's shareholders.

In general, dividends paid by a U.S. corporation to nonresident alien individuals and foreign corporations that are not effectively connected with a U.S. trade or business are subject to a U.S. withholding tax on the gross amount of such income at a rate of 30 percent (secs. 871(a) and 881(a)). The 30-percent withholding tax may be reduced pursuant to an income tax treaty between the United States and the foreign country where the foreign person is resident.

In addition, the United States imposes a branch profits tax on U.S. earnings of a foreign corporation that are shifted out of a U.S. branch of the foreign corporation. The branch profits tax is comparable to the second-level taxes imposed on dividends paid by a U.S. corporation to foreign shareholders. The branch profits tax is 30 percent (subject to possible income tax treaty reduction) of a foreign corporation's dividend equivalent amount. (sec. 884(a)). The "dividend equivalent amount" generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business (sec. 884(b)).

In general, U.S. withholding tax is not imposed with respect to a distribution of a U.S. corporation's earnings to a foreign corporation in complete liquidation of the subsidiary, because the distribution is treated as made in exchange for stock and not as a dividend. In addition, detailed rules apply for purposes of exempting foreign corporations from the branch profits tax for the year in which it completely terminates its U.S. business conducted in branch form (Temp. Treas. Reg. sec. 1.884–2T). The exemption from the branch profits tax generally applies if, among other things, for three years after the termination of the U.S. branch, the foreign corporation has no income effectively connected with a U.S. trade or business, and the U.S. assets of the terminated branch are not used by the foreign corporation or a related corporation in a U.S. trade or business.

Description of Proposal

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

Effective Date

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

Prior Action

No prior action.

Analysis

The proposal is intended to prevent taxpayers from creating and subsequently liquidating U.S. businesses with an intention of escaping U.S. withholding taxes. For example, foreign corporations with U.S. subsidiary operations may establish a U.S. holding company (to receive tax-free dividends from U.S. operating companies), liquidate the U.S. holding company (to distribute the U.S. earnings free of U.S. withholding tax), and then re-establish another U.S. holding company. In this manner, taxpayers might take the position that the U.S. earnings of U.S. operating subsidiaries could be repeatedly distributed in serial tax-free liquidations of U.S. holding companies to foreign corporations, even though the U.S. subsidiary producing the earnings continues in operation. Foreign corporations may be able to avoid the branch profits tax in a similar manner through terminations of U.S. businesses conducted in branch form.

It is argued that such instances of withholding tax abuse would be significantly restricted by requiring the imposition of U.S. withholding taxes upon liquidations of U.S. corporations created within five years of the liquidation. On the other hand, the proposal would not be limited to abusive tax avoidance situations, but would apply equally to liquidations of U.S. corporations (or terminations of U.S. branch operations) done for valid business reasons, but within five years of creation of the U.S. business. Such an approach would provide certainty but could be criticized as inflexible and unduly harsh.

11. Prevent capital gains avoidance through basis shift transactions involving foreign shareholders

Present Law

A shareholder that receives a distribution in redemption of stock generally is treated as having sold such stock for the amount of the distribution, thereby recognizing either gain or loss on the transaction (sec. 302). However, if the redemption is essentially equivalent to a dividend, the shareholder must report the distribution as dividend income, rather than gain or loss. A redemption of stock is considered essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest (determined by reference to stock held directly, indirectly, or constructively) in the distributing corporation. In determining whether a shareholder's proportionate interest in the distributing corporation has been meaningfully reduced, an option to acquire stock is treated as stock actually issued and outstanding.

Under Treasury regulations, if an amount received in redemption of stock is treated as a dividend, the basis of the remaining stock is adjusted (as appropriate) to reflect the basis of the stock redeemed (Treas. Reg. sec. 1.302–2(c)).

A shareholder generally is not required to reduce stock basis upon the receipt of a dividend. However, corporate shareholders that receive an extraordinary dividend are required to reduce their stock basis by the nontaxed portion of such dividend (sec. 1059).

Whether a dividend is "extraordinary" is determined by, among other things, reference to the size of the dividend in relation to the adjusted basis of the shareholder's stock. A dividend resulting from a non-pro rata redemption or a partial liquidation is automatically considered an extraordinary dividend, as is a dividend resulting from a redemption that is treated as a dividend due to options being treated as stock. The nontaxed portion of a dividend effectively equals the amount of the dividend that is reduced by a dividends received deduction. If the reduction in stock basis exceeds the total basis in the stock with respect to which an extraordinary dividend is received, the excess is taxed as gain on the sale or disposition of such stock.

Nonresident aliens and foreign corporations (collectively, "foreign persons") generally are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons (secs. 871(b) and 882). Foreign persons also are subject to a 30-percent gross basis tax, collected by withholding, on certain U.S.-source income, such as interest and dividends, that is not effectively connected with a U.S. trade or business. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable tax treaty. In the case of dividends, on portfolio investments, U.S. income tax treaties commonly provide for a withholding tax rate of at least 15 percent.

Dividends generally are treated as U.S.-source income if the payor is a U.S. corporation. Thus, foreign persons generally are subject to U.S. withholding tax on dividends from a U.S. corporation. A foreign person generally is not required to reduce its stock basis in a U.S. corporation with respect to such dividend distributions.

The United States generally does not tax capital gains of a foreign corporation that are not connected with a U.S. trade or business. Capital gains of a nonresident alien individual that are not connected with a U.S. business generally are subject to U.S. withholding tax only if the individual was present in the United States for 183 days or more during the year (sec. 871(a)(2)).

Tax-exempt organizations (such as sec. 501(c) nonprofit organizations and pension plans) generally are not subject to Federal income tax, for example, on dues and contributions they receive from their members, as well as other income from activities that are substantially related to the purpose of their tax exemption. However, tax-exempt organizations are subject to the unrelated business income tax ("UBIT") on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions (secs. 511–514). In addition, Native American Indian tribes, as well as wholly owned tribal corporations chartered under Federal law, generally are not subject to Federal income taxes.[191a]

Description of Proposal

The proposal would provide that for purposes of section 1059, the nontaxed portion of a dividend includes the amount of a dividend received by a shareholder that is not subject to current U.S. tax. Thus, shareholders (e.g., a foreign person or a tax-exempt organization such as a section 501(c) nonprofit organization) generally would be required to reduce their stock basis in a corporation upon receiving extraordinary dividends from such corporation that are not subject to current U.S. tax.

In the event that a treaty between the United States and a foreign country reduces (but does not fully exempt) U.S. tax imposed on a dividend (and the dividend is not otherwise subject to U.S. tax), the proposal would provide that the nontaxed portion of a dividend would be determined based on the amount of the dividend multiplied by a fraction, the numerator of which is the tax rate applicable without reference to the treaty less the tax rate applicable under the treaty, and the denominator of which is the tax rate applicable without reference to the treaty. For example, if a foreign person with a stock basis in a U.S. corporation of $100 receives an extraordinary dividend of $100 that is subject to a 15 percent reduced withholding rate under a tax treaty, the foreign person would be required to reduce its stock basis by 50 percent of the dividend (the 15 percent reduction from the 30 percent withholding tax, divided by 30 percent), or $50.

For these purposes, the nontaxed portion of a dividend would not include dividends that are currently subject to U.S. tax, such as dividends that are subject to the full 30-percent U.S. withholding tax, UBIT, or the portion of dividends received by a controlled foreign corporation, passive foreign investment company or a foreign personal holding company that are currently included in a U.S. shareholder's taxable income. Thus, such dividends generally would not cause a reduction in stock basis in a corporation.

Similar rules would apply in the event that a shareholder is not a corporation. No inference is intended as to the treatment of such transactions under present law.

Effective Date

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

Prior Action

The President's fiscal year 1999 budget proposal contained a related proposal which would have directed the Secretary of the Treasury to prescribe regulations to determine the basis of assets held directly or indirectly by a foreign person and the amount of

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[191a] See Rev. Rul. 94–65, 1994–2 C.B. 14; Rev. Rul. 94–16, 1994–1 C.B. 19; Rev. Rul. 81–295, 1981–2 C.B. 15; Rev. Rul. 67–284, 1967–2 C.B. 55. The Internal Revenue Service recently clarified that tribal corporations chartered under tribal law also can qualify for exemption as section 501(c)(3) organizations. See General Information Letter to First Nations Development Institute (September 8, 1998).

built-in deductions with respect to a foreign person or an entity held directly or indirectly by a foreign person as may be necessary or appropriate to prevent the avoidance of tax.

Analysis

The proposal would address transactions that might allow U.S. persons to create built-in losses in stock through certain redemption transactions involving foreign persons. For example, assume that a foreign parent corporation owns 100 percent of the stock of a foreign subsidiary. Also assume that an unrelated U.S. corporation acquires a minimal (e.g., one percent) interest in the foreign subsidiary, and an option to acquire a majority interest in the foreign parent. If the foreign subsidiary subsequently redeems all of its stock held by the foreign parent, the amount received by the foreign parent in redemption of such stock would be treated as dividend (because as a result of the option, the foreign parent is treated as owning the stock of the foreign subsidiary held by the U.S. corporation). The dividend generally would not be subject to U.S. tax; however, taxpayers might take the position that the foreign parent's basis in the stock would "shift" to the U.S. corporation and be added to its stock basis, creating a built-in loss with respect to such stock (i.e., a basis in excess of fair market value). The U.S. corporation could then sell such stock at a loss to offset other U.S. income (e.g., capital gains). Variations to this type of transaction might achieve the same or similar results.

Some argue that it is inappropriate to allow U.S. persons to create built-in loss property in this manner that may be used to reduce U.S. taxable income (e.g., upon a subsequent sale of the stock). The proposal would prevent this potential result by requiring a shareholder to reduce its stock basis in a corporation upon receiving an extraordinary dividend from such corporation that is not subject to current U.S. tax. Thus, the basis of any remaining shares following such a dividend would not be increased to the extent of the dividend amount that is not subject to current U.S. tax. In the example above, the redemption of the foreign parent's stock in the foreign subsidiary generally would be treated as an extraordinary dividend that is not subject to current U.S. tax. Under the proposal, such a dividend would reduce the foreign parent's basis in the foreign subsidiary stock such that the basis could not be "shifted" to the U.S. corporation as a result of the transaction.

Some have observed that the proposal would apply to legitimate business transactions. Such an approach of requiring basis adjustments in all such cases would provide greater certainty but could be criticized as inflexible.

12. Limit inappropriate tax benefits for lessors of tax-exempt use property

Present Law

Lessors of "tax-exempt use property" are limited in their ability to claim certain tax benefits. For example, a lessor of tax-exempt use property may not use an accelerated method of depreciation with respect to that property. Rather, it must use the alternative depreciation system which requires it to employ a straight-line method (without regard to salvage value) over a recovery period that is not less than 125 percent of the lease term (sec. 168(g)).

Tax-exempt use property generally means (1) that portion of any tangible property (other than nonresidential real property) leased to a tax-exempt entity, or (2) that portion of nonresidential real property leased to a tax-exempt entity which leases more than 35 percent of the property if certain other circumstances in which the lease resembles a financing also exist (sec. 168(h)(1)). A "tax-exempt entity" for these purposes includes the United States, State or local governments, tax-exempt organizations, and any foreign person or entity (sec. 168(h)(2)).

Lessors and lessees in certain rental agreements which involve either a deferral of a rental amount or an increase in the amounts to be paid as rent generally must report rental income and deductions using the accrual method of accounting (plus interest with respect to any amounts for which the payment is deferred beyond the taxable year of accrual) (sec. 467). Proposed Treasury regulations would expand this rule to include prepayments of rent and decreases in amounts to be paid as rent (Prop. Treas. Reg. sec. 1.467–1(c)). The amount accrued for a particular taxable year generally is the amount allocated to that period under the lease. If the transaction is a "leaseback" or a "long-term agreement," however, and a principal purpose for the stepping (e.g., increasing or decreasing) of rents is tax avoidance, the rents are deemed to accrue on a level, present-value basis and interest is deemed to accrue on the excess of accrued rents over rents actually paid.

Individuals, estates, trusts, closely held C corporations and personal service corporations generally may not deduct against other income any losses from passive activities in excess of gains from passive activities (sec. 469). Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the following year. Suspended losses from a passive activity are allowed in full upon a taxable disposition of the taxpayer's entire interest in the activity. A "passive activity" generally means any activity which involves the conduct of a trade or business and in which the taxpayer does not materially participate, and generally includes any rental activity, whether or not the taxpayer materially participates.

Description of Proposal

The proposal would provide that a lessor of tax-exempt use property would be entitled to recognize losses for the taxable year from a "leasing transaction" involving tax-exempt use property only to the extent of gains from that transaction for the year. Suspended losses from a leasing transaction would be carried forward to subsequent years and could be used by the lessor to offset net gains from the transaction in subsequent years. Suspended losses from the leasing transaction that had not been previously recognized would be allowed in full in the year the leasing transaction terminates.

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

Effective Date

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

Prior Action

No prior action.

Analysis

Under present law, taxpayers can enter into certain types of leasing transactions involving tax-exempt entities such as foreign persons that would allow the lessor to generate U.S. tax deductions without any party being subject to U.S. taxation on the corresponding income. Such transactions typically do not involve a mere lease, but also involve several related agreements, all of which would be treated as a "leasing transaction" under the proposal.

Advocates of the proposal would argue that taxable U.S. corporations should not be permitted to take advantage of the special tax status of tax-exempt entities participating in a lease in order to generate U.S. tax benefits. Like the timing mismatch that is addressed in section 467, the proposal is intended to address leasing transactions with tax-exempt entities which would create a mismatch in income and deductions. Leasing transactions involving tax-exempt entities can create timing mismatches in that current deductions such as depreciation, rents or interest are generated for the taxable lessor in early years with no corresponding current income inclusion to the accommodating party because it is exempt from tax. This tax benefit eventually is reversed because the taxable lessor will have income in the later years, but substantial deferral has been achieved. The deductions generated in the leasing transaction could be used by the taxable lessor to shelter other income.

The proposal adopts an approach similar to the rules addressing passive activity losses for individuals, in that, like passive activity losses, net losses from early years are deferred until the corresponding income is recognized by the taxpayer in later years (or upon termination of the leasing transaction). Advocates of the proposal argue that the mechanics of the passive activity loss rules provide an appropriate model for addressing the timing issues presented by leasing transactions with tax-exempt entities.

Some have observed that the proposal is unclear as to what would constitute a "leasing transaction." The proposal may be viewed as being overly broad and could inappropriately affect legitimate business deductions that may be tangentially related to a leasing transaction but are not merely generated to shelter income.

Some might argue that any inappropriate results from such leasing transactions are not merely a function of the presence of a tax-exempt accommodating party, but rather are related to (and therefore guidance should address) whether the leases that are part of the abusive transactions are or should be treated as leases under the tax law and whether such transactions have economic substance. In addition, it can be argued that a narrower solution for addressing certain specific mismatching problems could better be developed when the proposed Treasury regulations under section 467 are finalized. Finally, some might also observe that the result which the proposal is addressing similarly could be achieved where the accommodating party is a U.S. corporation with expiring net operating losses; the proposal, however, would not address that situation.

13. Prevent mismatching of deductions and income inclusions in transactions with related foreign persons

Present Law

As a general rule, there is allowed as a deduction all interest paid or accrued within the taxable year with respect to indebtedness (sec. 163(a)). With respect to debt instruments issued after July 1, 1982, this generally includes the aggregate daily portions of original issue discount ("OID") of the issuer for the days during such taxable year (sec. 163(e)(1)). If a debt instrument with OID is held by a related foreign person, however, any portion of such OID is not allowable as a deduction to the issuer until paid ("related-foreign-person rule") (sec. 163(e)(3)). This related-foreign-person rule does not apply, however, to the extent that the OID is effectively connected with the conduct by such foreign related person of a trade or business within the United States (unless such OID is exempt from taxation or is subject to a reduced rate of taxation under a treaty obligation). Treasury regulations further modify the related-foreign-person rule by providing that in the case of a debt owed to a foreign personal holding company ("FPHC"), controlled foreign corporation ("CFC") or passive foreign investment company ("PFIC"), a deduction is allowed for OID as of the day on which the amount is includible in the income of the FPHC, CFC, or PFIC, respectively (Treas. Reg. sec. 1.163–12(b)(3)).

In the case of unpaid interest and expenses of related persons, where, by reason of a payee's method of accounting, an amount is not includible in the payee's gross income until it is paid but the unpaid amounts would be deductible currently by the payor, the amount generally is allowable as a deduction when such amount is includible in the gross income of the payee (sec. 267(a)(2)). Treasury has been instructed to issue regulations to apply this matching principle in the case of payments to related foreign persons (sec. 267(a)(3)). With respect to interest that is not OID and other expenses owed to related foreign corporations, Treasury regulations provide a general rule that requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to such related foreign persons (with an exception for income of a related foreign person that is effectively connected with the conduct of a U.S. trade or business and that is not exempt from taxation or subject to a reduced rate of taxation under a treaty obligation) (Treas. Reg. sec. 1.267(a)(3). Additionally, as in the case of OID, the regulations provide that in the case of amounts owed to a FPHC, CFC, or PFIC, a deduction is allowed as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC.

Description of Proposal

The proposal would provide that deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) to related FPHCs, CFCs, or PFICs would be allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently included in the income of the direct or indirect U.S. owners of the related foreign person. Deductions that have accrued but are not allowable under this provision would be allowed when the amounts are paid. The proposal would provide an exception for amounts accrued where payment of the amount accrued occurs within a short period after accrual, and the transaction giving rise to the payment is entered into by the payor in the ordinary course of a business in which the payor is predominantly engaged. In addition, the proposal would grant the Secretary regulatory authority to provide exceptions to these rules.

No inference is intended as to the treatment of such payments under present law.

Effective Date

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

Prior Action

No prior action.

Analysis

Advocates of the proposal argue that there is no justification for mismatching in the case of related party OID and similar expenses. The mismatching is created because, under Treasury regulations, both U.S. payors and U.S.-owned foreign payors arguably might be able to accrue deductions for amounts owed to related FPHCs, CFCs or PFICs without the U.S. owners of such related entities taking into account for U.S. tax purposes a corresponding amount of income. These deductions can be used to reduce U.S. income or, in the case of a U.S.-owned foreign payor, to reduce earnings and profits which, for example, could reduce a CFC's income that would be currently taxable to its U.S. shareholders under subpart F.

The special rules in the Treasury regulations for FPHCs, CFCs and PFICs are an exception to the general rule in those regulations that unpaid interest and similar expenses owed to a related foreign person are deductible when paid (i.e., under a cash method). The relief was deemed appropriate in the case of FPHCs, CFCs and PFICs because it was thought that there would be little material distortion in matching of income and deductions with respect to amounts owed to a related foreign corporation that is required to determine its taxable income and earnings and profits for U.S. tax purposes pursuant to the FPHC, subpart F or PFIC provisions.[192] This premise fails to take into account the situation where amounts owed to the related foreign corporation are included in the income of the related foreign corporation but are not currently included in the income of the related foreign corporation's U.S. shareholders.

Opponents of the proposal might argue that any potential for mismatching of income and deductions with respect to accrued but unpaid interest and expenses owed to FPHCs, CFCs, and PFICs has been facilitated by Treasury regulations and, therefore, a regulatory rather than legislative solution is appropriate. Additionally, some might observe that present law properly requires FPHCs, CFCs, and PFICs and related persons to use the same method of accounting with respect to transactions between themselves. The potential for mismatching may result, for example, from a disproportionate allocation of income among shareholders rather than from the use of different accounting methods to which sections 163(e)(3) and, in particular, 267(a)(3) are targeted. On the other hand, the proposal would treat amounts owed to a related FPHC, CFC or PFIC that are not included in the income of a U.S. shareholder consistently with amounts owed to other related foreign persons (i.e., the amounts are deductible when paid) while at the same time retaining an exception for accrued amounts owed to FPHCs, CFCs and PFICs that are includible in their income and in the income of their U.S. shareholders.

14. Restrict basis creation through 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). The assumption by the controlled corporation of a liability of the transferor (or the acquisition of property "subject to" a liability) generally will not cause the transferor to recognize gain. However, under section 357(c), the transferor does recognize gain to the extent that the sum of the assumed liabilities, together with 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 indicate 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). Similar rules apply to reorganizations described in section 368(a)(1)(D).

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

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.

[192] See Notice of Proposed Rulemaking, 56 FR 11531 (Mar. 19, 1991) (Preamble to Proposed Treasury Regulations secs. 1.163–12 and 1.267(a)-3; T.D. 8465, 58 FR 235 (Jan. 5, 1993) (Preamble to Final Treasury Regulations secs. 1.163–12 and 1.267(a)-3).

Description of Proposal

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

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

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

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

Effective Date

The provision is effective for transfers on or after October 19, 1998. No inference regarding the tax treatment under present law is intended.

Prior Action

A similar provision was contained in the President's fiscal year 1999 budget proposal, and was contained in the Patient Protection Act of 1998, as passed by the House of Representatives on July 24, 1998. A substantially identical provision was introduced in the House of Representatives by Mr. Archer on October 19, 1998 (H.R. 4852) and was contained in the Miscellaneous Trade and Technical Corrections Act of 1998 (H.R. 4856), as passed by the House of Representatives on October 20, 1998.

A substantially identical provision was also included in the Miscellaneous Trade and Technical Corrections Act of 1999 (H. R. 435) as passed by the House of Representatives on February 10, 1999, and in the Miscellaneous Trade and Technical Corrections Act of 1999 (S. 262), as approved by the Senate Committee on Finance on January 22, 1999.

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*,[193] 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*,[194] 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*,[195] 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 re-

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[193] 62 T.C. 11, 19 (1974), affd. without published opinion 515 F.2d 507 (3d Cir. 1975).

[194] 881 F.2d 832 (9th Cir. 1989).

[195] 872 F.2d 519 (2d Cir. 1989); see also *Peracchi v. Commissioner*, 134 F.3d 487 (9th Circ. 1998).

structure 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 might 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 might obtain a stepped-up basis in the asset without a tax cost to A. X could 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 test regarding whether the transferee is expected to satisfy the liability, which includes a facts and circumstances test, it can also be argued 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.

15. Modify anti-abuse rules related to assumption of liabilities

Present Law

Generally, no gain or loss is recognized if property is exchanged for stock of a controlled corporation. The transferor may recognize gain to the extent other property ("boot") is received by the transferor. The assumption of liabilities by the transferee generally is not treated as boot received by the transferor. The assumption of a liability is treated as boot to the transferor, however, "[i]f, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer...was a purpose to avoid Federal income tax on the exchange, or...if not such purpose, was not a bona fide business purpose." Sec. 357(b). Thus, this exception requires that the principal purpose of having the transferee assume the liability was the avoidance of tax on the exchange.

The transferor's basis in the stock of the transferee received in the exchange is reduced by the amount of any liability assumed, but generally increased in the amount of any gain recognized by the transferor on the exchange. However, liabilities that would give rise to a future deduction is not considered a liability for purposes of basis reductions. Similar rules apply in connection with certain tax-free reorganizations.

Description of Proposal

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

Effective Date

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

Prior Action

No prior action.

Analysis

The Administration indicates concern that the present law anti-abuse provision is inadequate to address certain avoidance concerns, given the high standard that must be met before the provision is applicable.

In one transaction discussed by the Administration, taxpayers transfer assets with a fair market value basis in exchange for preferred stock and the transferee's assumption of a contingent liability that is deductible in the future but easily valued currently. The transferor claims that its basis in the stock it receives is not reduced by the amount of the liability because the liability payment would give rise to a deduction in the future and such a liability is not generally taken into account in determining the amount of liabilities assumed, absent application of an anti-abuse rule. The transferor may then accelerate the deduction by selling or exchanging the high-basis stock at a loss (since the liability in fact reduces the value of the subsidiary transferee). The transferee further might take the position that it is entitled to deduct payments on the liability, effectively duplicating the deduction attributable to the same liability.

Proponents argue that changing the standard for application of the anti-abuse rules will expand the types of transactions to which the rules of section 357(b) apply, and therefore would deter transactions such as those identified by the Administration in its description of the intended scope of the provision. It is argued that the change in standard could reduce the likelihood of various other types of transactions and would provide an additional tool to assist the Internal Revenue Service in identifying and pursuing problem cases.

Others might argue that the standard of "a principal purpose" has not been well developed in case law and may produce uncertainty of application.[196] In situations of uncertainty, there may be concern that the effectiveness of the provision might be challenged in some situations. It may also be contended that ordinary business transactions might be deterred.

16. Modify company-owned life insurance (COLI) rules

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").[197] 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 purposes of determining who is a 20-percent owner, all members of a controlled group are treated as one taxpayer. Interest

[196] The standard has been discussed in certain situations. See, e.g., *Santa Fe Pacific Corporation v. Central States, Southeast and Southwest Areas Pension Fund*, 22 F.3d 725 (7th Cir. 1994). Treasury has issued regulations dealing with "a plan, one of the principal purposes of which is the avoidance of tax under section 881". See Treas. Reg. Sec. 1.881–3(b)(1).

[197] This favorable tax treatment is available only if the policyholder has an insurable interest in the insured when the contract is issued and if the life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includable in income, to the extent that the amounts distributed exceed the taxpayer's investment in the contract; such distributions generally are treated first as a tax-free recovery of the investment in the contract, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59–1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than 7 annual level premiums (sec. 7702A). Certain amounts received under a life insurance contract on the life of a terminally or chronically ill individual, and certain amounts paid for the sale or assignment to a viatical settlement provider of a life insurance contract on the life of a terminally ill or chronically ill individual, are treated as excludable as if paid by reason of the death of the insured (sec. 101(g)).

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.

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 [198] 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.

[198] It was intended that if coverage for each insured individual under a master contract is treated as a separate contract for purposes of sections 817(h), 7702, and 7702A of the Code, then coverage for each such insured individual is treated as a separate contract, for purposes of the exception to the pro rata interest disallowance rule for a policy or contract covering an individual who is a 20-percent owner, employee, officer or director of the trade or business as the time first covered. A master contract does not include any contract if the contract (or any insurance coverage provided under the contract) is a group life insurance contract within the meaning of Code section 848(e)(2). No inference was intended that coverage provided under a master contract, for each such insured individual, is not treated as a separate contract for each such individual for other purposes under present law. A technical correction so providing was enacted in section 6010(o) of the Internal Revenue Service Restructuring and Reform Act of 1998.

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.

Prior Action

The proposal is identical to a proposal contained in the President's budget proposal for fiscal year 1999.

Analysis

The proposal is directed to an aspect of the issue addressed by Congress in 1996 and 1997: the issue of borrowing against life insurance contracts to achieve tax arbitrage. Businesses that own life insurance on employees and borrow from a third-party lender or from the public may still be able to achieve tax arbitrage by deducting interest that funds the tax-free inside buildup on the life insurance (or the tax-deferred inside buildup of annuity and endowment contracts). This continued opportunity for tax arbitrage results from the exception under the pro rata interest deduction limitation for insurance covering employees and others, it is argued. Businesses have been able to substitute third-party debt for debt that would have been subject to the 1996 Act limitations on interest deductibility with respect to insurance on employees. This tax arbitrage opportunity is being utilized by financial intermediation businesses (and could be utilized by other leveraged businesses), which often have a relatively large amount of debt in the ordinary course of business. Thus, it is argued, the exception should be repealed.

It can be argued, however, that retaining an exception from the pro rata interest disallowance rule for employees, officers, and directors is important for small businesses. Small businesses might argue that they need access to cash, in particular the cash value of life insurance on key employees, and that it would be inappropriate to reduce the tax subsidy stemming from the exception in their case. They might also argue that the proposal should be more targeted, perhaps to financial intermediaries or to large employers, or should provide for a narrower employee exception structured like the 20-key-person exception under the 1996 legislation, so as to address the tax arbitrage concern without negatively impacting their cash needs. On the other hand, it could be countered that in most cases the cash needs of small businesses have already been addressed by the proposal's continuation of the exception for 20-percent owners. In addition, it can be argued that insuring the lives of key employees can be accomplished by purchasing term life insurance, which is not affected by the proposal, and that cash needs arising from loss of a key employee can be addressed without the purchase of cash value life insurance. Further, because of the extension of the average person's expected life span in recent decades, it is argued that the purchase of term life insurance on a key employee through his or her likely retirement age is no longer difficult or expensive.

Opponents of the proposal argue that the funds borrowed under the life insurance contracts are used for tax-advantaged pre-funding of expenses such as retiree health benefits and supplemental pension benefits. On the other hand, Congress has already provided special tax-favored treatment specifically to encourage businesses to provide health and pension benefits. It was not intended that tax arbitrage with respect to investments in COLI be used to circumvent statutory limits that Congress enacted for these tax-favored health and pension benefits.

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.

B. Financial Products

1. Require banks to accrue interest on short-term obligations

Present Law

Cash method of accounting

The taxable income of a taxpayer is computed under the method of accounting on the basis which the taxpayer regularly computes his income in keeping his books so long as it clearly reflects income. A taxpayer generally is permitted to use the cash receipts and disbursement method (the "cash method") or an accrual method (sec. 446).

Certain corporations engaged in farming (sec. 447) and C corporations with average gross receipts of $5 million or more are required to use an accrual method of accounting (sec. 448).

Accrual of acquisition discount on short-term obligations

All taxpayers regardless of their method of accounting are required to accrue currently interest attributable to original issue discount generally on all debt instruments issued after July 1, 1982, with certain exceptions (sec. 1272). One of the exceptions where accrual of interest is not required is any debt instrument which has fixed maturity date not more than one year from the date of issue ("short-term obligations")(sec. 1272(b)(2)).

With respect to obligations acquired after July 18, 1984, certain taxpayers are required to accrue currently as interest acquisition discount on short-term governmental obligations and original issue discount on short-term nongovernmental obligations. The taxpayers required to accrue currently discount on short-term obligations are (1) accrual basis taxpayers, (2) taxpayers holding the obligations primarily for sale to customers, (3) banks, (4) regulated investment companies (mutual funds) or common trust funds, (5) taxpayers holding the obligation as part of a hedging transaction or (6) taxpayers who stripped the bond or coupons on the bond (sec. 1281).

Courts have held that banks using the cash method of accounting are not required to accrue income on discount on short-term loans to customers made in the ordinary course of the bank's business on the grounds that loans originated by the bank did not have acquisition discount (see, e.g., *Security Bank of Minnesota* v. *Comm.*, 994 F. 2d 432 (8th Cir. 1993)).

Description of Proposal

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

Effective Date

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

Prior Action

No prior action.

Analysis

The proposal would affect small banks[199] that are using the cash method of accounting with respect to loans originated by the bank that have a maturity of one year or less.

The proposal's proponents argue it would provide identical tax treatment to banks that both originate or purchase short-term loans.

Opponents of the proposal argue that adoption of the proposal may hurt small rural banks and their farmer customers. Many of the affected taxpayers would be small rural banks that make crop loans to farmers. Such loans often provide for a lump-sum repayment of principal and interest early the following year after the farmer has had time to harvest and sell the crop. Under the proposal, cash method banks making such loans would be required to pay tax on the interest accruing during the year even if it does not

[199] Banks with average gross receipts of $5 million or more are required to use an accrual method of accounting under section 448.

receive any cash with which to pay the tax until the following year. Banks facing such a situation may require the farmer to pay interest during that year or raise their interest rate on such loans to compensate for the earlier payment of tax.

For example, in February, a farmer may borrow funds from a local bank with which the farmer will use to buy seed for a Spring planting in April and supplies for this year's crop. The loan provides that the farmer will pay back the loan with interest in the following January after the farmer has had time to sell his crop.

2. Require current accrual of market discount by accrual method taxpayers

Present Law

A debt instrument has "market discount" if it is acquired other than at original issue for a price that is less than the principal amount of the debt instrument.[200] Market discount generally arises when a debt instrument has declined in value subsequent to its issuance (for example, because of an increase in interest rates or a decline in the credit-worthiness of the borrower).

In general, a holder of a debt instrument with market discount does not have to recognize any income with respect to the market discount until the debt instrument matures or is disposed. On the disposition of the debt instrument, the holder must treat any gain as ordinary income to the extent of the accrued market discount (sec. 1276).[201] However, when a holder receives a partial principal payment on the debt instrument, the payment is treated as ordinary income to the extent of any accrued market discount. A holder also may elect to include the market discount in income as it accrues.[202]

Description of Proposal

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

Effective Date

The proposal would be effective for debt instruments acquired on or after the date of enactment.

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[200] In the case of a debt instrument issued with original issue discount ("OID"), market discount exists when the debt instrument is acquired at a price that is less than its adjusted issue price.

[201] In determining the amount of accrued market discount, the holder can elect between treating the discount as accruing (1) ratably, or (2) on a constant yield basis. Under a de minimis rule, the market discount is considered to be zero if it is less than 1/4 of 1 percent of the stated redemption price of the bond multiplied by the number of complete years to maturity after the taxpayer acquired the bond.

[202] Section 1278(b). Revenue Procedure 92–67, 1992–2 C.B. 429, sets forth the procedures for making this election.

Prior Action

No recent prior action.[203]

Analysis

Present law provides a more favorable tax treatment for a holder of a debt instrument with market discount than a debt instrument with OID, notwithstanding that they are economically indistinguishable (i.e., both forms of discount represent substitutes for stated interest). The Administration proposal would eliminate this disparity.

The proposal would cap the yield by which the market discount would accrue to the greater of (1) the original yield-to-maturity of the debt instrument plus 5 percentage points, or (2) the applicable Federal rate at the time the holder acquired the debt instrument plus 5 percentage points. The cap is consistent with the policy reflected in the high-yield discount obligation rules (that a portion of the holder's return from such an instrument, if realized, is more properly viewed as gain on an equity investment). Notwithstanding the requirement of accrual and the cap on the yield, it is unclear how the proposal would apply in situations where a debt instrument is acquired at a deep discount because the borrower is in a distressed economic position. There is authority for the proposition that, in situations where the amount of realizable discount is uncertain, the taxpayer may recover his basis in the debt instrument before recognizing any market discount (i.e., an open-transaction approach).[204]

One concern with the Administration proposal is the additional complexity it may cause. When the market discount rules were added to the Code as part of the Deficit Reduction Act of 1984, Congress recognized the economic equivalence of market discount and original issue discount, yet it enacted a different set of rules for market discount. Accordingly, "the Congress appreciated that the theoretically correct treatment of market discount, which would require current inclusion in the income of the holder over the life of the obligation, would involve administrative complexity."[205]

The administrative complexity may be a particular concern with respect to the computation of market discount where the debt instrument was issued with OID; the market discount and the OID amounts could involve different computations.[206] The proposal's limited application to holders using an accrual method of accounting, however, would restrict the impact of the proposal to a class

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[203] The House of Representatives included a similar proposal in the Omnibus Budget Reconciliation Act of 1987 (section 10118), but the proposal was not adopted by the conference.

[204] See, e.g., Liftin v. *Comm'r*, 36 T.C. 909 (1961), aff'd, 317 F. 2d 234 (4th Cir. 1963) ("Where a taxpayer acquires at a discount contractual obligations calling for periodic payments of parts of the face amount of principal due...where it is shown that the amount of the realizable discount gain is uncertain or that there is 'doubt whether the contract [will] be completely carried out,' the payments should be considered as a return of cost until the full amount thereof has been recovered, and no allocation should be made as between such cost and discount income."); *Underhill* v. *Comm'r*, 45 T.C. 489 (1966) (same). See also, Garlock, *Federal Income Taxation of Debt Instruments*, ch. 10, pp. 13–16 (Aspen Law & Business, 1998 Supp.).

[205] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS–41–84), December 31, 1984, p. 93.

[206] Many of the complexities and uncertainties of the proposal exist in present law for taxpayers with OID instruments that elect current accrual of market discount. To date, no regulations have been issued under the market discount rules.

of taxpayers that is more familiar with the complexities of reporting income under an accrual method.

3. Limit conversion of character of income from constructive ownership transactions with respect to partnership interests

Present Law

The maximum individual income tax rate on ordinary income and short-term capital gain is 39.6 percent, while the maximum individual income tax rate on net long-term capital gain is generally 20 percent. Long-term capital gain means gain from the sale or exchange of a capital asset held more than one year. For this purpose, gain from the termination of a right with respect to property which would be a capital asset in the hands of the taxpayer is treated as capital gain.[207]

A partnership is not subject to Federal income tax. Rather, each partner includes its distributive share of partnership income, gain, loss, deduction or credit in its taxable income for the partnership's taxable year, regardless of whether a distribution was actually made to the partner in that taxable year. Generally, the character of the partnership item is determined at the partnership level and flows through to the partners. Thus, for example, the treatment of income by the partnership as ordinary income, short-term capital gain, or long-term capital gain retains its character when reported by each of the partners.

Investors may enter into forward contracts, notional principal contracts, and other similar arrangements with respect to property that provide the investor with the same or similar economic benefits as owning the property directly but with potentially different tax consequences (as to the character and timing of any gain).

Description of Proposal

The proposal would limit the amount of long-term capital gain a taxpayer could recognize from arrangements that substantially replicate the economic results of direct ownership of an partnership interest[208] during the term of the arrangement (a "constructive ownership transaction"). The long-term capital gain would be limited to the amount of long-term gain the taxpayer would have had if the taxpayer held the partnership interest directly during the term of the arrangement (the "net underlying long-term capital gain"). Any gain in excess of this amount would treated as ordinary income. To the extent that gain is recharacterized as ordinary income, an interest charge would be imposed.

A taxpayer would be treated as having entered into a constructive ownership transaction if the taxpayer (1) holds a long position under a notional principal contract with respect to a partnership interest, (2) enters into a forward contract to acquire a partnership interest, (3) is the holder of a call option, and the grantor of a put option, with respect to a partnership interest, and the options have substantially equal strike prices and substantially contempora-

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[207] Section 1234A, as amended by the Taxpayer Relief Act of 1997.

[208] The Administration proposal would not apply to other types of pass-through entities.

neous maturity dates, or (4) to the extent provided in regulations, enters into one or more transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.

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

A taxpayer would be treated as holding a long position under a notional principal contract with respect to a partnership interest if the person (1) has the right to be paid (or receive credit for) all or substantially all of the investment yield (including appreciation) on the partnership interest for a specified period, and (2) is obligated to reimburse (or provide credit) for all or substantially all of any decline in the value of the partnership interest. A forward contract is a contract to acquire (or provide or receive credit for the value of) a partnership interest unless the price or quantity is determined solely by reference to the value of the partnership interest on the date the partnership interest is to be acquired. A forward contract could be cash settled.

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

Effective Date

This proposal would apply to gains recognized on or after the date of first committee action.

Prior Action

No prior action. However, a similar proposal (H.R. 3170) was introduced in the 105th Congress by Representative Barbara Kennelly.

Analysis

Reports have described swap arrangements with respect to "hedge funds" that are designed to replicate the economic returns of a direct investment in the hedge fund while (1) converting any ordinary income (and short-term capital gain) attributable to the fund into long-term capital gain, and (2) deferring the tax on the gain until the arrangement is terminated.[209] As a simplified example, assume an investor enters into a three-year contract with a securities dealer, where the dealer agrees to pay the investor the amount of any appreciation in the value of a notional investment of $1 million in a domestic "hedge fund" partnership.[210] In return, the investor agrees to pay the dealer the amount of any deprecia-

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[209] See, e.g., Browning, "Where There's a Tax Cut, Wall Street Finds a Way," *The Wall Street Journal*, October 21, 1997, p. C–1; Sheppard, "Constructive Ownership of a Bag of Dead Cats," 81 *Tax Notes* 407, October 26, 1998.

[210] Assuming the securities dealer purchases the partnership interest, the dealer would mark both the partnership interest and the contractual arrangement to market under Code section 475, and the economic consequences of the two positions would offset each other. Therefore, the dealer would not pay tax on the return from the hedge fund.

tion in the value of the investment.[211] After three years, assume the value of a $1 million investment in the hedge fund would have increased by $200,000, of which $150,000 is ordinary income and short-term gain ($50,000 is long-term capital gain). The investor receives a termination payment of $200,000. Under present law, the investor may take the position that the entire $200,000 is long-term capital gain (taxed at a 20 percent rate) from the termination of a contract right. Moreover, the tax is deferred until the contract is terminated. Had the investor owned a direct interest in the hedge fund, the $200,000 would have been taxed in the year it was earned at the applicable rates (generally at a 20 percent rate for the long-term gain, and up to a 39.6 percent rate on the ordinary income and short-term gain).

The proposal would recharacterize $150,000 of the gain as ordinary income (the excess of $200,000 of long-term gain over $50,000 of net underlying long-term capital gain). For purposes of calculating the interest charge, the $150,000 of recharacterized income would be allocated ratably over the three year-term of the constructive ownership transaction.

Some would argue that it is inappropriate for an investor who engages in a transaction designed to replicate the economic returns of owning an interest in a partnership to be taxed in a more favorable manner than had the investor actually owned the partnership interest. If the investor has assumed substantially all of the economic burdens and benefits attributable to the partnership interest, then to the extent possible, the investor should be taxed in a comparable manner.[212] These types of conversion transactions also could be viewed as inconsistent with the objectives underlying the beneficial tax treatment of long-term capital gains. Moreover, if these conversion transactions could be accomplished via the use of other pass-through entities, the proposal arguably should cover such entities.

Others would argue that a derivative instrument which substantially replicates the economic position of direct ownership of an equity interest in a partnership is not tantamount to direct ownership of the partnership interest and should not be taxed as such. The investor does not have the legal benefits and burdens of actual ownership of a partnership interest. The investor has no actual relationship with the partnership and no involvement with respect to the partnership's management or operations. Rather, the investor has entered into a contractual relationship with his counterparty and thus bears the risks that are inherent in such a relationship. In addition, there may be non-tax reasons for structuring the investment in this manner, such as reduced borrowing costs for the investor.

In addition, treating the recharacterized gain as having been recognized ratably over the term of the constructive ownership transaction for purposes of imposing the interest charge would have the effect of overstating the underpayments of tax in the early years

[211] For purposes of this example, any interim payments or distributions between the parties are ignored.

[212] Code section 1259, enacted as part of the Taxpayer Relief Act of 1997, embodies a similar economic concept—a taxpayer who has substantially eliminated both the risk of loss and opportunity for gain on an appreciated investment is treated for Federal income tax purposes as if the taxpayer had sold the investment.

and understating them in later years relative to true economic accrual. Moreover, the interest rate imposed by section 6601 exceeds the interest rate that a taxpayer engaging in such a transaction would typically pay on a borrowing.[213] However, the proposal does allow taxpayers to avoid this result by electing mark-to-market treatment with respect to the constructive ownership transactions.

4. Modify rules for debt-financed portfolio stock

Present Law

In general, a corporate shareholder can deduct 70 percent of the dividends that it receives from another corporation (80 percent in the case of dividends received from a 20-percent-owned corporation and 100 percent in the case of certain dividends from affiliated corporations) (sec. 243). A special rule, however, reduces the dividends-received deduction on "debt-financed portfolio stock" so that the deduction is available, in effect, only with respect to dividends attributable to that portion of the stock which is not debt financed (sec. 246A). Generally, this is accomplished by determining the percentage of the cost of an investment in portfolio stock which is debt financed and by reducing the otherwise allowable dividends-received deduction with respect to any dividends received on that stock by that percentage. Debt-financed portfolio stock is defined as any "portfolio stock" with respect to which there is "portfolio indebtedness" at any time during the "base period."

Stock held by a corporation generally is portfolio stock unless, as of the ex-dividend date for the dividend involved, the corporate shareholder holds stock (1) possessing at least 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote and (2) having a value equal to at least 50 percent of the value of all the stock of such corporation. Additionally, stock is specifically excluded from treatment as portfolio stock if, as of the beginning of the ex-dividend date for the dividend involved, (1) the taxpayer owns stock of such corporation possessing at least 20 percent of the voting power and value of all the stock of such corporation and (2) five or fewer corporate shareholders own stock of such corporation possessing at least 50 percent of the voting power and value of all the stock of such corporation. The base period with respect to any dividend is the shorter of (1) the period beginning on the ex-dividend date for the most recent previous dividend on the stock and ending on the day before the ex-dividend date for the dividend involved, or (2) the one-year period ending on the day before the ex-dividend date for the dividend involved.

Portfolio indebtedness is any indebtedness which is "directly attributable" to an investment in portfolio stock with respect to which a dividend is received. The directly attributable standard is satisfied if there is a direct relationship between the debt and the investment in portfolio stock. The directly attributable standard does not incorporate any allocation or apportionment formula or fungibility concept. If debt is clearly incurred for the purpose of ac-

[213] New York State Bar Association Tax Section, "Comments on H.R. 3170," 98 *TNT* 136–38 (July 18, 1998).

quiring or carrying dividend-paying portfolio stock or is otherwise directly traceable to such stock, however, the indebtedness would constitute portfolio indebtedness. This would be the case, for example, if the corporation incurred a nonrecourse loan secured, in whole or in part, by dividend-paying portfolio stock, or it purchased portfolio stock by issuing its own indebtedness to the seller.

Description of Proposal

The proposal would modify the standard for determining whether portfolio stock is debt-financed. Under the proposal, the percentage of portfolio stock treated as debt-financed would equal the sum of (1) the percentage of stock that is directly financed by indebtedness, and (2) the percentage of remaining stock that is indirectly financed by indebtedness. A pro rata allocation formula would be used to determine the percentage of the remaining stock that is indirectly financed by indebtedness.

Effective Date

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

Prior Action

No prior action.

Analysis

The purpose of the dividends-received deduction is to reduce multiple corporate-level taxation of income as it flows from the corporation that earns it to the ultimate noncorporate shareholder. When dividends are paid on debt-financed portfolio stock, however, the combination of the dividends-received deduction and the interest deduction would enable a corporate shareholder to shelter unrelated income. A corporation could arbitrage the tax system by having partially tax-exempt income on one hand and related fully deductible expenses on the other. The debt-financed portfolio stock rule is intended to prevent such a result. The reduction may be viewed as a surrogate for limiting the interest deduction as is accomplished in other areas of the Code in which the potential for such mismatching exists (e.g., the interest deduction is limited with respect to interest on debt to fund life insurance (sec. 264) and with respect to debt incurred to purchase or carry tax-exempt obligations (sec. 265)).

Advocates of the proposal argue that present law is not achieving its intended effect because the "directly attributable" standard is easily avoided. Under present law, a corporation may be able to structure indebtedness that is designed to purchase or carry the portfolio stock but that does not meet the "directly attributable" standard. The proposal would tighten the standard by including stock that is indirectly debt-financed. A pro rata formula (similar to the formula used with respect to the allocation of interest expense to life insurance policy cash values (sec. 264(f)) and the pro rata allocation of interest expense of financial institutions to tax-exempt interest (sec. 265(b))) would determine the amount of stock indirectly debt-financed. Advocates of the proposal might further argue that the allocation formula recognizes the economic reality of the fungibility of funds.

Opponents of the proposal argue that the "directly attributable" standard is the appropriate standard for eliminating tax arbitrage with respect to the dividends-received deduction for portfolio stock. When debt is incurred for the purpose of acquiring dividend-paying portfolio stock or is otherwise directly traceable to such an acquisition or carrying of that stock, it is appropriate to reduce the dividends-received deduction. Introducing an allocation formula or fungibility concept, however, is not consistent with the underlying purpose of the dividends-received deduction. Multiple corporate-level taxation could still exist to the extent that unrelated indebtedness is allocated to portfolio stock so as to reduce the dividends-received deduction. Under the proposal, any corporation that merely issues commercial paper from time to time as part of its cash management program or that owns mortgaged real estate would inappropriately suffer a reduction in its dividends-received deduction with respect to unrelated portfolio stock.

5. Modify and clarify certain rules relating to debt-for-debt exchanges

Present Law

In general, if a debt instrument is repurchased by the issuer for a price in excess of its adjusted issue price, the excess ("repurchase premium") is deductible as interest for the taxable year in which the repurchase occurs. However, in a debt-for-debt exchange, where neither debt instrument is publicly traded, any repurchase premium is amortized over the term of the newly issued debt as if it were original issue discount ("OID").[214] If the issuer repurchases a debt instrument in a debt-for-debt exchange, the repurchase price is the issue price of the newly issued debt instrument (reduced by any unstated interest under section 483).

If a debt instrument is repurchased by the issuer for a price which is less than its adjusted issue price, the issuer recognizes income from the discharge of indebtedness. If the debtor issues a debt instrument in satisfaction of the indebtedness, the new debt instrument is treated as having satisfied the indebtedness with an amount of money equal to the issue price of the new debt instrument (sec. 108(e)(10)). If the new debt instrument provides for contingent payments, and neither the new debt instrument nor the old debt instrument is publicly traded, then the holder includes the fair market value of the contingent payments in determining the amount realized in the exchange.[215] The issuer does not include the value of the contingent payments in determining the issue price of the new debt instrument.[216]

Under present law, gain is recognized by a shareholder or securityholder in a reorganization (or distribution under section

[214] Treas. reg. sec. 1.163–7(c). The regulation overturned the result in *Great Western Power Company of California v. Commissioner*, 297 U.S. 543 (1936), in which the Supreme Court held any repurchase premium in a debt-for-debt exchange must be amortized over the term of the new debt rather than deducted immediately.

[215] Treas. reg. sec. 1.1001–1(g)(2)(ii).

[216] Treas. reg. sec. 1.1274–2(g).

355) only to the extent that property other than stock or securities in a corporation that is a party to the reorganization is received. For purposes of this rule, "other property" includes the fair market value of the excess of the principal amount of securities received over the principal amount of any securities surrendered (if any). If the principal amount of the securities received and the principal amount of the securities surrendered are the same, no gain is recognized.

Description of Proposal

The proposal would require an accrual basis taxpayer to amortize any repurchase premium in a debt-for-debt exchange over the term of the new debt instrument as if it were OID. The proposal would clarify that where the new debt is contingent and neither the new debt nor the old debt is publicly traded, in applying the debt-for-debt exchange rule to the debtor, the fair market value of any contingent payments would be added to the issue price of the new debt.

The proposal also would provide that for purposes of determining the amount of gain recognized to a securityholder in a reorganization (or a section 355 distribution), the excess of the issue price of the securities received over the adjusted issue price of the securities surrendered would be treated as "other property." If securities are received and none are surrendered, the issue price of the securities received would be treated as other property. However, if either the securities surrendered or the securities received is publicly traded, the amount treated as "other property" would be limited to the excess of the issue price of the securities received over the fair market value of the securities surrendered.

Effective Date

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

Prior Action

No prior action.

Analysis

The proposal would require an accrual basis taxpayer to amortize any repurchase premium in a debt-for-debt exchange over the life of the new debt. This proposal is consistent with the rationale in the U.S. Supreme Court decision in *Great Western Power* which ruled that these expenses are properly allocated to the cost of obtaining a new loan rather than a cost of terminating the old loan, and thus amortizable over the life of the new loan. This differs from the result that would occur if the transactions are viewed as separate transactions in which the old debt is first repurchased for money and then new debt is separately incurred (in which case the repurchase premium would be immediately deductible).

The proposal would result in the asymmetrical treatment of repurchase premium—a holder would include the premium as income in the year of the exchange, while the issuer would be required to amortize the premium over the life of the new debt. Opponents of the proposal may question the appropriateness of this treatment. However, present law already provides inconsistent treatment as to the character of the repurchase premium. Thus, the holder deducts the repurchase premium as interest while the holder treats the premium as capital gain.[217]

Where a contingent payment debt instrument is issued in exchange for a debt instrument and neither the new debt nor the old debt is publicly traded, the debtor excludes this amount for purposes of determining the issue price of the debt instrument under sec. 108(e)(10). This treatment could result in an overstatement of the debtor's discharge of indebtedness income and thereby fail to reflect the true economics of the exchange. The proposal would require both parties to take into account the fair market value of the contingent payments.

The present law rules measuring the amount of "other property" received in an exchange of securities relies on the principal amount of the securities. The principal amount rule acts as a safe harbor; the securityholder does not have to determine the fair market value of the securities unless the principal amount of securities received exceeds the principal amount of any securities surrendered. However, because the principal amount may include amounts otherwise treated as interest for other purposes of the Code, the "principal amount" may not properly measure whether a creditor receives additional debt in an exchange. Indeed, some commentators believe that "principal amount" in present law could refer to amounts that are treated as principal for purposes of the OID rules.[218] The proposal would explicitly adopt this approach. In the case of publicly traded debt, the proposal would rely on fair market value as the indicator of whether other property was received; in the case of other debt, the proposal would rely on the issue price of each security.

6. Modify and clarify straddle rules

Present Law

A "straddle" generally refers to offsetting positions with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. When a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for any taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle (sec. 1092). Deferred losses are carried forward to the succeeding taxable year and are subject to the same limitation with respect to unrecognized gain in offsetting positions.

The straddle rules generally do not apply to positions in stock. However, the straddle rules apply to straddles where one of the positions is stock and at least one of the offsetting positions is either

[217] GCM 39543 (August 8, 1986).

[218] See, e.g., Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders,* ¶ 12.27[4][b] at p. 113–114 (Warren, Gorham & Lamont, 6th ed. 1998); Garlock, *Federal Income Taxation of Debt Instruments,* ch. 17, pg. 120 at note 367 (Aspen Law & Business, 1998 Supp.).

(1) an option with respect to the stock or (2) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. In addition, the straddle rules apply to stock of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder.

Taxpayers are required to capitalize certain otherwise deductible expenditures allocable to personal property which is part of a straddle (sec. 263(g)). Such amounts must be charged to the capital account of the property to which the expenditures relate. Expenditures subject to this requirement are interest on indebtedness incurred or continued to purchase or carry property (including any amount paid or incurred in connection with personal property used in a short sale) as well as all other amounts paid or incurred to carry the property, including insurance, storage, or transportation charges ("carrying charges"). The amount of the expenditures to be capitalized is reduced by (1) any interest income from the property (including original issue discount) which is includible in gross income for the taxable year, (2) certain amounts of acquisition and market discount treated as ordinary income with respect to such property for the taxable year, (3) the excess of dividends includible in gross income over any dividends-received deduction with respect to such property for the taxable year, and (4) an amount which is payment with respect to a security loan includible in gross income with respect to such property for the taxable year.

Description of Proposal

The proposal would clarify that expenses (including interest and other periodic payments) associated with structured financial transactions that are part of a straddle would be capitalized as carrying costs of the straddle under section 263(g). Thus, for example, if a taxpayer holds an appreciated position in actively traded personal property and the taxpayer enters into a prepaid (or collateralized) forward contract to sell the property, the taxpayer must capitalize all expenses associated with that forward contract.

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

No inference would be intended with respect to the tax treatment of transactions entered into before the effective date.

Effective Date

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

Prior Action

A similar proposal was included in the President's tax simplification proposals released in April 1997 and, with respect to the repeal of the exception for stock in the definition of personal property, in the President's fiscal year 1999 budget proposal.

Analysis

Under present law, when a one of the positions that is part of a straddle consists of a debt or a debt-like component, some taxpayers have taken the position that interest expense or similar periodic payments with respect to that component are not costs incurred to purchase or carry personal property that is part of the straddle and, therefore, do not have to be capitalized. Advocates of the proposal argue that it is inappropriate for a taxpayer to deduct expenses associated with one position in a straddle to the extent that there is unrecognized gain in the offsetting position in the straddle. When one position in a straddle has a debt or debt-like component, the related interest expense should be viewed as a cost of the straddle.

Opponents of the proposal would argue, on the other hand, that interest expense or similar periodic payments should be capitalized only when the proceeds from the debt or debt-like component of the straddle are used to purchase or carry a position in the straddle. To the extent that the proceeds from the debt or debt-like component are not used to fund a position in personal property that is part of the straddle (e.g., to fund a long position that is offset by a forward contract) and therefore are available for other purposes, it arguably is inappropriate to capitalize the expenses related to the debt or debt-like component.

The repeal of the exception from the straddle rules for stock arguably is consistent with the policy of those rules, which is to prevent deduction of losses in situations where a taxpayer has entered into an offsetting transaction that has unrecognized gain, until such time as the gain on the offsetting position is recognized. Advocates of the proposal also would observe that the offsetting appreciated stock positions are subject to the constructive sale rules added by the Taxpayer Relief Act of 1997 (sec. 1259) which have more onerous results than loss deferral under the straddle rules. Additionally, it must be pointed out that proposed Treasury regulations would severely limit the stock exception even if the proposal is not adopted.[219] Nonetheless, because stock is widely held, the repeal of the stock exception would subject many more taxpayers to the complicated straddle rules.

7. Defer interest deduction and original issue discount (OID) on certain convertible debt

Present Law

The issuer of a debt instrument may deduct stated interest as it economically accrues. If the debt 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 in income 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

[219] Prop. Treas. Reg. sec. 1.1092(d)–2.

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 generally 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 and 1999 budget proposals.

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").[220] 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 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

[220] 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.

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. They would further 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.

C. Corporate Provisions

1. Conform control test for tax-free incorporations, distributions, and reorganizations

Present Law

The tax consequences of a particular corporate transaction (such as an incorporation, distribution, or a reorganization) often depend on whether a "control" test is satisfied. In general, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation (sec. 368(c)).

For purposes of determining whether two corporations are sufficiently affiliated so that, in essence, they are treated as a single corporation for some tax purposes (such as the filing of a consolidated return, tax-free liquidations, and qualified stock purchases), the ownership test requires at least 80 percent of the total voting power of the corporation's stock and at least 80 percent of the total value of the corporation's stock (sec. 1504(a)(2)). For this purpose, stock does not include preferred stock that meets the requirements of section 1504(a)(4).

Proposal

The proposal would conform the control test under section 368(c) with the affiliation test under section 1504(a)(2). Thus, "control" would be defined as the ownership of at least 80 percent of the total voting power and at least 80 percent of the total value of the corporation's stock. For this purpose, stock would not include preferred stock that meets the requirements of section 1504(a)(4).

Effective Date

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

Prior Action

No prior action.

Analysis

Recent publicized corporate transactions have highlighted the use of an equity structure where the voting power and the value have been separated (e.g., one class of common stock is heavy vote-light value stock, and another class is light vote-heavy value). This separation of vote from value permits a party to satisfy the "control" test through voting power, while disposing of much of the value of the common stock and future growth of a subsidiary. Some observers have characterized this as the disposition of a subsidiary in a transaction that has characteristics of a sale but nonetheless is designed to qualify for tax-free treatment.[221]

The development of this proposal is comparable to the history of the affiliation test under section 1504(a). Prior to 1984, the affiliation test required an ownership of 80 percent of the voting power and 80 percent of each class of the nonvoting stock of each includible corporation. In the Deficit Reduction Act of 1984, Congress amended section 1504(a) to include an 80-percent value test, in part because "notwithstanding the intent of the provision, corporations were filing consolidated returns under circumstances in which a parent corporation's interest in the issuing corporation accounted for less than 80 percent of the real equity value of such corporation."[222] However, Congress did not amend the section 368(c) control test.[223]

One type of transaction where the disproportionate equity structure has been used is with tax-free spin-offs. A corporation must "control" a subsidiary at the time of the spin-off to qualify for tax-free treatment. However, the disposition of significant stock value can occur prior to the spin-off through the issuance of "light vote" stock. The parent corporation may use the proceeds of such stock issuance as cash it retains tax-free in connection with the disposition. This transaction can be illustrated with the following simplified example: P, a corporation, owns 100 percent of S (with a value of $100). P plans to dispose of S by combining an initial public offering ("IPO") of S with a tax-free spin-off of S. The S equity structure is comprised of two classes of voting common stock—60 shares of class A stock, which is issued and owned by P (and has five votes per share) and 40 shares of unissued class B stock (which has one vote per share). Prior to the IPO, S declares a $40 dividend to P and issues a note to P in that amount. The class B stock is sold in the IPO for $40. S uses the proceeds to pay off its note to P. Thereafter, P distributes the class A stock to its shareholders in a transaction that qualifies as a tax-free spin-off under section 355 (because the class A stock represents more than 80 percent of the voting control of S).

Light vote-heavy value stock also has been used in connection with reorganizations. Voting preferred stock is combined with voting common stock in a transaction that arguably resembles a disguised sale but is structured to qualify as a tax-free reorganization (so the seller can avoid capital gains). The putative seller transfers appreciated property in exchange for a stock interest that shares in little, if any, of the economic growth potential of the property it formerly owned—this economic interest now belongs to the other party to the transaction (the buyer). Instead, the seller's stock in-

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[221] See, e.g., Sloan, "Did Times Mirror Deserve That Tax Break? It Depends on Your Definition of a 'Sale,'" *The Washington Post,* October 13, 1998, p. C–3; Sisk, "Conoco Deal Seen Legitimizing Spinoff Tax Technique," *Corporate Financing Week,* Vol. XXIV, No. 46, November 16, 1998.

[222] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS–41–84), December 31, 1984, pp. 170–171.

[223] In 1985, the staff of the Senate Finance Committee recommended amending the control test to conform with the new affiliation test. See, Senate Finance Committee Staff Report, *The Subchapter C Revision Act of 1985,* S. Print 99–47, 99th Cong., 1st Sess. (1985), proposed section 366(c).

terest reflects the economic value of property (including cash) contributed by the buyer as part of the transaction.[224]

The Administration proposal is intended to curtail the ability to engage in tax-free transactions with "sales-like" characteristics. At the same time, some commentators might argue that the proposal is overly broad because it would affect other corporate transactions that lack this element. Some might question whether changing this long-standing rule[225] is necessary, and whether it could result in new planning opportunities.

Under present law, if light vote-heavy value stock is issued in an IPO that is related to a tax-free spin-off, and the stock has a value equal to or greater than 50 percent of the issuing corporation, then the IPO would result in a corporate level tax under section 355(e). Thus, in section 355 transactions, the disproportionate equity structure is relevant only when the stock being issued has a value of between 20–50 percent of the issuing corporation. Moreover, a similar result might be achieved by having the issuing corporation borrow funds and distribute the proceeds to the parent prior to the spin-off. It is also arguable that to the extent that the parent's basis in the stock of the subsidiary reflects post-affiliation earnings, the parent corporation should be able to receive these amounts regardless of whether the source of the funds is from leveraging or from an IPO using light vote-heavy value stock.

One aspect of the proposal is that, in determining whether the 80-percent vote and value test is satisfied, so-called "pure" preferred stock would be excluded from the calculations.[226] This raises a question of whether pure preferred stock could be used as a substitute for light vote-heavy value stock.[227] However, in certain other instances where ownership is relevant, the value of pure preferred stock is disregarded.[228]

2. Tax issuance of tracking stock

Present Law

The term "tracking stock" refers to a special class of stock of the issuing corporation that tracks the performance or value of one or more separate assets of the issuing corporation. The holder of tracking stock has the right to share in the earnings or value of less than all of the corporate issuer's earnings or assets (a vertical slice of the issuer). Subsidiary tracking stock is in form stock of a parent corporation that is intended to relate to and track the economic performance of a subsidiary of the parent. The Internal Revenue Service has indicated it will not rule on whether tracking

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[224] See, e.g., Sheppard, "Corporate Sales: Ignore that LLC behind the Curtain," 82 *Tax Notes* 32, January 4, 1999.

[225] Section 202(c)(3) of the Revenue Act of 1921 provided that "for purposes of [the predecessor to section 351], a person is, or two or more persons are, 'in control' of a corporation when owning at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation."

[226] The term "pure" preferred stock refers to preferred stock that satisfies the requirements of section 1504(a)(4).

[227] The pure preferred stock could not be considered "nonqualified preferred stock" as defined in section 351(g).

[228] See, e.g., secs. 332(b)(1) and 338(d)(3). Cf., section 382(e)(1), where the value of pure preferred stock is included in determining the value of a corporation.

stock is treated as stock of the issuer.[229] Whether tracking stock is stock of the issuer is dependent upon the correlation of the rights of the stock to the underlying assets.

Description of Proposal

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

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

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

Effective Date

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

Prior Action

No prior action.

Analysis

Tracking stock has been utilized in a number of acquisition transactions as well as in distribution type transactions. The Adminstration's concern is that such stock is utilized to create a structure that is the economic equivalent of an actual division and distribution of the underlying assets. An actual distribution of only a portion of the assets of a corporation or the stock of a subsidiary would generally result in tax on any appreciation. Section 355 provides the ability to distribute the stock of a subsidiary tax-free. However, section 355 contains a number of specific requirements,

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[229] Rev. Proc. 99–3, 1999–1 I.R.B. 109, sec. 3.01(44) states that the IRS will not issue rulings regarding the classification of an interest that has certain voting and liquidation rights in an issuing corporation but whose dividend rights are determined by reference to the earnings of a segregated portion of the issuing corporation's assets, including assets held by a subsidiary.

including a 5-year active business requirement and various requirements limiting spin-offs of recently purchased businesses or spin-offs involving certain changes in ownership of the parent or subsidiary corporation. There is also a requirement that the distributing corporation own control (as defined) of the distributed subsidiary and that control be distributed. If any interest in the subsidiary is retained, there must be a showing that the purpose is not the avoidance of tax. It can often be difficult to satisfy all the requirements for a tax free distribution under section 355.

Some commentators have suggested that tracking stock can be used to obtain some of the benefits of an actual distribution that would not qualify under section 355, without the related tax burden. However, others contend that the rights associated with tracking stock can reflect significant differences from a stock ownership that is limited directly to the underlying tracked assets. Opponents may also argue that taxpayers should be free to issue equity and debt instruments with features that satisfy current investor demands.

Under present law, the IRS has indicated that it will not rule on the proper classification of tracking stock. However, taxpayers have been permitted to represent that tracking stock is stock of the parent corporation issuer (rather than of a subsidiary, for example) in obtaining private letter rulings. Some observers have suggested that the Treasury Department presently has regulatory authority under section 337(d) to issue regulations with respect to whether tracking stock should be treated as in effect the distribution of underlying assets.

Analytical questions have been raised regarding the proper treatment of tracking stock. Some commentators have suggested that if there is a high correlation between the economic performance of the tracking stock and the tracked assets, the tracking stock could be viewed as if it were an interest in a joint venture between the parent corporation and the holders of tracking stock. (NYSBA report, 43 Tax Law Review 51 (1987)). If a corporation actually distributed or sold to its shareholders an interest in a joint venture that was not treated as stock of the issuer, then the corporation would generally pay tax on the excess of the value of the distributed rights over the basis in the hands of the corporation. Alternatively, a primary offering by the joint venture might be nontaxable. Disposition or offering of a sufficiently large interest in the venture would prevent consolidation with the parent.

Issues may arise regarding the value and nature of the interest deemed distributed under the Treasury proposal. For example, tracking stock may be structured in any number of ways that could result in holders having very different types of rights with respect to tracked assets. While it generally is anticipated that the issuing corporation will pay dividends linked to the tracked assets, in many instances holders of tracking stock may not actually be entitled to the dividends, even though the tracked assets are profitable, if the parent corporation does not declare dividends. The tracked assets may be subject to liabilities of the parent corporation that may diminish the tracking stock shareholders' interests in the values of such assets. Under such circumstances, it might be questioned whether the issuance of such stock is economically equivalent to a direct ownership of the underlying assets. If tracking stock has a value that differs from the value of the underlying assets, it could be questioned whether the issuing corporation is properly treated as having distributed the entire value of the attributable portion of the tracked asset.

The Administration proposal authorizes the Secretary of the Treasury to treat tracking stock as an interest other than stock, or as stock of another entity, and to provide for increased basis in the tracked assets as the result of gain recognized. While it would be anticipated that any unfavorable guidance would apply only on a prospective basis, until guidance is issued, taxpayers would face uncertainty regarding the treatment of any particular transaction.

Some might argue that basis should be increased in underlying assets if gain is recognized. However, present law generally does not increase the basis of assets as a result of gain recognition on the distribution or sale of stock, unless an election is made under section 338 of the Code.[230]

A question could also be raised whether the issuance of subsidiary tracking stock should be taxed under the proposal if an actual distribution of the stock of the subsidiary would have qualified for tax free treatment under section 355.

Under the proposal, the issuance of tracking stock would not generally cause other classes of stock to be classified as tracking stock if the dividend and liquidation rights of such other classes are determined by reference to the corporation's general assets. Uncertainty may arise regarding whether there are cases that would, however, result in such reclassification and regarding appropriate transition rules.

3. Require consistent treatment and provide basis allocation rules for transfers of intangibles in certain nonrecognition transactions

Present Law

Generally, no gain or loss is recognized if one or more persons transfer property to a corporation solely in exchange for stock in the corporation and, immediately after the exchange such person or persons are in control of the corporation. Similarly, no gain or loss is recognized in the case of a contribution of property in exchange for a partnership interest. Neither the Internal Revenue Code nor the regulations provide the meaning of the requirement that a person "transfer property" in exchange for stock (or a partnership interest). The Internal Revenue Service interprets the requirement consistent with the "sale or other disposition of property" language in the context of a taxable disposition of property. See, e.g., Rev. Rul. 69–156, 1969–1 C.B. 101. Thus, a transfer of less than "all substantial rights" to use property will not qualify as a tax-free exchange and stock received will be treated as payments for the use of property rather than for the property itself. These amounts are characterized as ordinary income. However, the Claims Court has rejected the Service's position and held that the transfer of a non-

[230] Section 336(e) grants regulatory authority to permit taxpayers to treat the distribution of 80 percent of vote and value (as defined) of a subsidiary as an asset sale. However, no regulations have been issued.

exclusive license to use a patent (or any transfer of "something of value") could be a "transfer" of "property" for purposes of the nonrecognition provision. See *E.I. DuPont de Nemours & Co. v. U.S.*, 471 F.2d 1211 (Ct. Cl. 1973).

Description of Proposal

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

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

Effective Date

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

Prior Action

No prior action.

Analysis

The Administration proposal is directed at the potential "whipsaw" that could arise under present law. For example, some taxpayers apparently take the position they may rely on case law permitting transfer of less than all rights in intangible property to be treated as a transfer of property, but do not allocate basis between the rights transferred and the rights retained (the particular case in question did not address that issue). Also, the transferor and transferee might take inconsistent positions regarding whether the transfer qualified at all as a transfer of property under section 351. For example, the transferor might take the position that the transfer qualified as a transfer of property (resulting in no gain to the transferor) while the transferee might take the position that the transfer failed to qualify, resulting in "sale" treatment and a basis step-up to the transferee.

The proposal would generally remove much of the uncertainty regarding whether transfers of less than all intangible rights can qualify as a transfer of property. The proposal would also require basis allocation, thus clarifying the appropriate results when "contribution" treatment is provided. The requirement of valuation of rights retained and transferred, however, arguably may add complexity.

The proposal would apparently allow some amount of electivity, since taxpayers would still be permitted to "properly structure" a transfer of less than all rights as a license rather than a contribution or property with basis allocation. However, the proposal would require consistent treatment by transferor and transferee. It is unclear how the proposal would enforce this requirement. Disputes could also arise regarding whether a transfer had been "properly structured" as a license or instead is a transfer of property subject to the provision.

4. Modify tax treatment of downstream mergers

Present Law

The combination of a parent and subsidiary corporation may qualify for tax-free treatment as either a tax-free liquidation pursuant to section 332 or a tax-free reorganization pursuant to section 368. The determination of which rule may apply to a particular transaction depends on the legal form (e.g., upstream v. downstream and statutory merger v. asset transfer) of the transaction. In both of these tax-free transactions, any difference between the value and basis of any subsidiary corporation stock held by the parent corporation disappears, without recognition of gain or loss.

A subsidiary corporation that merges upstream (or completely liquidates) into its parent corporation may receive tax-free treatment as either a section 332 liquidation or a section 368 reorganization. If the parent corporation owns at least 80 percent of the subsidiary corporation's voting power and value (as defined in section 1504) and certain other requirements are satisfied, the transaction generally qualifies as a tax-free liquidation pursuant to sections 332 (tax-free to the parent corporation) and 337 (tax-free to the subsidiary corporation).[231] If, however, the parent owns less than either 80 percent of the stock of the subsidiary corporation, by vote or value, sections 332 and 337 are not applicable. In cases where the parent corporation does not satisfy the 80 percent ownership requirement, an upstream merger of a subsidiary corporation into its parent corporation may qualify as a tax-free reorganization pursuant to section 368, if certain other requirements are met.[232]

A parent corporation that merges (or transfers its assets) downstream into its subsidiary may qualify for tax-free treatment pursuant to section 368, irrespective of the amount of subsidiary corporation stock held by the parent corporation, assuming that certain other requirements are met.[233]

Description of Proposal

Under the proposal, where a parent corporation does not satisfy the stock ownership requirements of section 1504(a)(2) (generally, 80 percent or more of vote and value) with respect to a subsidiary

[231] Section 332(b) (last sentence) and Treas. reg. sec. 1.332–2(d).

[232] Treas. reg. sec. 1.368–1(e)(6), Ex. 7; Rev. Rul. 58–93, 1958–1 C.B. 188; *May B. Kass v. Commissioner*, 60 T.C. 218 (1973); GCM 39404; PLR 9321025 (2–22–93); and PLR 9011042 (12–20–89).

[233] Rev. Rul. 78–47, 1978–1 C.B. 113; Rev. Rul. 70–223, 1970–1 C.B. 79; Rev. Rul. 57–465, 1957–2 C.B. 250; Rev. Rul. 85–107, 1985–2 C.B. 121; *Commissioner v. Estate of Gilmore*, 130 F.2d 791 (3d Cir. 1942); *Edwards Motor Transit Co. v. Commissioner*, 23 T.C.M. (CCH) 1968 (1964); *George v. Commissioner*, 26 T.C. 396 (1956); PLR 9212018 (12–20–91); PLR 9506036 (11–15–94); and *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75 (2d Cir. 1959).

corporation, and the parent corporation combines with the subsidiary corporation in a reorganization in which the subsidiary corporation is the survivor, the parent corporation must recognize gain, but not loss, as if it distributed the subsidiary corporation stock that it held immediately prior to the reorganization. As long as the other requirements for a reorganization are satisfied, nonrecognition treatment will continue to apply to other assets transferred by the parent corporation to the subsidiary and to the stock and securities received by the parent corporation shareholders. The proposal also would apply to the acquisition of parent corporation stock by the subsidiary corporation in a transaction qualifying for nonrecognition treatment where the parent corporation is liquidated pursuant to a plan of liquidation adopted not more than two years after the acquisition date.

Effective Date

The proposal would be effective for transactions that occur on or after the date of enactment.

Prior Action

No prior action.

Analysis

The proposal would require gain, but not loss, to be recognized with respect to subsidiary corporation stock in what would otherwise qualify as tax-free downstream reorganizations, but only where the parent corporation owns less than 80 percent of the voting power or less than 80 percent of the value of the subsidiary corporation stock. The proposal would also require similar gain recognition in certain inversion transactions that are unwound in otherwise tax-free liquidations within a two year period. The proposal would alter long-standing judicial and administrative precedents that generally support nonrecognition treatment for all parties, and with respect to all assets, in otherwise qualifying downstream reorganizations (as well as other forms of corporate tiering and untiering where gain inherent in underlying assets is preserved). Furthermore, while the proposal would require gain recognition in a downstream merger (where less than 80 percent ownership), an upstream merger (and other economically similar transactions) could still qualify as fully tax-free and result in the same corporate structure.[234] Imposing taxation on only one of several economically similar transactions will place increased importance on form and may cause gain recognition only to the ill-advised.

Proposal advocates argue that a downstream reorganization is functionally equivalent to a taxable distribution by parent corporation of the subsidiary corporation stock, followed by a tax-free merger. In the case of a direct distribution of subsidiary corporation stock, tax law neutrality principles suggest that economically similar transactions should receive similar tax treatment.

[234] "NYSBA Offers Recommendations On Treatment of Inversion Transactions and Downstream Reorganizations," 95 TNT 31–26, February 15, 1995.

The carryover basis rules of tax-free reorganizations contemplate that the basis will be relevant to the subsidiary corporation. In a downstream reorganization, the parent corporation's basis in the subsidiary corporation stock will be irrelevant in the hands of the subsidiary corporation. Since the carryover basis rationale in tax-free reorganizations cannot apply to subsidiary corporation stock in a downstream merger, proposal advocates argue that the non-recognition is not warranted.

Opponents of the proposal argue that downstream mergers that appear similar to stock distributions at least do not step up the basis of underlying assets, and may even result in an additional corporate level of taxation. However, present law generally does tax a direct sale or distribution of subsidiary stock unless the distribution qualifies under section 355 as a tax-free spin-off. Furthermore, after the merger, the former parent corporation shareholders may not own separate interests in the former parent corporation and subsidiary corporation. Thus, the transaction may differ from an actual distribution.

Some commentators have suggested that the Treasury Department presently has authority under section 337(d) to issue regulations that would implement the features of this proposal. However, the matter of authority is not entirely clear and would require further analysis.

As with any gain recognition provision, increased complexity may be caused by valuation issues. Non-publicly traded stock valuations are difficult because the underlying tangible and intangible business assets must be valued and other factors such as minority discounts and control premiums must be considered.

5. Deny 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.[235]

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

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

for corporate investors) to take advantage of the dividends received deduction.

As one example, 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, certain 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.

D. Provisions Affecting Pass-Through Entities

1. Require partnership basis adjustments upon distributions of property and modify basis allocation rules

Present Law

In general

The partnership provisions of present law generally permit partners to receive distributions of partnership property without recognition of gain or loss (sec. 731).[236] Rules are provided for determining the basis of the distributed property in the hands of the distributee, and for allocating basis among multiple properties distributed, as well as for determining adjustments to the distributee partner's basis in its partnership interest. Property distributions are tax-free to a partnership. Adjustments to the basis of the part-

[236] Exceptions to this nonrecognition rule apply: (1) when money (and the fair market value of marketable securities) received exceeds a partner's adjusted basis in the partnership interest (sec. 731(a)(1)); (2) when only money, inventory and unrealized receivables are received in liquidation of a partner's interest and loss is recognized (sec. 731(a)(2)); (3) to certain disproportionate distributions involving inventory and unrealized receivables (sec. 751(b)); and (4) to certain distributions relating to contributed property (secs. 704(c) and 737). In addition, if a partner engages in a transaction with a partnership other than in its capacity as a member of the partnership, the transaction generally is considered as occurring between the partnership and one who is not a partner (sec. 707).

nership's remaining undistributed assets are not required unless the partnership has made an election that requires basis adjustments both upon partnership distributions and upon transfers of partnership interests (sec. 754).

Partner's basis in distributed properties and partnership interest

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

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

Present law does not provide for a partial liquidation of a partnership interest. A distribution that is not in complete liquidation of a partner's interest is treated as a current distribution, even if the distribution has the effect of reducing the partner's interest in the partnership.

Allocating basis among distributed properties

In the event that multiple properties are distributed by a partnership, present law provides allocation rules for determining their bases in the distributee partner's hands. An allocation rule is needed when the substituted basis rule for liquidating distributions applies, in order to assign a portion of the partner's basis in its partnership interest to each distributed asset. An allocation rule is also needed in a non-liquidating distribution of multiple assets when the total carryover basis would exceed the partner's basis in its partnership interest, so a portion of the partner's basis in its partnership interest is assigned to each distributed asset.

Present law allocates basis first to unrealized receivables and inventory items in an amount equal to the partnership's adjusted basis (or if the total basis to be allocated is less than partnership basis, then by first reducing basis in proportion to any unrealized depreciation in the assets and then reducing basis in proportion to their adjusted bases), and then among other properties. Basis is allocated among the other assets first to the extent of each distributed property's adjusted basis to the partnership. Any remaining basis adjustment, if an increase, is allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation, and then in proportion to their respective fair market values. If the remaining basis adjustment is a decrease, it is allocated among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation, and then in proportion to respective adjusted bases.[237]

Partnership's basis in remaining undistributed assets

No gain or loss is recognized to a partnership on the distribution of property (sec. 731(b)). Nevertheless, no adjustment is required to a partnership's basis in its remaining undistributed assets, following a distribution of property to a partner, unless the partnership has an election under section 754 of the Code in effect.

An electing partnership decreases the basis of its remaining property to take account of any increase in the basis in the distributee partner's hands, compared to the basis the partnership had in the property. This preserves future taxation to the other partners to the extent built-in gain was eliminated in the hands of the distributee partner, who in a liquidating distribution takes a substituted basis in the distributed property and will never, therefore, be taxed on that built-in gain. The amount of the decrease in the basis of remaining partnership property equals (1) the excess of the distributee's basis in the distributed property over the partnership's adjusted basis in the distributed property immediately before the distribution, plus (2) the amount of any loss recognized by the distributee partner.[238]

Similarly, an electing partnership increases the basis of its remaining property to take account of the extent to which the distributee's basis is less than the partnership's basis was in the same property. This preserves a future loss (or reduces a future gain) for the other partners, and can arise in a liquidating or nonliquidating distribution where the distributee partner's basis in its partnership interest is less than the partnership's total adjusted basis in the distributed properties. The amount of the increase in the basis of remaining partnership property equals (1) the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution, over the basis of the distributed property to the distributee partner, plus (2) the amount of gain recognized by the distributee partner on the distribution.[239]

Allocating basis among partnership's remaining assets

For purposes of allocating basis to remaining partnership assets following a distribution of property by an electing partnership, in-

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[237] A special rule allows a partner that acquired a partnership interest by transfer within two years of a distribution to elect to allocate the basis of property received in the distribution as if the partnership had a section 754 election in effect (sec. 732(d)). The special rule also allows the Service to require such an allocation where the value at the time of transfer of the property received exceeds 110 percent of its adjusted basis to the partnership (sec. 732(d)). Treas. Reg. sec. 1.732–1(d)(4) generally requires the application of section 732(d) where the allocation of basis under section 732(c) upon a liquidation of the partner's interest would have resulted in a shift of basis from non-depreciable property to depreciable property. In the preamble to the proposed regulations under section 732, comments were requested as to whether these rules are still necessary in light of the changes made to section 732(c) in the Taxpayer Relief Act of 1997. See REG 209682–94, 1998–17 I.R.B. 20, 26.

[238] The general rule is that loss is not recognized by a distributee partner on a distribution of partnership property, except that a loss may be recognized in a liquidating distribution consisting of nothing other than money, unrealized receivables and inventory.

[239] Generally, gain is not recognized to a distributee partner, except to the extent that any money and the fair market value of marketable securities distributed exceeds the adjusted basis of its partnership interest immediately before the distribution.

creases and decreases are divided into two categories: (1) capital assets and property used in the trade or business; and (2) other assets (sec. 755(b)). Adjustments are made to partnership property in the same category as that of the distributed property giving rise to the adjustment (Treas. reg. sec. 1.755–1(b)(1)).

Within each category of assets, adjustments are made among the assets so as to reduce proportionately the difference between the fair market value and the adjusted basis of each asset in the category. If the adjustment increases basis, assets with an adjusted basis in excess of value are not adjusted, and if the adjustment decreases basis, assets with a value in excess of adjusted basis are not adjusted (Treas. Reg. sec. 1.755–1(a)(1)(ii) and (iii)). The basis of an asset cannot be reduced below zero. If an adjustment is allocated to a category of property in which the partnership has no property, or if a negative adjustment cannot be fully absorbed by the basis of property in the category, the adjustment is applied to subsequently acquired property in the category (sec. 755(b) and Treas. Reg. sec. 1.755–1(b)(3)). Under these rules, it is possible that a required basis adjustment might never be applied to any property held by the partnership.[240]

Treatment as an exchange

Under present law, distributions by a partnership in which a partner receives substantially appreciated inventory and unrealized receivables in exchange for his interest in other partnership property (or receives other property in exchange for substantially appreciated inventory) are treated as a taxable exchange of property, rather than as a nontaxable distribution (sec. 751(b)). For this purpose, inventory generally is treated as substantially appreciated if the value of the partnership's inventory exceeds 120 percent of its adjusted basis.

Tax-free liquidation of corporate subsidiary

Present law generally provides that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation in which it holds 80 percent of the stock (by vote and value) (sec. 332). The basis of property received by a corporate distributee in the distribution in complete liquidation of the 80-percent-owned subsidiary is a carryover basis, i.e., the same as the basis in the hands of the subsidiary (provided no gain or loss is recognized by the liquidating corporation with respect to the distributed property) (sec. 334(b)).

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

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[240] In January, 1998, the Treasury Department proposed regulations which would modify the basis allocation rules of section 755 when there is a distribution of partnership property. Prop. Reg. sec. 1.755–1(c).

can be negated by a subsequent liquidation of the corporation under section 332.[241]

Description of Proposal

In general

The proposal would make mandatory the currently elective adjustments to the basis of partnership properties following a liquidating distribution to a partner. Second, the proposal would modify the calculation of the adjustments to better achieve an appropriate measure of the aggregate amount of remaining gain or loss. Third, the proposal would modify the manner in which the basis is allocated among both the distributed and the retained assets. The proposal also would treat partial liquidations as if a portion of a partner's interest were liquidated. Further, the proposal would repeal the rule of section 751(b) treating certain distributions as exchanges. Finally, the proposal would require a reduction in the basis of a corporation's assets following certain distributions of the corporation's stock.

Basis adjustment to partnership property

In the case of a distribution of property (including money) to a partner in complete or partial liquidation of its partnership interest, the partnership would be required to adjust the basis of its undistributed partnership property.

Under the proposal, the partnership would increase the basis of its undistributed partnership property by the excess (if any) of (1) the amount of money and adjusted basis of property distributed over (2) the amount by which the distributee partner's share of the partnership's adjusted basis in partnership property and money (immediately before the distribution) is reduced by reason of the distribution. Likewise, the partnership would reduce its basis in its undistributed property by the excess (if any) by which the amount described in (2) exceeds the amount described in (1). Thus, for example, assume a partnership has $11,000 cash, property with a basis of $19,000 and a value of $22,000, and no liabilities. Assume that A receives the $11,000 cash in liquidation of his entire one-third interest in the partnership. Under the proposal, the partnership basis in its undistributed property would be increased by $1,000 (the excess of $11,000 distributed over $10,000 (A's one-third share of the partnership's basis in its property)) to $20,000.[242]

The allocation of the basis adjustments among properties would be made under rules similar to the rules applicable to adjustments made to the basis of distributed property. Under the proposal, adjustments would be made to nondepreciable capital assets. A nondepreciable capital asset would mean property other than inventory, unrealized receivables, other property that would generate ordinary income on sale (e.g., marketable stock in a passive foreign

[241] In a similar situation involving the purchase of stock of a subsidiary corporation as replacement property following an involuntary conversion, the Code generally requires the basis of the assets held by the subsidiary to be reduced to the extent that the basis of the stock in the replacement corporation itself is reduced (sec. 1033).

[242] These are the facts in Example (1) in Treas. Reg. sec. 1.734–1(b)(1). Unlike present law, the $1,000 amount of adjustment is not dependent upon A's adjusted basis in the partnership.

investment company (sec. 1296(c))), and property of a character subject to an allowance for depreciation, amortization, or depletion. If a positive adjustment could not be made because the partnership holds no nondepreciable capital assets, the partnership would be treated as recognizing a long-term capital loss in the amount of the required adjustments. If a negative adjustment could not be made because the partnership holds no nondepreciable capital assets or has insufficient basis in such capital assets, then adjustments would be made to the basis of other property in the amount of the prevented adjustments. The adjustments would be made first to the depreciable assets of the partnership, and if there is insufficient basis in those assets, then to the remaining assets of the partnership. If a negative adjustment could not be made because the partnership has insufficient basis in assets (other than money), the partnership would be treated as recognizing a long-term capital gain in the amount of the prevented adjustments. Within each category of property, adjustments would be made first to reduce proportionately the difference between fair market value and adjusted basis of each asset. Additional positive adjustments would be made in proportion to the fair market value of each asset and additional negative adjustments would be made in proportion to the adjusted basis of each property.

Special rules would apply to tiered partnerships.

Allocation of basis among distributed properties

The proposal would modify the present-law rule allocating basis adjustments among the distributed properties received by a partner (sec. 732(c)).

First, depreciable property would be treated in the same manner that unrealized receivables and inventory are presently treated. Thus, allocations would be made first to nondepreciable capital assets. Similarly with present law, if no nondepreciable capital assets are distributed, loss from the sale or exchange of the partnership interest would be recognized in the amount of any positive adjustments which cannot be made, and if there is insufficient basis in nondepreciable capital assets to make required negative adjustments, negative adjustments would be made to property other than nondepreciable capital assets, being applied first to depreciable assets, and then to the remaining assets.

Treatment of partial liquidations

The proposal would provide that the distribution rules applicable to complete liquidations of partnership interests also would apply to partial liquidations. A distribution in partial liquidation would be defined as a distribution that reduces the distributee partner's percentage share in partnership capital (resulting from the distribution or a series or related distributions). The portion of the partnership interest reduced would be treated as a separate interest in determining gain or loss and the basis of the distributed property to the partner. For example, assume that partner A, with a partnership basis of $100, receives a distribution of property with an adjusted basis to the partnership of $60. A's interest in the partnership is reduced by one-half as a result of the distribution. Under the bill, the distribution would be treated as a liquidation of an interest of A with a basis of $50. A's basis in the distributed property would be $50, and A's basis in his remaining partnership interest would be $50 (as opposed to $60 basis in distributed property and $40 basis in A's partnership interest under present law).[243]

Section 751(b)

The proposal would repeal the rule of section 751(b) treating certain distributions as sales or exchanges.

Acquisition of subsidiary corporation

The proposal would require that if stock is distributed to a corporate partner and after the distribution (and taking into account related transactions), the corporation controls the distributed corporation, then the distributed corporation must reduce the basis of its assets by the same amount by which the basis of the stock is reduced, using the same allocation method.

Effective Date

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

Prior Action

No prior action.

Analysis

Under present law, the failure to require a partnership to make basis adjustments following a distribution of property to a partner may result in excessive basis.[244] This occurs because one partner may take out relatively low basis property which is properly "stepped up" to its basis in its partnership interest, while leaving an excessive amount of basis in the remaining partnership properties, which may reduce the remaining partners' gain or create a loss when the properties are sold by the partnership. Similar transactions outside the partnership area require appropriate basis adjustments to prevent the creation of basis.[245]

The present-law formula for measuring the amount of the adjustments, if an election under section 754 is in effect, is imperfect. If a partner's basis in its partnership interest is not the same as its interest in the partnership assets, too large or too small an adjustment is made.[246] In an inflationary economy, the imperfection will

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[243] Under the proposal described previously, the partnership would have a basis adjustment to its undistributed properties to the extent that the $60 basis in the distributed property differed from the reduction of A's distributive share of the adjusted basis of partnership property by reason of the distribution.

[244] These deficiencies have been noted by commentators. See, for example, W. Andrews, "Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions," 47 *Tax Law Review*, 3 (Fall, 1991); Noel Cunningham, "Needed Reform; Tending the Sick Rose," 47 *Tax Law Review*, 77 (Fall, 1991); Freeman and Stephens, "Using a Partnership When a Corporation Won't Do: The Strategic Use and Effects of Partnerships to Conduct Joint Ventures and Other Major Business Activities," 68 *Taxes*, 962 (Dec. 1990). See also Joint Committee on Taxation, *Review of Selected Entity Classification and Partnership Tax Issues* (JCS–6–97), April 8, 1997, pp. 27–40.

[245] See, for example, section 1031(d), relating to basis adjustments in like-kind exchanges.

[246] This can occur where a partnership interest was transferred before the section 754 election was made.

tend to result in too small a basis adjustment. Suggestions to correct this defect have been previously made.[247]

The Administration proposal would prevent the increase in the basis of depreciable property in the same way that distributed inventory and unrealized receivables may not be stepped up under present law. This will tend to cause more basis to be allocated to capital assets, such as stock or land. This may result in it being easier to create a capital loss, which in the case of a corporation may offset capital gain which is taxed at the same rate as ordinary income. There is no perfect method of allocating basis. The Administration proposal would make it more difficult than under present law to create depreciation deductions, but easier to create capital losses. In lieu of permitting a capital loss, or allocating basis to depreciable assets, in the case in which a partnership basis adjustment cannot be made to the right category of asset, an alternative could be to suspend the amount of the adjustment for a period of time, or until the partnership acquires property of that type or completely liquidates.

The Administration proposal would treat the liquidation of a portion of a partner's capital account in the same manner as if that part of the account were held by a separate partner. This would equalize the tax results in cases in which the interests were held by one person or by more than one person. Thus, advocates argue, providing for partial liquidation of a partnership interest permits greater accuracy and fairness than does present law. On the other hand, introducing the concept of partial liquidation would require the partnership to determine the reduction in capital accounts upon the partial liquidation of a partner's interest. This part of the proposal could be criticized as overly burdensome relative to the gain in accuracy, if a partnership is required to treat as a partial liquidation every non-pro rata distribution to partners. It could be argued that a de minimis rule might address this point (for example, the distribution would not be treated as a partial liquidation if only a tiny fraction of the partner's capital interest, or a small dollar value were distributed), but it would still be necessary for the partnership to determine whether the de minimis rule applied or not to a particular distribution.

The Administration proposal would repeal the exchange rule of section 751(b). This rule has universally been criticized for its complexity.[248] The repeal of the rule would allow the distribution of ordinary income assets to some partners and the distribution of capital assets to other partners, so that on a subsequent sale of the assets, some partners will recognize ordinary income and others capital gain. Advocates of repeal argue the rule would no longer be needed, because the proposal also would prevent the reduction of the total amount of ordinary income by preventing the basis of the partnership's ordinary income assets from being increased.

[247] In 1974, the Tax Section of the American Bar Association recommended that the amount of the adjustment be determined using the approach in the Treasury proposal. Recommendation #1974–9.

[248] For example, the American Law Institute, *Federal Income Tax Project: Subchapter K: Proposals on the Taxation of Partners* (R. Cohen, reporter, 1984) recommended the repeal of section 751(b); see also Brannan, "The Subchapter K Reform Act of 1997," 75 *Tax Notes* 121, 136 (Apr. 7, 1997).

Nevertheless, the basis proposal would not address instances of conversion of ordinary income to capital gain for specific partners that are addressed by section 751(b). In addition, it could be said that the repeal of section 751(b) is not a necessary corollary to the basis proposal, so need not be connected to it.

Finally, the Administration proposal would require a subsidiary corporation to reduce the basis of its assets by the amount in which the distributee corporate partner reduced the basis in its stock. This would eliminate the tax benefits to a transaction in which assets are contributed to a corporation and the stock of the corporation is distributed, followed by a subsequent liquidation of the corporation. The proposal would be consistent with the rules recently enacted requiring basis reduction by a subsidiary corporation following the acquisition of stock in the subsidiary corporation as replacement property following an involuntary conversion.

2. Modify structure of businesses indirectly conducted by REITs

Present Law

Real estate investment trust ("REITs") are treated, in substance, as pass-through entities under present law. Pass-through status is achieved by allowing the REIT a deduction for dividends paid to its shareholders. REITs' are restricted to investing in passive investments primarily in real estate and securities. Specifically, a REIT is required to receive at least 95 percent of its income from real property rents and from securities. A REIT is limited in the amount that it can own in other corporations. Specifically, a REIT cannot own more than 10 percent of the voting securities of any corporate issuer nor can more than 5 percent of its assets be stock of a single corporation.

Description of Proposal

The proposal would modify the 10-percent requirement of present law so a REIT generally would be prohibited from owning more than 10 percent of the vote or value of any issuer. The proposal would provide, however, an exception to this general rule for two newly described subsidiaries to be known as "qualified independent contractor subsidiaries" or "qualified business subsidiaries."

A "qualified business subsidiary" would be permitted to undertake activities such as management and development to entities that were not tenants of the REIT. A "qualified independent contractor subsidiary" would be allowed to perform non-customary and other currently prohibited services to the tenants of the REIT.

The combined value of all "qualified independent contractor subsidiaries" or "qualified business subsidiaries" could not be more than 15 percent of the total value of a REIT's assets, nor may more than five percent of the value of the REITs assets consist of qualified independent contractor subsidiaries. "Qualified independent contractor subsidiaries" or "qualified business subsidiaries" would not be entitled to a deduction for any interest paid directly or indirectly to the REIT. A 100-percent excise tax would be imposed on any payments made by "qualified independent contractor subsidiaries" or "qualified business subsidiaries" for services provided to the REIT or its tenants in excess of their arm's length value or for any expenses shared between the REIT and its subsidiaries. "Significant limits" would be placed on intercompany rentals between the REIT and its taxable subsidiaries and certain additional limitations would apply.

Effective Date

The proposal generally would be effective on the date of enactment. Transition rules would be provided that would permit REITs to combine and convert preferred stock subsidiaries into taxable subsidiaries on a tax-free basis prior to a future date. The revision of the 10-percent test also would be delayed until that date. Non-REIT holders of any stock in a preferred stock subsidiary would recognize taxable gain to the extent that they receive consideration other than stock in the REIT for their interest in the preferred stock subsidiary.

Prior Action

A related provision in the President's fiscal year 1999 budget proposal would have modified the rules limiting REIT ownership of corporate stock, but that proposal did not contain the qualified business subsidiary provisions of this proposal.

Analysis

The Administration proposal reflects a concern that REITs currently may be deriving significant income from business that could not be directly conducted by the REIT, through ownership of business corporations (i.e., preferred stock subsidiaries) that perform active businesses. The Administration proposal also indicates a concern that revenues from such active businesses may be extracted by the REIT in the form of interest or other payments that are deductible by the C corporation and taxed only at a single level through the REIT, thus escaping corporate level tax entirely. There also may be difficulty for the IRS and REITs in determining the scope of permissible REIT services.

The proposal would permit REITs to use a subsidiary structure to perform certain types of business activities. The proposal would limit the extent of REIT involvement in such activities by permitting no more than a limited amount of the value of REIT assets to be in the form of stock of such active business entities. Furthermore, the proposal seeks to improve corporate level tax collection with respect to revenues of such businesses by prohibiting the subsidiary from deducting interest on debt directly or indirectly funded by the REIT, placing "significant limits" on intercompany rentals, and imposing an excise tax on "excess payments" in an attempt to police arm's length payments and sharing of expenses.

Proponents of the proposal contend that REITs should be permitted to perform at least some independent contractor services for REIT related property and to engage in limited third party management services. At the same time, some may contend that corporate level tax collection from such business activities might improve under the proposal, due to the denial of direct or indirect interest payments and imposition of other limitations including the proposed excise tax.

Others would contend, however, that the proposed interest limitations and excise tax may be insufficient to police the tendency for related party REIT and C corporation entities to allocate income and expenses in a manner that reduces the value and taxable income of the C corporation while directly or indirectly benefitting the REIT through the C corporation's business activities.[249]

The concept of "direct or indirect" interest payments has proved difficult to administer in other areas. For example, a similar standard in section 265 has been revised in the past in certain contexts; and a further proposed revision is contained in a different Administration proposal.

Imposition of the excise tax would not prohibit the tendency to move consistently to the highest end of any range of potentially "arm's length" transactions in cases where such range could be identified. In addition, it may be difficult to identify such a range. In many situations involving real estate, where rental or other payments might be based on unique aspects such as particular values or revenues of a specific property, arm's length comparisons may be difficult to establish or to challenge. The area of shared expenses may be particularly difficult to police. Some shared expenses may result in the parent and subsidiary collectively incurring less cost than would have been incurred if the REIT and its subsidiary had separately procured such items from unrelated persons who required an arm's length profit element to be retained in their hands. Determination of what portion of these savings should benefit the parent REIT or its taxable subsidiaries is especially problematic since such savings do not occur on an independent basis. Further, to the extent expenses or certain other items are shifted to the C corporation, the "value" of the REIT investment in that corporation may be technically diminished, raising questions regarding the effectiveness of the "value" limitations in the proposal.

Imposition of the tax may also result in many controversies between the IRS and the REIT subsidiary regarding the exact amount of an arm's length transaction.[250]

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.

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[249] For example, Code section 269B addressing stapled entities takes the approach that related entities are treated as one. Such an approach reflects the perceived difficulty of enforcing allocations. A parent subsidiary relationship is effectively similar to a paired share structure.

[250] The Administration proposal does not contain any safe-harbor rules in determining whether transactions are at arm's length and, as a result, imposition of the proposed excise tax technically requires a determination to the closest dollar of the extent to which every transaction between the REIT and its subsidiaries is an arm's length transaction.

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

Under the organizational structure test, except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons. Generally, no more than 50 percent of the value of the REIT's stock can be owned by five or fewer individuals during the last half of the taxable year. Certain attribution rules apply in making this determination.

Description of Proposal

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

Effective Date

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

Prior Action

A similar provision was contained in the President's fiscal year 1999 budget. That prior provision differed from the present proposal in that (1) the limitation on ownership was more than 50 percent of vote or value of a REIT (rather than 50 percent or more of vote or value), and (2) that proposal would not have affected any entity that elects REIT status for a taxable year beginning prior to the date of committee action. That proposal also did not contain an exception for REITs owning other REITs.

Analysis

REITs allow individual investors to obtain a single level of tax on passive real estate investments, often in publicly-traded entities. Present law requires that ownership interests must be held by at least 100 persons and that 5 or fewer individuals cannot own more than 50 percent of the value of the REIT. These ownership requirements indicate that Congress intended that REIT benefits not be available to closely-held entities. A REIT held largely by a single corporation does not meet this objective of Congress.

It is clear that, under present law, it is unnecessary for a corporation to establish a separate real estate entity as a REIT in order to ensure that there is a single corporate level tax. If the separate entity is a corporation, the dividends-received deduction and the benefits of consolidation can eliminate a second corporate tax. If the separate entity is a non-publicly-traded partnership or limited liability company, only one level of tax is imposed. The REIT rules were enacted earlier than most of the rules for other pass-through regimes and lack some of the more sophisticated rules of such regimes aimed at preventing unwarranted shareholder benefits. For example, the REIT rules contain no provisions to prevent REIT shareholders from structuring their interests in order to divide the income from the REIT's assets among themselves in a tax-motivated manner (cf. secs. 704(b) and (c) and 1361(b)(1)(D)). Consequently, where REIT status is elected by an entity with a substantial corporate shareholder, a principal reason may be to take advantage of deficiencies in the REIT rules that have been the basis for several recently reported tax-motivated transactions.

Congress may have believed that improper use of the REIT rules was limited by the restrictions on REIT ownership. The 100-or-more shareholder requirement, and the rule that no more than 50 percent of the value of the REIT's stock can be owned by five or fewer individuals, generally require that REIT stock be widely held, with the result that it is less likely that shareholders will be able to agree on a structure designed to yield tax benefits for certain shareholders. However, present law does not contain a provision prohibiting ownership of large amounts of a REIT's stock by one or a few corporations.

Several recent transactions have utilized REITs to obtain tax benefits for large corporate shareholders. In such transactions, the requirement that the REIT have 100 or more shareholders often may be met by having related persons (such as employees of the majority holder) acquire small amounts of stock. The most well-known of these was the so-called "step-down preferred" transaction. In such a transaction, the REIT issued a class of preferred stock that paid disproportionately high dividends in the REIT's early years and "stepped down" to disproportionately low dividends in later years. Such stock might be sold to a tax-exempt entity. One or more corporate shareholders held the REIT's common stock and were in effect compensated for the preferred's dividend rights in the early years by the right to higher payments on, or liquidation proceeds with respect to, the common stock after the preferred dividends "step down." These corporate shareholders generally funded the high dividends paid to the preferred shareholders by making deductible rent payments to the REIT for real property it leased to the corporate shareholders.[251]

The 50-percent or more rule of the proposal is also designed to reduce the ability of REITs and related C corporations to continue to engage in "stapled stock" structures that would otherwise result in single entity treatment under section 269B. For example, under present law there may be instances in which a C corporation owns more than 50 percent of REIT stock and the remaining 49 percent of the REIT stock is stapled to the C corporation stock. Since no more than 49 percent of the C corporation stock would be stapled,

[251] The Treasury Department issued IRS Notice 97–21, 1997–11 I.R.B. 9, which denies the benefits of a step-down preferred transaction based on a conduit analysis. The Treasury Department subsequently issued Proposed Regulations sec. 1.7701(l)-3, addressing such transactions.

the arrangement may not fall within the scope of section 269B even though no stock of the REIT is unrelated to the C corporation. Under the proposal, at least some portion of REIT stock would have to be unstapled to the C corporation.

By preventing a shareholder from owning a 50-percent or greater interest in the REIT, the proposal would also substantially reduce the ability of a single shareholder or a small group of shareholders to utilize a REIT to achieve tax benefits based on their individual tax situations. One example of such use may be to place various assets in a REIT in order to obtain "dividend" treatment for income from the REIT where desired, even though the assets if held directly might produce a different form of income (e.g. interest income). However, the proposal may not prevent such structures entirely. For example, it still might be possible under the proposal for three corporations to acquire nearly all of the REIT's shares (with additional small shareholders to meet the 100-shareholder test).

Opponents of the 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 complexity to the already complex REIT rules. For example, individual shareholders apparently would be subject to the proposal even though they also are subject to the present-law rule preventing five or fewer shareholders from owning more than 50 percent of a REIT's shares by value.

4. Repeal tax-free conversion of large 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 to 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[252] 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 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, 2000. Thus, C corporations would continue to be permitted to elect S corporation status effective for taxable years beginning in 1999 or on January 1, 2000. The proposal would apply to acquisitions (e.g., the merger of a C corporation into an existing S corporation) after December 31, 1999.

Prior Action

Similar proposals were included in the President’s budget proposals for fiscal years 1997, 1998 and 1999.

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 pass-through 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 pass-through entity status where the pass-through entity is an S corporation with the present-law treatment where the pass-through entity is a partnership or a sole proprietorship.

The proposal would eliminate some of the complexity of subchapter S under present law.[253] 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

[252] 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.

[253] 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 tax simplification proposals. See, Committee on Ways and Means, *Written Proposals on Tax Simplification* (WMCP 101–27), May 25, 1990, p. 24.

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 corporations 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, 2000, 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 [254] 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,[255] 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.[256]

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

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

[256] 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.

E. Tax Accounting Provisions

1. Require IRS permission to change accounting methods

Present Law

Tax-free transactions

Present law provides a number of ways in which assets or entire businesses may be transferred without the immediate recognition of gain or loss. Some of the most common of these tax-free transactions include contributions to a corporation in exchange for stock where the contributors are in control of the recipient corporation immediately after the exchange (sec. 351), contributions to a partnership in exchange for an interest in the partnership (sec. 721), distributions in complete liquidation of a corporation (sec. 332), and certain exchanges of property for stock or securities in corporations pursuant to a plan of reorganization (sec. 361). Section 381 provides rules allowing for the carryover of certain tax attributes, including accounting and inventory methods, in the case of the tax-free acquisition of assets of a corporation by another corporation under section 332, and most acquisitions under section 361. However, section 381 does not apply to tax-free contributions under section 351. Further, no equivalent to section 381 exists for the tax-free contributions of assets to a partnership.

Methods of accounting

A taxpayer is allowed to adopt any permissible method of accounting. A permissible method of accounting generally must (1) be used consistently, (2) clearly reflect the taxpayer's income, (3) not be prohibited to the taxpayer by the Code or regulations, and (4) be used in keeping the taxpayer's books and records.[257] Once adopted, a method of accounting may not be changed without the consent of the Commissioner. While automatic consent is provided for certain changes, most accounting methods may not be changed without first applying for and obtaining the consent of the Commissioner to the change.

Section 381 provides special rules that are applicable to certain nonrecognition (tax-free) transactions. In a nonrecognition transaction to which section 381 applies, an acquiring corporation must use the method of accounting that was used by the distributor or transferor corporation, unless different methods of accounting were used by the parties to the transaction. If different methods of accounting were used by the parties to the transaction, Treasury regulations generally provide that the acquiring corporation must adopt the principal method of accounting of the parties to the transaction. An acquiring corporation may use a method of accounting other than that required by section 381 and the regulations thereunder only if consent of the Commissioner is obtained.

If the transaction does not involve the integration of separate trades or businesses, then each trade or business retains its accounting methods. If separate trades or businesses are to be inte-

[257] A method of accounting generally will be considered used in keeping the taxpayer's books and records if the taxpayer can reconcile its books and records to the amounts disclosed on the tax return.

grated, but both parties to the transaction use the same method of accounting, that method will be the principal method. If, however, separate trades or businesses are to be integrated as part of the transaction, and the separate trades or businesses use different methods of accounting, the regulations provide specific rules for determining which method will be the principal method required to be used by the integrated business.

The principal method of accounting is determined by comparing the adjusted bases of assets and gross receipts of each component trade or business to the transaction. If this comparison shows that component trades or businesses that use a common method of accounting have both (1) the greatest total of the adjusted bases of assets and (2) the greatest total of gross receipts, such method of accounting is the principal method of accounting. However, if one group using a method of accounting has the greatest total of adjusted bases of assets and a group using a different method has the greatest total of gross receipts, there is no principal method of accounting and the taxpayer is required to request that the Commissioner determine the appropriate method of accounting.[258]

Under present law, section 381 generally does not apply to the tax-free contribution of assets to a corporation described in section 351,[259] or the tax-free contribution of assets to a partnership described in section 721. A corporation or partnership that receives assets in a section 351 or section 721 transaction is required to continue to use its previously adopted methods of accounting, unless the consent of the Commissioner is obtained to change methods of accounting. If the recipient corporation or partnership is a new entity, or has not yet adopted a method of accounting, it is free to adopt any method of accounting provided the method (1) is used consistently, (2) is used in keeping its books and records, (3) clearly reflects its income, and (4) is not prohibited by the Code or regulations.

Inventories

Taxpayers are required to determine inventories whenever the production, purchase or sale of merchandise is a material income producing factor. The method the taxpayer uses in keeping inventories must conform as closely as possible to the best accounting practices in the trade or business and must clearly reflect income. Inventories of fungible items are generally determined using either the first-in, first-out (FIFO) method or the last-in, first-out (LIFO) method. Inventories may be priced under both the FIFO or LIFO methods in terms of units of goods (the specific goods method) or in terms of dollars (the dollar value method).

If a taxpayer using the LIFO method purchases or produces more of a particular type of inventory than it sells in a given year, it creates a layer of inventory attributable to that year. The inventory in the layer will not be considered sold until the taxpayer sells more of that type of inventory than it purchases or produces in a later year. Growing businesses may establish inventory layers

[258] Treas. Regs. sec. 1.381(c)(4)–1(c)(2).

[259] Treas. Regs. sec. 1.1502–17 mandates the application of section 381 where the principal purpose of a section 351 transfer between members of a consolidated group is to effect a change in method of accounting.

every year. If the cost of purchasing or producing an item of inventory consistently increases from year to year, the cost of items in older layers may be a fraction of the cost of purchasing or producing equivalent inventory in the current year. The gross income attributable to the sale of any item of inventory is equal to its selling price less its cost. Thus, higher taxable income will result if the item sold is considered to come from an older, lower cost layer than if the item sold is considered to come from a later, higher cost layer or from current purchases.

Inventory that is received in a section 351 transaction must be accounted for using the inventory methods of the recipient company. If the recipient company is currently using LIFO and receives LIFO inventory of the same type, the layers established at the contributing company are carried over and integrated into the equivalent inventory layers of the recipient company.[260] If, on the other hand, the recipient company is not using LIFO or is a new company that must adopt an inventory method, the inventory will be considered acquired at its average price in the hands of the contributing company.[261]

Under present law, it is not clear whether the transfer of LIFO inventory to a partnership in a section 721 transaction can result in the integration of existing layers into the recipient partnership's inventory.

Depreciation

Special rules apply to methods of computing depreciation allowances. Section 168(i)(7) requires that a corporation or partnership that receives assets in a section 351 or section 721 transaction be treated as the transferor for purposes of computing depreciation deductions with respect to so much of the basis of the property as does not exceed the basis of the property in the hands of the transferor. This "step-in-the-shoes" approach has the same effect as requiring the transferee to use the transferor's method of accounting on that portion of the basis that is carried over. Additional basis, as may be the case when gain is recognized by the transferor due to the receipt of boot, is treated as a new asset that is placed in service on the date of acquisition. Depreciation on this portion of the asset may be accomplished by the use of different methods.

Description of Proposal

The proposal would extend the application of the rules of section 381(c)(4) (regarding methods of accounting) to section 351 and section 721 transactions. If the transferee is a new corporation or partnership (one that has not yet adopted its methods of accounting), it would be required to use the methods of accounting that were used by the transferring entity. An existing corporation or partnership could be required to change its methods of accounting

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[260] See *Joseph E. Seagram & Sons* v. *Commissioner* 394 F. 2d 738 (2d Cir. 1968), reversing 46 T.C. 698 (1966).

[261] If inventory is considered to be acquired at its average price in the hands of the contributing company, the identity of the LIFO layers is lost. Any sales in the year of acquisition will be considered to come from a combination of current purchases and production and the LIFO layers. Assuming that costs have increased, this will result in an overall lower cost of sales and higher taxable income than would have been the case had the original LIFO layers been preserved.

to those of the transferring entity if the transferring entity's method of accounting were considered the integrated business' principal method of accounting.

The proposal would also extend the application of the rules of section 381(c)(5) (regarding inventories) to section 351 and section 721 transactions. Similar to the extension of section 381(c)(4), this could require an existing corporation or partnership to change its methods of keeping inventory to those of the transferring entity if the transferring entity's methods of keeping inventory were considered the integrated business' principal method. However, the proposal would also preserve LIFO inventory layers and allow them to be integrated into the inventory of the recipient entity, rather than treating them as acquired at average cost, assuming the recipient entity will be using LIFO. This could reduce the taxable income of the recipient company, compared to present-law treatment.

The proposal would not modify the present-law rules regarding the methods that must be used to determine depreciation on property that is contributed in a section 351 or 721 transaction.

Effective Date

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

Prior Action

No prior action.

Analysis

Methods of accounting

A taxpayer that is otherwise unable to obtain the consent of the Secretary to a change in its method of accounting may seek to circumvent the consent requirement by contributing the assets to a new or inactive corporation or partnership in a tax-free transaction under section 351 or section 721. Many commentators feel that it is not appropriate to allow taxpayers to circumvent the requirement that they obtain the consent of the Commissioner to changes in methods of accounting in this manner. They note that the consent requirement will support sound tax administration by permitting the Commissioner to review the proposed change in method of accounting to make certain that the change will be to a correct method, that no tax abuse will result from the change, and that the change will be made with the appropriate section 481(a) adjustment so that no items of income escape taxation and no items of expense are deducted twice. They also note that the consent requirement enables the Commissioner to insure taxpayer compliance with the clear reflection of income requirement.

On the other hand, other commentators have expressed concern that the Commissioner sometimes may withhold consent to changes from one permissible method of accounting to a different permissible method, particularly where such change is beneficial to the taxpayer. They note that the Commissioner currently can disallow the use of the new method if the method does not clearly reflect the acquiring entity's income. They suggest that an opportunity to restructure in order to adopt new permissible methods of accounting is a necessary check on the Commissioner's authority in the accounting method area.

The proposal also may create additional complexities in more complex section 351 or section 721 transactions. If a single company contributes assets to a new or inactive corporation in a section 351 transaction, it is not difficult to determine which methods of accounting would be required under the proposal. If multiple companies contribute several trades or businesses to a joint venture (whether operated as a partnership or a separate corporation), determining which method of accounting is the principal method of accounting under the section 381 regulations may be very complex. The application of the section 381 regulations may result in determining that there is no principal method of accounting, thus necessitating a determination by the Commissioner of which accounting methods will be used. This would introduce an additional level of uncertainty into the transaction.

It should be noted that the present section 381 regulations are primarily designed to address the treatment of tax attributes in the tax-free combination of two or more active trades or businesses. It is not clear how or if the section 381 regulations would be modified if they were to be expanded to include the transactions under section 351 and 721. In particular, it is not clear how the section 381 regulations would be intended to apply if one party to the transaction contributes assets that do not, in and of themselves, constitute a trade or business. If such assets are considered, their contribution to an active trade or business may force that acquiring company to change its methods of accounting to those of the contributing company. This may be appropriate in certain circumstances, such as when the contributing entity acquires most of the ownership of the receiving entity in the transaction. However, in other circumstances, it may not be appropriate for the receiving entity's accounting methods to be called into question.

Inventories

Proponents of the proposal will argue that it facilitates the transfer of inventory by LIFO taxpayers in section 351 and section 721 transactions. Allowing LIFO inventory layers to be preserved and integrated into the recipient entity's inventory will preserve one of the essential benefits of the use of the LIFO method. Thus, the proposal will contribute to an accurate reflection of income in the same manner as the contributing entity's use of the LIFO method did.

Opponents of the proposal will argue that requiring the acquiring taxpayer to maintain the LIFO layers created by the contributor will create additional record keeping burdens since a record of the layers and the underlying information supporting their valuation must be maintained. This may be particularly troublesome if the contributing company does not fully share its records relating to the inventory or the contributing and recipient entities use different systems of record retention. It may be appropriate to consider a taxpayer to elect to use an averaging convention where record keeping is considered too burdensome.

2. Repeal installment method for most accrual basis taxpayers

Present Law

An accrual method taxpayer is generally required to recognize income when all events have occurred that fix the right to its receipt and its amount can be determined with reasonable accuracy. The installment method of accounting provides an exception to this general recognition principle by allowing a taxpayer to defer the recognition of income from the disposition of certain property until payment is received. Taxpayers (other than farmers and dealers in timeshares and residential lots) are not allowed to use the installment method for sales to customers in the ordinary course of business. Dealers in timeshares and residential lots must pay interest on any taxes deferred by use of the installment method.

For sales in excess of $150,000, several rules limit the benefits of the installment method. If the amount of installment obligations that arose in, and remain outstanding at the end of, any year exceed $5 million, interest must be paid on the deferred tax attributable to the excess. Also, a pledge rule provides that if an installment obligation is pledged as security for any indebtedness, the net proceeds [262] of such indebtedness are treated as a payment on the obligation, triggering the recognition of income. Actual payments received on the installment obligation subsequent to the receipt of the loan proceeds are not taken into account until such subsequent payments exceed the loan proceeds that were treated as payments.

For example, in 1999 a taxpayer (who is not in the trade or business of selling real estate) sells non-farm real property with a basis of $100 for $1,000, a gain of $900. At closing, the taxpayer receives $200 in cash and an $800 note bearing adequate interest that is due in 2002. In 2000, the taxpayer borrows $300, pledging the note as collateral. In 2001, the taxpayer receives a $300 prepayment on the note. The remainder of the note is paid when due in 2002.

The accrual method would require the taxpayer to report the entire $900 gain in the year of sale, 1999. Under the installment method, the taxpayer only reports the portion of the gain equal to the percentage of the total sales price it has received. In this case, since the taxpayer has received 20 percent of the sale price, it reports 20 percent of the gain (.2 X $900 = $180) in 1999.

In 2000, this taxpayer is required to report an additional 30 percent of the gain (.3 X $900 = $270), since the pledging of the note for the $300 loan is treated as a payment of $300 on the installment obligation. Subsequent payments on the loan would not be taken into account until they exceed the amount ($300) that was considered paid as a result of the pledge. Thus, this taxpayer would not report any gain as a result of the $300 prepayment in 2001. The final payment of the note in 2002 causes the remaining portion of the deferred gain, $450, to be taken into income.

A taxpayer who borrows money and pledges its installment obligation as security triggers the recognition of such installment obligation as if payment was received. However, it is not clear whether

[262] The net proceeds equal the gross loan proceeds less the direct expenses of obtaining the loan.

a taxpayer who borrows money and gives a put or similar right against its installment obligation as security for the loan also triggers recognition of the installment obligation.

Description of Proposal

The proposal would repeal the installment method of accounting for accrual method taxpayers (other than those taxpayers that are eligible to use the dealer disposition exceptions under present law).

The proposal would also provide that the granting of put rights in connection with a loan, or any similar arrangement, would receive the same treatment as pledges and require the amount of the loan to be treated as a payment on the installment obligation.

Further, the proposal would modify the subsequent payment rule to take into account both loan proceeds and subsequent payments to the extent of the full amount of the installment obligation.[263]

Effective Date

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

Prior Action

No prior action.

Analysis

Repeal of installment method for accrual basis taxpayers

The installment method is inconsistent with the accrual method of accounting in that it allows an accrual method taxpayer to defer the recognition of gain on the sale of certain property until the funds from the sale are received. The installment method arguably fails to reflect the economic results of a taxpayer's business during the taxable year, since it does not recognize the gain from the sale of property in the period in which the sale is completed. Opponents of the installment method contend that it makes the U.S. Treasury an obligatory lender, requiring it to loan an amount equal to the deferred taxes to the taxpayer.

On the other hand, the installment method insures that a taxpayer will not be required to pay tax attributable to extraordinary sales, those that are not in connection with its ordinary trade or business, prior to the time the taxpayer receives the funds from the sale. Although this deferral of tax creates a benefit that would not otherwise be available under the accrual method of accounting, the pledging rule and the requirement that interest be paid on larger deferrals limits the potential for abusing this benefit.

Clarifications to the pledge rule

The pledge rule, requiring that the net proceeds of any indebtedness that is secured by the installment obligation be considered the same as a payment on the obligation, is designed to require the

[263] In the example discussed as part of present law, the $300 prepayment in 2001 would result in an additional taxable gain of $270 in 2001, rather than offsetting the earlier pledge as is the case under present law. The final payment of $500 in 2002 would result in the recognition of the remaining taxable gain on the sale, or $180.

recognition of income when the taxpayer receives cash related to an installment obligation. This recognition of income could be avoided if transactions that are equivalent, but not identical to, the pledging of the installment obligation do not result in income recognition. The purpose for permitting the reporting of gain using the installment method is to tax the income from a deferred payment sale at the time that the taxpayer receives the cash from which the taxes are to be paid. A taxpayer who uses the unpaid balance of an installment obligation to obtain a loan has received cash equal to the net proceeds of the loan. This is true whether the installment obligation has been formally pledged, or utilized in some other fashion to obtain cash currently. In either case, arguably there is no need to defer recognition of gain until the cash is received.

Modifications to the subsequent receipt rule

The subsequent receipt rule provides that, where loan proceeds are treated as a payment on the installment obligation under the pledging rule, subsequent payments received on the pledged installment obligation are not taken into account until they exceed the loan proceeds that were treated as payments. This may result in the deferral of gain beyond the time cash is received with respect to the installment obligation if the net proceeds of the secured loan are less than the unpaid amount of the installment obligation. For example, a taxpayer sells an asset with no basis in 1999 for a $1,000 installment obligation, payable $500 in 2000 and $500 in 2001. In 1999, the taxpayer pledges the installment obligation as collateral for a $500 loan. Under present law, the taxpayer recognizes a $500 gain in 1999, but no gain in 2000, despite the fact that it has collected all $1,000 it expects to receive as a result of the sale.[264]

On the other hand, to the extent the amount of the secured loan decreases as the installment obligation is repaid, the subsequent receipt rule may be necessary to prevent gain recognition in advance of the receipt of cash. If the terms of the loan in the above example had required repayment of half of its balance ($250) when half of the balance of the installment obligation was received in 2000, the taxpayer will have received only $750 of cash flow (the $250 loan that remains outstanding plus the $500 payment) from the installment obligation at the end of 2000, while the proposal would require all $1,000 of the gain to be recognized. Thus, it may be appropriate to retain the subsequent receipt rule to the extent that net proceeds from a loan secured by an installment obligation are no longer outstanding at the time of the payment on the installment obligation is received.

3. Deny deduction for punitive damages

Present Law

A deduction is allowed for all ordinary and necessary expenses pair or incurred by the taxpayer during the taxable year in carry-

[264] The taxpayer will recognize the remaining $500 of gain in 2001. However, that event does not affect the taxpayer's cash flow because it is offset by the repayment of the $500 loan.

ing on any trade or business (Code sec. 162(a)). A deduction is not allowed, however, for any payment made to an official of any government or governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government that illegal under Federal law (sec. 162(c)). In addition, no deduction is allowed for any fine or similar payment made to a government for violation of any law (sec. 162(f)). Finally, no deduction is allowed for two-thirds of the damage payments made by the taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law (sec. 162(g)).

In general, gross income does not include amounts received on account of personal injuries and physical sickness (sec. 104(a)). This exclusion generally does not apply, however, to punitive damages (P.L. 104–188; *K. M. O'Gilvie v. U.S, 519 U.S.* 79 (1996)).

Description of Proposal

No deduction would be allowed for punitive damages paid or incurred by the taxpayer as a judgment or in settlement of a claim. Where the liability for punitive damages is covered by insurance, any such damages paid by the insurer would be included in the gross income of the insured person and the insurer would be required to report such amounts to both the insured person and the Internal Revenue Service.

Effective Date

The proposal would apply to damages paid or incurred on or after the date of enactment.

Prior Action

No prior action.

Analysis

Proponents of the Administration proposal argue that allowance of a tax deduction for punitive damages undermines the role of punitive damages in discouraging and penalizing the activities or actions for which the punitive damages were imposed. Further, proponents note that the determination of the amount of punitive damages generally can be determined by reference to pleadings filed with a court and such a determination already is made by plaintiffs in determining the portion of any payment that is taxable.

Opponents of the proposal argue that a deduction should be allowed for all ordinary and necessary expenses paid or incurred by the taxpayer in carrying on a trade or business in order to properly measure the income of the taxpayer. Disallowance of punitive damages would result in the taxpayer paying taxes on amounts in excess of his income. Opponents also note that determining the amount of any punitive damages will be difficult in many cases, especially where the payment arises from a settlement of a claim.

4. Apply uniform capitalization rules to certain contract manufacturers

Present Law

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

A taxpayer is generally not considered to be producing property, and thus subject to the uniform capitalization rules, unless it is considered the owner of the property produced under Federal income tax principles. Such ownership is determined by consideration of the facts and circumstances, including who bears the benefits and burdens of ownership. A taxpayer may be considered the owner of property for Federal income tax purposes even though it does not hold legal title.

Property produced for a taxpayer pursuant to a contract with another party is considered to be produced by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs with regard to the property. There is an exception to this rule for routine purchase orders.

Certain contract manufacturers, known as "tollers", perform manufacturing or processing operations on property owned by their customers either for a fee (known as a toll) or for a share of the production. The toller may not consider itself the owner of the property, and thus subject to the uniform capitalization rules.

Description of Proposal

The proposal would apply section 263A to tollers and other contract manufacturers in the same manner and to the extent as would be required if the contract manufacturer owned the property. Such manufacturers would be required to capitalize the direct costs, and an allocable portion of the indirect costs, allocable to property manufactured or processed under such a contract manufacturing arrangement. For this purpose, a contract manufacturing arrangement is one in which the taxpayer performs manufacturing or processing operations (including manufacturing, processing, finishing, assembling, or packaging) on property owned by its customers for a fee without the passage of title. Tollers would be required to capitalize direct and indirect costs (such as labor and overhead) allocable to property tolled. The proposal would not apply to a toller or other contract manufacturer whose average annual gross receipts for the prior three taxable years are less than $1 million. Appropriate aggregation rules would be provided.

Effective Date

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

Prior Action

No prior action.

Analysis

The uniform capitalization rules generally require the costs of producing property to be recovered at the time the property is sold or used by the taxpayer, rather than as period costs. In choosing to enact a uniform set of rules, Congress was concerned that differences in capitalization rules could distort the allocation of economic resources and the manner in which certain economic activity is organized.[265]

The manufacturing and processing operations performed by a toller may be identical to the manufacturing and processing operations performed by a producer subject to section 263A. If a toller is able to currently deduct the direct and indirect costs attributable to its manufacturing activities, while a producer must capitalize the same costs when it manufacturers its own items, a disparate treatment based on ownership of the property results.

The requirement that a contract manufacturer's customer must capitalize its costs under section 263A is not by itself sufficient to prevent the disparate treatment. The customer may take the position that it is not the owner of the property, with the result that the uniform capitalization rules are not applied to the manufacturing activity at all. Even if the customer recognizes ownership of the property, and applies the uniform capitalization rules, that capitalization need not occur at the same time as would be the case if the manufacturer were subject to the uniform capitalization rules. In particular, where the customer is not obligated to pay for the manufacturing activities until delivery, capitalization of the customer's costs at the time of delivery does not fully offset the benefit of allowing the toller an earlier deduction of its direct and indirect costs.

5. Repeal the lower of cost or market inventory accounting method

Present Law

A taxpayer that sells goods in the active conduct of its trade or business generally must maintain inventory records in order to determine the cost of goods it sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain

[265] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, (JCS–10–87), May 4, 1987, p. 508.

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 pricing ending inventory. Under the retail method, the total of the retail selling prices of goods on hand at year-end is reduced to approximate cost by deducting an amount that represents the gross profit embedded in the retail prices. The amount of the reduction generally is determined by multiplying the retail price of goods available at year-end by a fraction, the numerator of which is the cost of goods available for sale during the year and the denominator of which is the total retail selling prices of the goods available for sale during the year, with adjustments for mark-ups and mark-downs (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 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. Generally, any section 481(a) adjustment required to be taken into account pursuant to the change of method of accounting under the proposal would be taken into account ratably over a four taxable year period beginning with the first taxable year the taxpayer is required to change its method of accounting.

Prior Action

The proposal is substantially similar to a provision that was 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, 1998 and 1999.

Analysis

Under present law, income or loss generally is not recognized until it is realized. In the case of a taxpayer that sells goods, income or loss generally is realized and recognized when the goods are sold or exchanged. The LCM and subnormal goods inventory methods of present law represent exceptions to the realization principle by allowing the recognition of losses without a sale or exchange. These methods have been described as one-sided in that they allow the recognition of losses, but do not require the recognition of gains.

In general, the LCM and subnormal goods inventory methods have been long-accepted as generally accepted accounting principles ("GAAP") applicable to the preparation of financial statements and have been allowed by Treasury regulations for tax purposes since 1918. However, the mechanics of the tax rules differ from the mechanics of the financial accounting rules. Moreover, the conservatism principle of GAAP requires the application of the LCM and subnormal goods methods so that the balance sheets of dealers in goods are not overstated relative to realizable values. There is no analog to the conservatism principle 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.

6. Repeal the 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 generally would be taken into account ratably over a four-year period.

Prior Action

The proposal is identical to a provision contained in the President's budget proposals for fiscal year 1999.

A related provision, that would have limited the use of the non-accrual experience method of accounting to amounts to be received for the performance of qualified professional services, was included in H.R. 4250 (105th Cong.), "The Patient Protection Act of 1998," as passed by the House of Representatives on July 24, 1998.

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).

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 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. Where accrual basis service providers compete on a relatively even footing with entities using the cash method, it may be appropriate to continue to allow the use of the non-accrual experience method to avoid the disparity of treatment between accrual and cash method competitors that could otherwise result.

7. Disallow interest on debt allocable to tax-exempt obligations

Present Law

In general

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is not subject to tax (tax-exempt obligations) (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.[266]

Application to non-financial corporations

General guidelines.—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 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 generally is not disallowed if during the taxable year the average adjusted basis of the tax-exempt obligations does not exceed 2 percent of the average adjusted basis of the individual's portfolio investments and trade or business assets. In the case of a corporation other than a financial institution or a dealer in tax-exempt obligations, interest on indebtedness generally is not disallowed if during the taxable year the average adjusted basis of the tax-exempt obligations does not exceed 2 percent of the average adjusted basis of all assets held in the active conduct of the trade or business. These safe harbors are inapplicable to financial institutions and dealers in tax-exempt obligations.

Interest on installment sales to State and local governments.—If a taxpayer sells property to a State or local government in exchange for an installment obligation, interest on the obligation may be exempt from tax. Present law has been interpreted to not disallow interest on a taxpayer's indebtedness if the taxpayer acquires nonsalable tax-exempt obligations in the ordinary course of busi-

[266] Code section 7701(f) (as enacted in the Deficit Reduction Act of 1984 (sec. 53(c) of P.L. 98–369)) provides that the Treasury Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of any income tax rules which deal with linking of borrowing to investment or diminish risk through the use of related persons, pass-through entities, or other intermediaries.

ness in payment for services performed for, or goods supplied to, State or local governments.[267]

Application to financial corporations and dealers in tax-exempt obligations

In the case of a financial institution, the allocation of the interest expense of the financial institution (which is not otherwise allocable to tax-exempt obligations) is based on the ratio of the average adjusted basis of the tax-exempt obligations acquired after August 7, 1987, to the average adjusted basis of all assets of the taxpayer (sec. 265). In the case of an obligation of an issuer which reasonably anticipates to issue not more than $10 million of tax-exempt obligations (other than certain private activity bonds) within a calendar year (the "small issuer exception"), only 20 percent of the interest allocable to such tax-exempt obligations is disallowed (sec. 291(a)(3)). A similar pro rata rule applies to security dealers in tax-exempt obligations, but there is no small issuer exception, and the 20-percent disallowance rule does not apply, and the proportional disallowance rule does not apply to interest of debt whose proceeds the dealer can trace to uses other than the acquisition of tax-exempt obligations (Rev. Proc. 72–18).

Treatment of insurance companies

Present law provides that a life insurance company's deduction for additions to reserves is reduced by a portion of the company's income that is not subject to tax (generally, tax-exempt interest and deductible intercorporate dividends) (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 and (2) the deductible portion of dividends received (with special rules for dividends from affiliates) (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 proposal would amend the definition of financial institution to which the proportionate disallowance rule applies also to include any person engaged in the active conduct of a banking, financing, or similar business, such as securities dealers and other financial intermediaries. Thus, the rule that applies to financial institutions that disallows interest deductions of a taxpayer (that are not otherwise disallowed as allocable under present law to tax-exempt obligations) in the same proportion as the average basis of its tax-exempt obligations bears to the average basis of all of the taxpayer's assets would be applied to all financial intermediaries. This proposal would not apply to insurance companies (although a separate proposal included in the President's fiscal 2000 budget proposals

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[267] *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.

would increase the proration percentage for property and casualty insurance companies).

Effective Date

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

Prior Action

The proposal is substantially similar to a proposal made in the President's fiscal year 1999 budget proposal. In addition, the proposal is narrower than a similar proposal made by the President's fiscal year 1998 budget proposal. In general, the fiscal year 1998 budget proposal would have applied the proportional disallowance rule to all corporations and would have applied the proportionate disallowance rule to all assets and borrowings of all related corporations. No legislative action was taken on either proposal.

Analysis

In general

The present-law rules which disallow interest deductions on indebtedness whose proceeds are used to finance tax-exempt obligations are intended to limit what is perceived as double tax benefit of (1) exclusion of interest received on tax-exempt obligations from income and (2) deduction of interest paid on obligations that finance the tax-exempt obligations. Present law provides different rules for different types of taxpayers. The Administration proposal is based on acceptance of the premise that money is fungible for all financial intermediaries that operate similarly and, accordingly, all debt of any financial intermediary finances its proportionate share of all of that intermediary's assets, including tax-exempt obligations.

Limitations to 2-percent de minimis exception

The Administration proposal would extend the pro rata rule that presently only applies to banks to all financial intermediaries. Extension of the pro rata rule would repeal the 2-percent de minimis exception for non-bank financial intermediaries. In addition, extension of the statutory pro rata rule to securities dealers would remove their ability to avoid an administrative pro rata rule where the taxpayer can establish through tracing of funds that borrowings were not used to acquire tax-exempt obligations.

Proponent's arguments

Some proponents of the Administration proposal accept the premise that money of all financial intermediaries is fungible and, accordingly, would disallow interest deductions on a pro rata basis (e.g., in the same proportion as the taxpayer's average basis in its tax-exempt obligations bears to the average basis of its total assets). These proponents argue that permitting the holding of tax-exempt obligations without limiting the deductibility of interest expense under the 2-percent de minimis exception for some financial intermediaries, but not others, may be viewed as a tax subsidy which may create a competitive advantage for some financial intermediaries over other financial intermediaries with whom they compete. These proponents argue that the proposed pro rata allocation of indebtedness among assets (in the manner prescribed for financial institutions) has the additional administrative benefit, for taxpayer's that own more tax-exempt obligations than the 2-percent de minimis amount, of avoiding the difficult and often subjective inquiry of when indebtedness is incurred or continued to purchase or carry tax-exempt obligations.

Opponent's arguments

Opponents of the Administration proposal argue that the proposal would have the effect of raising the financing costs for a State or local government. Opponents also argue that the scope of the Administration proposal is unclear since it is unclear what taxpayers will be treated as financial intermediaries for this purpose. Finally, opponents note that the 2-percent de minimis exception of present law avoids the complexity of complying with the proposed pro rata rule.

F. Cost Recovery Provisions

1. Modify treatment of start-up and organizational expenditures

Present Law

At the election of the taxpayer, start-up expenditures (sec. 195) and organizational expenditures (sec. 248) may be amortized over a period of not less than 60 months, beginning with the month in which the trade or business begins. Start-up expenditures are amounts that would have been deductible as trade or business expenses, had they been paid or incurred after business began. Organizational expenditures are expenditures that are incident to the creation of a corporation, are chargeable to capital, and that would be eligible for amortization had they been paid or incurred in connection with the organization of a corporation with a limited life.

The regulations [268] require that a taxpayer file an election to amortize start-up expenditures no later than the due date for the taxable year in which the trade or business begins. The election must describe the trade or business, indicate the period of amortization (not less than 60 months), describe each start-up expenditure incurred, and indicate the month in which the trade or business began. Similar requirements apply to the election to amortize organizational expenditures. A revised statement may be filed to include start-up expenditures that were not included on the original statement, but a taxpayer may not include as a start-up expenditure any amount that was previously claimed as a deduction.

Section 197 requires most acquired intangible assets (goodwill, trademarks, franchises, patents, etc.) that are held in connection with the conduct of a trade or business or an activity for the pro-

[268] Treas. Regs. sec. 1.195–1.

duction of income to be amortized over 15 years beginning with the month in which the intangible was acquired.

Description of Proposal

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

Effective Date

The proposal would be effective for start-up and organizational expenditures incurred after the date of enactment. Start-up and organizational expenditures that are incurred on or before the date of enactment would continue to be eligible to be amortized over a period not to exceed 60 months. However, all start-up and organizational expenditures related to a particular trade or business, whether incurred before or after the date of enactment, would be considered in determining whether the cumulative cost of start-up or organizational expenditures exceeds $50,000.

Prior Action

No prior action.

Analysis

Allowing a fixed amount of start-up and organizational expenditures to be deductible, rather than requiring their amortization, may help encourage the formation of new businesses that do not require significant start-up or organizational costs to be incurred. However, requiring all start-up or organizational costs to be amortized over 15 years (rather than 5 years as under present law) if such category of costs exceeds $55,000 may discourage the formation of businesses that incur greater costs prior to the commencement of business.

2. Establish specific class lives for utility grading costs

Present Law

A taxpayer is allowed a depreciation deduction for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or held for the production of income. For most tangible property placed in service after 1986, the amount of the depreciation deduction is determined under the modified accelerated cost recovery system (MACRS) using a statutorily prescribed depreciation method, recovery period, and placed in service convention. For some assets, the recovery period for the asset is provided in section 168. In other cases, the recovery period of an asset is determined by reference to its class life. Section 168 provides specific class lives for certain assets. The class life of other assets is determined by reference to the list of class lives provided by the Treasury Department that was in effect on January 1, 1986.[269] If no class life is provided, the asset is allowed a 7-year recovery period under MACRS.

Assets that are used in the transmission and distribution of electricity for sale are included in asset class 49.14, with a class life of 30 years and a MACRS life of 20 years. The cost of initially clearing and grading land improvements are specifically excluded from asset class 49.14. Prior to adoption of the accelerated cost recovery system (ACRS), the IRS ruled that an average useful life of 84 years for the initial clearing and grading relating to electric transmission lines and 46 years for the initial clearing and grading relating to electric distribution lines, would be accepted.[270] However, the result in this ruling was not incorporated in the asset classes included in Rev. Proc. 87–56 or its predecessors. Accordingly such costs are depreciated over a 7-year life under MACRS as assets for which no class life is provided.

A similar situation exists with regard to gas utility trunk pipelines and related storage facilities. Such assets are included in asset class 49.24, with a class life of 22 years and a MACRS life of 15 years. Initial clearing and grade improvements are specifically excluded from the asset class, and no separate asset class is provided for such costs. Accordingly, such costs are depreciated over a 7-year life under MACRS as assets for which no class life is provided.

Description of Proposal

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

Effective Date

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

Prior Action

No prior action.

Analysis

The clearing and grading costs in question are incurred for the purpose of installing the transmission lines or pipelines. They are properly seen as part of the cost of installing such lines or pipelines and their cost should be recovered in the same manner. There is

[269] Rev. Proc. 87–56, 1987–2 C.B. 674.
[270] Rev. Rul. 72–403, 1972–2 C.B. 102.

no indication that the clearing and grading costs have a useful other than the useful life of the transmission line or pipeline to which they relate.

G. Insurance Provisions

1. Require recapture of policyholder surplus accounts

Prior and Present Law

Under the law in effect from 1959 through 1983, a life insurance company was subject to a three-phase taxable income computation under Federal tax law. Under the three-phase system, a company was taxed on the lesser of its gain from operations or its taxable investment income (Phase I) and, if its gain from operations exceeded its taxable investment income, 50 percent of such excess (Phase II). Federal income tax on the other 50 percent of the gain from operations [271] was accounted for as part of a policyholder's surplus account and, subject to certain limitations, taxed only when distributed to stockholders or upon corporate dissolution (Phase III). Under these rules, the deferred income (i.e., 50 percent of gain from operations in excess of taxable investment income) was added to a policyholders surplus account. Amounts in the policyholders surplus account were taxed only when distributed by the company to its shareholders. To determine whether amounts had been distributed, a company maintained a shareholders surplus account, which generally included the company's previously taxed income that would be available for distribution to shareholders.[272] Distributions to shareholders were treated as being first out of the

[271] The legislative history to the Life Insurance Company Tax Act of 1959 states that "[t]his 50 percent reduction in underwriting gains is made because of the claim that it is difficult to establish with certainty the actual annual income of life insurance companies. It has been pointed out that because of the long-term nature of their contracts, amounts, which may appear as income in the current year and as proper additions to surplus, may, as a result of subsequent events, be needed to fulfill life insurance contracts. Because of this difficulty in arriving at true underwriting gains on an annual basis, the bill provides for the taxation of only 50 percent of this gain on a current basis." Report of the Committee on Ways and Means to accompany H.R. 4245, H. Rep. No. 34, 86th Cong., 1st Sess. at 13 (1959). Similarly, the Senate report provides, "Although it is believed desirable to subject this underwriting income to tax, it is stated that because of the long-term nature of insurance contracts it is difficult, if not impossible, to determine the true income of life insurance companies otherwise than by ascertaining over a long period of time the income derived from a contract or block of contracts. Because of this, the bill as amended by your committee, like the bill as passed by the House, does not attempt to tax on an annual basis all of what might appear to be income. In both the House and your committee's bill, half of the underwriting income is taxed as it accrues each year. The other half of the underwriting income is taxed when it is paid out in a distribution to shareholders after the taxed income has been distributed, or when it is voluntarily segregated and held for the benefit of the shareholders. This other half of the underwriting income also is taxed if the cumulative amount exceeds certain prescribed limits or if for a specified period of time the company ceases to be a life insurance company." Report of the Committee on Finance to accompany H.R. 4245, S. Rep. No. 291, 86th Cong., 1st Sess. at 7 (1959).

[272] Other events are treated as a subtraction from the policyholders surplus account. If for any taxable year the taxpayer is not an insurance company, or for any 2 taxable years the company is not a life insurance company, then the balance in the policyholder surplus account at the close of the preceding taxable year is taken into income (former sec. 815(d)(2) as in effect prior to the 1984 Act, which is referred to in present-law sec. 815(f)). Further, the policyholder surplus account is reduced by the excess of the account over the greatest of 3 amounts related to reserves: (1) 15 percent of life insurance reserves at the end of the taxable year; (2) 25 percent of the amount by which the life insurance reserves at the end of the taxable year exceed the life insurance reserve at the end of 1958; or (3) 50 percent of the net amount of the premiums and other consideration taken into account for the taxable year (former sec. 815(d)(4)(A)–(C), as in effect prior to the 1984 Act, which is referred to in present-law sec. 815(f)).

shareholders surplus account, then out of the policyholders surplus account, and finally out of other accounts.

The Deficit Reduction Act of 1984 included provisions that, for 1984 and later years, eliminated further deferral of tax on amounts (described above) that previously would have been deferred under the three-phase system. Although for taxable years after 1983, life insurance companies may not enlarge their policyholders surplus account, the companies are not taxed on previously deferred amounts unless the amounts are treated as distributed to shareholders or subtracted from the policyholders surplus account.

Under present law, any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company is subject to tax at the corporate rate in the taxable year of the distribution (sec. 815). Present law provides that any distribution to shareholders is treated as made (1) first out of the shareholders surplus account, to the extent thereof, (2) then out of the policyholders surplus account, to the extent thereof, and (3) finally, out of other accounts (sec. 815(b)).

Description of Proposal

The proposal would require a stock life insurance company with a policyholders surplus account to include in income the amount in the account as of the beginning of the first taxable year beginning after the date of enactment. The inclusion generally would be ratable over the 10-year period beginning with the first taxable year after the date of enactment. Thus, one-tenth of the total includable amount would be included in each year of the 10-year period. In the event of a direct or indirect distribution to shareholders or other event that requires inclusion in income of any amount in a policyholders surplus account, then the company would include a pro rata portion of the remaining amount in the policyholders surplus account in income over the remainder of the 10-year period.

Effective Date

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

Prior Action

No prior action.

Analysis

Proponents of the proposal argue that continued deferral of income that was tax-deferred in years before 1984 is no longer justified. Proponents argue that the original rationale for permitting the deferral—that ascertaining the underwriting underwriting of a life insurance company on an annual basis is too difficult and could result in an overestimate of the company's income—no longer applies. Present law taxing life insurance companies provides for inclusion of underwriting income without a 50 percent exclusion as under the prior three-phase system. Further, virtually all the contracts that generated the deferred income have either terminated (whether through surrender of the contract, non-payment of premiums, or because the insured person has died), or have been reinsured with other companies. Thus, the risks are no longer with the companies that maintain the policyholders surplus accounts and continue to defer pre-1984 income with respect to those contracts.

Opponents might argue that both the 1959–1983 rules that permitted deferral, and the 1984 (present-law) rules that generally continue the deferral of tax on that income, were structured so favorably to taxpayers that events triggering tax on the deferred amounts are extremely unlikely to occur. It is argued that this structure reflects an implicit Congressional intent never to impose tax on the deferred amounts except in the extraordinary circumstances which would arise only if a company were liquidating and going out of business. Therefore, it is argued, it would be inconsistent with Congressional intent, and with taxpayers' understanding of the 1959 and 1984 legislation, to impose tax now on amounts in stock life insurance companies' policyholders surplus accounts.

On the other hand, it could be said that there is no reason to assume that Congress believed no amount would ever be included in a taxpayer's income, but rather, that such amounts were simply deferred and could be taxed later. The rules would not have listed events triggering tax on amounts in the policy holder's surplus account, if Congress had intended permanent deferral, it is argued.[273] Also, it could be argued that other favorable tax rules, some explicitly providing for permanent deferral or exclusion, have been repealed by Congress as it became clear that the rationale for them no longer applied. Thus, it is argued, the fact that Congress enacted a deferral provision in the past is not a sufficient reason to retain the deferral rule permanently.

Generally, the rules relating to amounts in policyholder surplus accounts affect stock but not mutual life insurance companies, because direct and indirect distributions to shareholders trigger tax on amounts in the policyholder surplus account under present law. Some might argue that the proposal would have a disparate impact on stock life insurance companies that is based only on their form of doing business and not related to any real economic distinction among the companies. As a practical matter, it is understood that mutual companies under the prior three-phase system rarely came within Phase II, but rather, were ordinarily taxed under Phase I on their taxable investment income (because their gain from operations generally did not exceed their taxable investment income). Thus, only the companies that had the benefit of deferral would be affected by the proposal.

2. Modify rules for capitalizing policy acquisition costs of insurance companies

Present Law

Insurance companies are required to capitalize policy acquisition expenses and amortize them on a straight-line basis, generally over

[273] In addition, the prior law has been interpreted in a recent case as requiring taxpayers to include amounts from the policyholders surplus account in income. See *Bankers Life and Casualty Co. v. U.S.*, 142 F.3rd 973 (7th Cir. 1998), cert. denied (Nov. 2, 1998), 119 S. Ct. 403.

a period of 120 months [274] beginning with the first month in the second half of the taxable year. Policy acquisition expenses required to be capitalized and amortized are determined, for any taxable year, for each category of specified insurance contracts, as a percentage of the net premiums for the taxable year on specified insurance contracts in that category. The percentages for each of the categories are as follows:

	Percent
Annuities	1.75
Group life	2.05
Other life (including noncancellable or guaranteed renewable accident and health)	7.70

Specified insurance contracts that are subject to the capitalization and amortization rule do not include any pension plan contract, any flight insurance or similar contract, contracts of certain noncontiguous foreign branches, or any contract that is a medical savings account ("MSA").

Regulatory authority is provided to the Treasury Department to provide a separate category for a type of insurance contract, with a separate percentage applicable to the category, under certain circumstances. The authority may be exercised if the Treasury Department determines that the deferral of policy acquisition expenses for the type of contract which would otherwise result under the provision is substantially greater than the deferral of acquisition expenses that would have resulted if actual acquisition expenses (including indirect expenses) and the actual useful life of the contract had been used. In making this determination, Congress intended that the amount of a reserve for a contract not be taken into account.[275] If the authority is exercised, the Treasury Department is required to adjust the percentage that would otherwise have applied to the category that included the type of contract, so that the exercise of the authority does not result in a decrease in the amount of revenue received by reason of the amortization provision for any fiscal year.

Description of Proposal

The proposal would modify the categories of specified insurance contracts under the rules requiring capitalization and amortization of policy acquisition expenses. The proposal would also provide for a different amortization percentage for the first five years and the second five years of the amortization period, for some categories of specified insurance contracts. The proposal would provide for the following categories:

	Percent
Term life insurance (group or individual)	2.05
Non-pension annuity contracts:	
1st through 5th year	4.25
6th and later years	5.15

[274] A special rule permits a 60-month amortization period for certain small companies.

[275] See H. Rept. 101–964, Conference Report to accompany H.R. 5835, Omnibus Budget Reconciliation Act of 1990 (101st Cong., 2d Sess.), 1066, 1070.

	Percent
Group or individual noncancellable health insurance	7.70
Cash value life insurance, credit life insurance, credit health insurance, and any other specified insurance contracts:	
1st through 5th year	10.50
6th and later years	12.85

The category of group or individual noncancellable health insurance at 7.70 percent is the same as under present law. In addition, the percentage of net premiums capitalized for group or individual non-cancellable health insurance remains at 7.70 percent, as under present law.

The proposal retains the present-law exceptions from the definition of specified insurance contracts for any pension plan contract, any flight insurance or similar contract, certain contracts of noncontiguous foreign branches, or any contract that is an MSA.

The proposal would also provide that an insurance company would be able to elect to capitalize the amount of its actual policy acquisition expenses, in lieu of applying the above percentages to its net premiums. This election would be made on a one-time basis for all lines of business of all members of the controlled group (within the meaning of sec. 848(b)(3)), and would be treated as a method of accounting.

Effective Date

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

Prior Action

The proposal is similar to a narrower proposal contained in the President's budget proposals for fiscal year 1999, that applied only to credit life insurance (whether or not group credit life insurance). That proposal would have required insurance companies to capitalize and amortize 7.70 percent of net premiums for the taxable year with respect to credit life insurance, not 2.05 percent as under present law.

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.[276]

It could be argued that Congress was aware that a proxy approach could not be accurate with respect to the actual percentage of net premiums representing commissions and other policy acquisition costs, and therefore, that all of the percentages were calculated deliberately to err on the low side rather than on the high side. On the other hand, it could be said that there is no evidence that Congress intended the percentages to be low, or it is possible that accurate information was not available at the time the percentages were set, so that the percentages represented the best approximation that could be made at the time. Now that specific, current information about commission rates for particular lines of insurance business is available, it arguably is appropriate to revise the percentages applicable under present law. It could further be argued that, even if Congress did have specific, current information at the time the percentages were set, that commissions and other policy acquisition costs may have changed, and updating the percentages, modifying the amortization periods, and increasing the number of categories would be appropriate to achieve greater accuracy in measuring income.

For some lines of business, it could be argued that even though that line of business has relatively high actual acquisition expenses, the contracts tend to have a relatively short duration and therefore the present value of the amortization deduction (plus any currently deductible amounts) is lower under present law than if the contracts had a shorter amortization period for tax purposes (even if the entire actual amount of such expenses were capitalized). Therefore, it is argued, the percentages for these lines of business should not be increased, so as to take account indirectly of the short duration of such contracts. On the other hand, proponents point to the high ratio of commissions (which do not necessarily include all policy acquisition expenses) to net premiums. These ratios are higher than the percentages under the proposal. Also, they argue that the actual duration of most contracts is longer than ten years, and the duration is shorter than ten years generally for lines of business with particularly high ratios of policy acquisition expenses to net premiums. Further, they argue, some lines of insurance business may be reinsured with small companies eligible for the more favorable 60-month amortization period, and consequently the present value of the deductions for acquisition expenses in such a case is greater.

Proponents of the proposal argue that the revision of the categories and percentages for capitalization and amortization is similar to the methodology that insurance companies use for financial reporting purposes under generally accepted accounting principles ("GAAP"). While a GAAP approach may have been rejected at the time the present-law rules were enacted, at least in part because some mutual insurance companies did not file GAAP statements, some observers point to a change in financial reporting practices under which insurance companies now generally report on a GAAP

[276] Finance Committee Report, *supra*, at S 15961 (see footnote 271, *supra*).

basis. They argue that GAAP more accurately measures income than the present-law tax rules do.

Opponents of increasing the percentages may argue that efficient companies with relatively low acquisition costs would be unfairly penalized by the increases under the proposal. Proponents point to the election under the proposal to capitalize and amortize actual acquisition expenses, and argue that efficient companies could make this election. They argue that the election could be based on the amount of policy acquisition expenses the company reports for GAAP purposes, so that the election could be relatively simple to administer.

The Treasury Department has regulatory authority to create an additional category of contract (provided it adjusts the category from which the contract was drawn so that there is no decrease in revenue from the provision), as noted above. Some may argue that this may suggest that legislation might not be required to change the capitalization percentages. On the other hand, it could be said that determining the proper percentage for any new category of contract and making the correct adjustment to its former category might be viewed as a judgment that is best left to Congress. Further, it could be said that the regulatory authority may not encompass changing the amortization period for a particular percentage, nor increasing the percentages in all the categories without offsetting reductions. Some might argue that the requirement that adjustments to the categories be balanced by an offsetting adjustment indicates that Congress viewed unfavorably any administrative change to the categories, making legislation the preferred means for any change to the categories.

Some argue that the proposal would apply with respect to existing contracts, and would change the percentages for them. It is argued that this type of effective date is unfair, and that it would be preferable to apply the proposal to premiums paid on newly issued contracts. On the other hand, it could be argued that if the percentages had been based on the ratio of commissions to first-year premiums, then the percentages would have been considerably higher, to reflect current commission payment practices for the first year of premiums. Proponents argue that because the percentages in the proposal are not based on the ratio of commissions to first-year premiums, it would be theoretically incorrect to apply the percentages in the proposal only to premiums on newly issued contracts.

3. Increase the proration percentage for property and casualty insurance companies

Present Law

The taxable income of a property and casualty insurance company is determined as the sum of its underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions. Underwriting income means premiums earned during the taxable year less losses incurred and expenses incurred. In calculating its reserve for losses incurred, a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment or annuity contracts.

This 15-percent proration requirement was enacted in 1986. The reason the provision was adopted was Congress' belief that "it is not appropriate to fund loss reserves on a fully deductible basis out of income which may be, in whole or in part, exempt from tax. The amount of the reserves that is deductible should be reduced by a portion of such tax-exempt income to reflect the fact that reserves are generally funded in part from tax-exempt interest or from wholly or partially deductible dividends." [277] In 1997, the provision was modified to take into account the increase for a taxable year in the cash value of certain insurance contracts.[278]

Description of Proposal

The proposal would increase the proration percentage applicable to a property and casualty insurance company from 15 percent to 25 percent.

Effective Date

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

Prior Action

The proposal is similar to a provision contained in the President's budget proposal for fiscal year 1999, except that in the prior proposal the percentage was 30 percent, not 25 percent.

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,[279] and about 21 percent of these companies' financial assets were invested in tax-exempt debt.[280] Proponents of the proposal interpret this as evidence that property and casualty insurers continue to find tax-exempt debt more profitable than otherwise comparable taxable debt.

Critics of the proposal note that by reducing the effective yield received by property and casualty insurers on their holdings of tax-exempt debt, the proposal can reduce the demand for tax-exempt bonds by this industry. As noted above, property and casualty insurers are large holders of tax-exempt bonds. A reduction in demand for these securities by the property and casualty insurers may lead to an increase in borrowing costs for State and local governments. Even a small increase in the interest cost to tax-exempt

[277] 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.
[278] P.L. 105–34, The Taxpayer Relief Act of 1997, section 1084.
[279] Federal Reserve Board, *Flow of Funds Accounts, Flows and Outstanding*, second quarter 1997.
[280] *Ibid*.

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.

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.[281] 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.[282]

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 another. Some observers point out that health, disability and long-term care insurance are sold by both life insurance companies and property and casualty companies, so in some respects property and casualty insurers cannot be distinguished from life companies, even though life insurers have more rigorous proration rules. The pro-

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[281] 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 $r_{te} > r \cdot (1 - t)$, where t is the taxpayer's marginal tax rate.

[282] By reducing the deduction for increases in reserves by 15 percent of the taxpayer's tax-exempt interest earnings, the taxpayer's taxable income is increased by 15 percent of the taxpayer's tax-exempt interest earnings. Thus, the 15-percent proration requirement has the effect of imposing tax on the interest paid by a tax-exempt bond at an effective marginal tax rate equal to $(.15) \cdot t$, where t is the taxpayer's marginal tax rate. One effect of creating an effective tax on the interest earned from a tax-exempt bond is that a property and casualty insurer would only find holding the tax-exempt bond more profitable than holding an otherwise comparable taxable bond when $r_{te} \cdot (1 - (.15)t) > r \cdot (1 - t)$. This is equivalent to: $r_{te} > r \cdot \{(1 - t)/(1 - (.15)t)\}$.

If the statutory marginal tax rate of the property and casualty insurer were 35 percent, then it would be profitable to purchase tax-exempt debt in lieu of taxable debt when $r_{te} > (.686)r$. Under the proposal, it would be profitable to purchase tax-exempt debt in lieu of taxable debt when $r_{te} > (.726)r$

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 $(.15) \cdot t$. However, in considering the "implicit" tax one must recognize that this implicit tax is not paid to the Federal Government, but rather is received by the issuer of the tax-exempt debt in the form of a lower borrowing cost.

posal alternatively could be criticized because it would still provide property and casualty insurers with more favorable proration rules than currently apply to banks and life insurance companies.

More broadly, it is said that the present tax rules provide an inefficient subsidy for borrowing by State and local governments. The interest rate subsidy provided to State and local governments by the ability to issue tax-exempt bonds cannot efficiently pass the full value of the revenue lost to the Federal Government to the issuer. The Federal income tax has graduated marginal tax rates. Thus, $100 of interest income forgone by a taxpayer in the 31-percent bracket costs the Federal Government $31, while the same amount of interest income forgone by a taxpayer in the 28-percent bracket costs the Federal Government $28. Consequently, if a taxpayer in the 28-percent bracket finds it profitable to hold a tax-exempt security, a taxpayer in the 31-percent bracket will find it even more profitable.[283] 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.

H. Exempt Organizations

1. Subject investment income of trade associations to tax

Present Law

Under present law, nonprofit business leagues, chambers of commerce, trade associations, and professional sports leagues described in section 501(c)(6) generally are exempt from Federal income taxes. Such organizations generally are not subject to tax on membership dues and contributions they receive, and generally are not subject to tax on their investment income. However, section 501(c)(6) organizations are subject to tax on their unrelated business taxable income. The unrelated business income tax ("UBIT") applies with respect to income derived from a trade or business regularly carried on by the organization unless the conduct of the trade or business is related substantially (aside from the organization's need for or use of the revenues) to performance of its tax-exempt functions. Under special rules, dividends, interest, royalties, certain rental income, certain gains or losses from dispositions of property, and certain other specified types of income (and directly connected deductions) of a tax-exempt organization generally are excluded from unrelated business taxable income subject to UBIT, except where derived from debt-financed property or certain controlled entities (sec. 512(b)).

In the case of tax-exempt social clubs, voluntary employees' beneficiary associations (VEBAs), and certain other mutual benefit organizations, the UBIT generally applies under present law to all gross income—including investment income—other than certain "exempt function income." Exempt function income includes items such as membership receipts, income set aside to be used for chari-

[283] 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.

table purposes specified in section 170(c)(4), and "rollover" gain on certain dispositions of property directly used by the organization in carrying out its exempt functions (sec. 512(a)(3)).

Dues paid by members of a section 501(c)(6) organization generally are deductible as ordinary and necessary business expenses under section 162(a). However, section 162(e), as amended by the Omnibus Budget Reconciliation Act of 1993, provides that no deduction shall be allowed for any amount paid or incurred in connection with certain lobbying and political activities. For section 501(c)(6) organizations, the primary consequence of this provision is to deny members a deduction for dues or similar amounts allocable to lobbying and political activities. An organization must notify its members of a reasonably estimated disallowance percentage for the year at the time of assessment or payment of the dues for that year. Under section 6033(e)(1)(C), any lobbying and political expenditures made by an organization described in section 501(c)(6) are deemed to be made first out of the dues payments made by the members during the tax year. As an alternative to the notice requirement and the disallowance of otherwise deductible dues, an organization may choose to pay a proxy tax on the actual amount of its expenditures for lobbying and political expenditures for the year (sec. 6033(e)(2)).

Under section 527(f), a tax-exempt organization, including an organization described in section 501(c)(6), that makes expenditures in an attempt to influence the selection of an individual to any Federal, State, or local public office (which generally are referred to as "electioneering" expenditures) is subject to a tax at the highest corporate rates.[284] This tax is determined by computing an amount equal to the lesser of the organization's net investment income for the year involved or the amount expended on electioneering activities (sec. 527(f)(1)). In computing net investment income for purposes of this tax, items of the organization's income already subject to UBIT are excluded from the computation (sec. 527(f)(2)).

Description of Proposal

Under the proposal, trade associations and other organizations described in section 501(c)(6) generally would be subject to tax (at applicable corporate income tax rates) on their net investment income in excess of $10,000. For this purpose, "net investment income" would include dividends, interest, royalties, rent, and certain gains and losses from dispositions of property, minus all expenses directly connected with such items of income.

As under present-law section 512(a)(3), tax would not be imposed under the proposal to the extent that income is set aside to be used exclusively for a charitable purpose specified in section 170(c)(4). In addition, if an organization described in section 501(c)(6) sells property that is used directly in the performance of its exempt function, any gain from such sale is subject to tax under the proposal only to the extent that the association's sales price of the old property exceeds the association's cost of purchasing certain replacement property (see sec. 512(a)(3)(D)).

[284] The electioneering activities covered by section 527 are somewhat different than the lobbying and political activities covered by section 162(e).

Effective Date

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

Prior Action

A similar proposal was included in the House version of the Omnibus Budget Reconciliation Act of 1987; however, that proposal did not include the exemption for the first $10,000 of investment income. The provision was not included in the conference report.

Analysis

In general

Under present law, dues payments by members of an organization described in section 501(c)(6) generally are deductible. In addition, the organization generally is not subject to tax on its investment income. Thus, members of such an organization are able to fund future operations of the organization through deductible dues payments, even though the members would have been subject to tax on the earnings attributable to such dues payments if they had been retained and invested by the members and paid at the time the organization had expenses. Supporters of the Administration proposal argue that the tax-exempt treatment accorded to organizations described in section 501(c)(6) should not extend to the accumulation of assets on a tax-free basis. Thus, it can be argued that such organizations should be subject to tax on earnings attributable to amounts collected in excess of the amounts needed to fund current operations of the organization.

Opponents of the proposal will argue that the proposal does not permit organizations described in section 501(c)(6) to plan for anticipated expenditures, such as the purchase of a headquarters building. Thus, it could be argued that the proposal has the effect of forcing such an organization to collect substantial dues from members in the year in which an extraordinary expense arises and that this will have the effect of penalizing those individuals who are members at the time of an extraordinary expense. On the other hand, the Administration proposal does not subject the first $10,000 of investment earnings to tax, and thus allows an organization described in 501(c)(6) to accumulate some assets to meet future expenses.

Opponents of the proposal also may contend that it is not appropriate to extend the tax treatment of social clubs (and other mutual benefit organizations) to other organizations described in section 501(c)(6), because the purposes and activities of these types of entities are not analogous. The purpose of a social club is to provide to its members benefits of a recreational or social nature, which generally would not be deductible if directly paid for by the members. Accordingly, it is considered appropriate to prevent such benefits from being provided through tax-free investment income. In contrast, expenditures for many of the activities of a trade association (e.g., although not expenditures for lobbying or political activities (sec. 162(e)(2)) would be deductible by the association's members if carried on by the members directly, because the expenditures would constitute ordinary and necessary business expenses under section 162(a).

Alternatively, opponents might argue the proposal is too narrow because it would not impose tax on the investment income of organizations exempt under other provisions of section 501 (for example, labor, agricultural or horticultural organizations under sec. 501(c)(5)). On the other hand, it could be argued that such organizations are not analogous to the ones taxed under the proposal, or to organizations subject to UBIT under present law on all gross income other than exempt function income.

The proposal does not explicitly address what effect it would have on the section 527(f) tax imposed on an organization because of its involvement in electioneering activities. Because the proposal would subject the net investment income (above the $10,000 threshold) of section 501(c)(6) organizations to UBIT under all circumstances, section 527(f)(2) would prevent that investment income from being taken into account for purposes of computing the tax under section 527(f)(1). Consequently, it is unclear whether the tax imposed under section 527(f) would have continuing applicability to section 501(c)(6) organizations.

Economic analysis of proposal

In general, the dues collected by a trade association are established at levels that are intended to provide sufficient funds to carry out the exempt purposes of the trade association. That is, the trade association ultimately spends all dues collected on the exempt purposes of the trade association. The effect of the present-law exclusion from UBIT for certain investment income of trade associations is that if the trade association collects $1.00 in dues today, but does not incur expenses until some point in the future, the association will have an amount with a present value of $1.00 available to meet those expenses. For example, if interest rates are 10 percent and the trade association collects $1.00 in January 1999, but incurs no expenses until January 2000, at that time it will have $1.10 available to meet expenses.

The deductibility of dues paid by the trade association member to the trade association effectively reduces the cost of paying such dues.[285] Depending upon whether investment earnings of trade associations predominately are earned and used to fund current year operations or whether substantial balances of assets are carried forward for a number of years, the present-law exclusion from UBIT for investment income of trade associations may permit the trade association and its members to effectively lower the cost of the trade association's dues below the cost reduction created solely by deductibility of dues.

Assume that a trade association does not anticipate any expenses during the first half of 1999, but anticipates $1.05 in expenses in the second half of 1999. The trade association could collect $1.00 in dues in January 1999 and by investing the $1.00 at 10-percent

[285] In general, permitting a taxpayer to deduct certain expenses from gross income for the purpose of computing taxable income means that the taxpayer makes those expenditures out of pretax income. The taxpayer must make most other purchases out of after-tax income. As a result, the "cost," in terms of the forgone other (non-deductible) spending, of the deductible expenditures is $1.00(1 - t), where t is the taxpayer's marginal tax rate. Thus, to give $1.00 to the trade association, the trade association member must sacrifice less than $1.00 of other spending.

(as in the example above) for half of the year have sufficient funds to meet the future expense. Alternatively, the trade association could collect $1.05 in dues from its members in July 1999. In that case, the association member could invest the $1.00 in dues that was not collected in January and, at a 10-percent rate of return, could realize a gross return of $1.05 in July 1999. The association member could use the $1.05 to pay the association dues at that time. By investing, the association member would have earned an additional $0.05 in income, but by paying dues of $1.05 which are deductible against income, the association member's after-tax (and after dues) income is the same as when he or she paid $1.00 in dues in January 1999. Because the trade association receives $1.05 in July 1999, the trade association is in the same position as if it had received $1.00 in January 1999. Thus, within a single tax year, present law leaves a trade association member indifferent between paying deductible dues now and letting the trade association earn pre-tax rates of return to meet exempt purpose expenses or earning the income itself and paying the income over to the trade association as part of its deductible dues.

If the trade association carries over assets on which it earns income from the current year to future years, the trade association member may not be indifferent between paying $1.00 in dues in 1999 or $1.21 in dues in 2001. Under present law, the trade association could invest $1.00 in 1999 at 10 percent and have $1.21 available in 2001. However, the trade association member that invests $1.00 in 1999 may not have $1.21 to contribute as dues to the trade association in 2001, because the member would have to pay taxes on the annual interest earnings if the $1.00 were invested in a bank account. As a result, the trade association member would have somewhat less than $1.21 available in its bank account in 2001 and would have to sacrifice some other consumption to pay $1.21 in dues in 2001. By transferring $1.00 in dues in 1999, the trade association member can both obtain a current deduction and avoid income tax liability on the investment earnings attributable to the dues payment because the trade association's investment earnings are not taxed. Thus, the trade association member would prefer to pay $1.00 in dues in 1999 and let the trade association earn pre-tax rates of return to meet exempt purpose expenses. In this way, the present-law exclusion from UBIT for investment income of trade associations effectively lowers the amount of spending on other goods that the trade association members must give up to fund the activities of the trade association.

The proposal would subject the investment income of the trade association to income tax. In the example above, if the trade association collected $1.00 in dues in 1999 and invested the proceeds, it would have something less than $1.21 in funds available in 2001 to meet expenses, the same result as if the trade association member had retained the $1.00 and invested it itself. Compared to present law, the proposal would have the effect of raising the amount of spending on other goods that the trade association members must give up to fund the exempt purposes of the trade association. If the rate of tax applicable to the trade association and the rate of tax applicable to the trade association member were equal, the trade association member will be indifferent between paying deductible dues now and letting the trade association earn after-tax rates of return to meet exempt purpose expenses or earning the income itself, paying tax on the annual income, and paying the after-tax proceeds over to the trade association as part of its deductible dues.[286]

I. Estate and Gift Tax Provisions

1. Restore phase-out of unified credit for large estates

Present Law

Prior to enactment of the Taxpayer Relief Act of 1997, a 5-percent surtax was imposed upon cumulative taxable transfers between $10 million and $21,040,000 in order to phase out the benefits of the graduated rates and the unified credit. The Taxpayer Relief Act of 1997 increased the unified credit, beginning in 1998, from an effective exemption of $600,000 to an effective exemption of $1 million in 2006. A conforming amendment made to the 5-percent surtax phased out the benefits of the graduated rates but not of the unified credit, such that the 5-percent surtax applies to taxable estates between $10 million and $17,184,000.

Description of Proposal

The proposal would extend the phaseout in section 2001(c)(2), which currently applies only to the graduated rates, to the unified credit. The phase-out range would increase as the unified credit continues to rise until 2006. In order to phase out the benefit of both the graduated rates and unified credit, the 5-percent surtax would apply to taxable estates between $10 million and $21,410,000 for 1999; between $10 million and $21,595,000 for 2000 and 2001; between $10 million and $21,780,000 for 2002 and 2003; between $10 million and $22,930,000 for 2004; between $10 million and $23,710,000 for 2005; and between $10 million and $24,100,000 for 2006 and thereafter.

Effective Date

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

Prior Action

A similar provision was included as a technical correction in the Senate version of the Internal Revenue Service Restructuring and Reform Act of 1998. The provision was deleted in conference.

Analysis

The phaseout of the unified credit and the benefits of the graduated rates was originally adopted in the Omnibus Budget Reconciliation Act of 1987 to restrict the full benefits of the unified credit and graduated rates to small estates, which the Congress

[286] In general, if the trade association were subject to a higher marginal tax rate than the trade association member, the trade association member would prefer not to pre-fund future expenses of the trade association.

had determined had the greatest need for tax relief. Under the proposal, in 2006 for example, the phase out would have the effect of increasing the marginal tax rate to 60 percent with respect to taxable estates between $17,184,000 and $24,100,000. Taxable estates above $24,100,000 would continue to be taxed at a marginal tax rate of 55 percent. This would have the effect of creating a tax liability equal to 55 percent of the taxable estate on all estates valued at $24,100,000 or greater. That is, the average tax rate on estates of $24,100,000 or greater would be 55 percent. Under present law, the average tax rate, in 2006, on an estate of $24,100,000 would be 50.9 percent, and the average tax rate would increase for estates above $24,100,000, although the average tax rate would never reach 55 percent.

2. Require consistent valuation for estate and income tax purposes

Present Law

Under present law, property included in the gross estate of a decedent generally is valued at its fair market value on the date of death (or on an alternate valuation date). Likewise, the basis of property acquired from a decedent is its fair market value on the date of death. However, there is no statutory requirement that the determination of fair market value for estate tax purposes and the determination of fair market value for income tax purposes be consistent. The only current statutory duty of consistency for estates concerns the duty of the beneficiary of a trust or estate to report for income tax purposes consistent with the Form K–1 information received from the trust or estate.[287] The K–1, however, does not include basis information.

When a lifetime gift of property is made, the donee generally takes a carryover basis in the property. (Adjustments are made if gift tax is paid on the transfer, and the dual basis rules apply if the property is later sold at a loss.) The donor has no duty to notify the donee of the basis of the transferred property.

Description of Proposal

The proposal would require that a person receiving property from a decedent use, as basis, the fair market value of the property as reported on the decedent's estate tax return (if one is filed).

The proposal further would require that an estate, by its representative, notify each heir, as well as the Internal Revenue Service, of the fair market value on the date of the decedent's death of any property distributed to such heir. Moreover, donors of lifetime gifts (other than annual exclusion gifts) would be required to notify donees, as well as the IRS, of the donor's basis in the property at the time of the transfer as well as any payment of gift tax that would increase the basis of the property.

[287] Code section 6034A.

Effective Date

The proposal would be effective for estates of decedents dying after the date of enactment in the case of transfers at death, and transfers after the date of enactment in the case of lifetime gifts.

Prior Action

No prior action.

Analysis

The proposal would impose both a duty of consistency and a reporting requirement. To ensure consistency, the proposal would require that an individual taking a basis under section 1014 (property acquired from a decedent) use the fair market value as reported on the decedent's estate tax return, provided one was filed, as the basis of the property for income tax purposes.

Courts have recognized that taxpayers have a duty to maintain consistent positions with the IRS.[288] In fact, a duty of consistency has been held to apply when an estate determines the fair market value of property at the date of death, and a recipient/heir (who was the estate's executor) later argues, after the period of limitations on the estate tax assessment had expired, that the property had a basis different from that reported (or stipulated to) by the estate.[289] The proposal would codify a duty of consistency with respect to the reporting of the basis of property received from a decedent's estate.

It may be appropriate to codify a duty of consistency for those heirs who participated in valuing property for estate tax purposes initially or by agreement with the IRS. In such a case, an heir would be estopped from claiming a value different than the one claimed on the estate tax return or agreed to with the IRS.

Estoppel, however, may not be appropriate for those transferees who had not participated in the valuation process for an estate. In this instance, the proposal would require these individuals to report, for income tax purposes, the value as reported on the estate tax return or agreed to with the IRS, without an opportunity to challenge such value. The proposal may preclude an heir, who had no role in determining the value of property for estate tax purposes, from challenging the property's value for personal income tax purposes.

It is unclear, under the proposal, what would result when an estate tax return need not be filed, or when the IRS later asserts that an estate tax return should have been filed. It may be that, when an estate is not required to file a return, there would be no duty of consistency under the proposal. In such case, an heir would not be bound to use any value determined by the estate. If an adjust-

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[288] See, e.g., *LeFever v. Commissioner,* 103 T.C. 525 (1994) (applying a duty of consistency where taxpayers agreed to special-use valuation, then, after the period of limitations on the estate tax return expired, tried to argue that the special-use valuation election was invalid).

[289] See *Cluck v. Commissioner*, 105 T.C. 324 (1995) (estopping the taxpayer from arguing, after the period of limitations on the estate tax expired, that the basis in land inherited by her spouse should be higher because it was undervalued for estate tax purposes; the taxpayer's spouse in this case was the executor of the decedent's estate, and he was one of the individuals who entered into a prior agreement with the IRS as to the value of the property for estate tax purposes).

ment has been made to an estate, then the estate may have a duty under the proposal to notify heirs of such changes to the valuation of property. When an estate tax return is filed but an item of property is omitted, the proposal may require that the heir takes such property at a zero basis if the period of limitations on assessment of the estate tax has lapsed. In such case, another possible result would be that the heir would take the property at a carryover basis.

The proposal also would impose reporting requirements on estates and donors of lifetime gifts. The representative of an estate would be required to notify heirs, and the IRS, of the fair market value on the date of death of property distributed to such heir. This requirement extends to both property passing under a will and property not passing under a will, so long as the property is included in the decedent's gross estate. Donors of lifetime gifts (other than annual exclusion gifts) also would be required to notify donees, and the IRS, of the donor's basis in the property at the time of transfer, as well as any payment of gift tax which would increase the basis.

3. Require basis allocation for part-sale, part-gift transactions

Present Law

Under present law, where there is a transaction that is a part-sale, part-gift, the donee takes a basis equal to the greater of the amount paid by the donee or the donor's adjusted basis at the time of transfer, plus any gift tax paid by the donor. If the property is later sold by the donee at a loss, then the basis is limited to the fair market value at the time of the gift.

Under the rules for bargain sales to charities, the basis of property sold must be allocated between the portion of the property which is "sold" to the charity and the portion of the property which is "donated" to the charity. Thus, the adjusted basis for determining the gain from a bargain sale is that portion of the adjusted basis which bears the same ratio to the property's adjusted basis as the amount realized on the sale bears to the property's fair market value.

The dual basis rule that applies both to gifts and charitable bargain sales requires that, if property is later sold by a donee at a loss, the basis is limited to its fair market value. There is neither gain nor loss on the property's disposition when the amount realized is less than the basis for gain and greater than the basis for loss.

Description of Proposal

The proposal would require that the basis of property transferred in a part-gift, part-sale transaction be allocated ratably between the gift portion and the sale portion based on the fair market value of the property and the consideration paid.

Effective Date

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

Prior Action

No prior action.

Analysis

Under the proposal, the charitable bargain sale rule would be adopted for all part-sale, part-gift transactions, including those in which a charity is not involved. Under section 1011, the adjusted basis for determining the gain from a charitable bargain sale is that portion of the adjusted basis which bears the same ratio to the property's adjusted basis as the amount realized on the sale bears to the property's fair market value. The proposal would allocate the basis of part-sale, part-gift property ratably between the gift portion and the sale portion based on the fair market value of the property on the date of transfer and the consideration paid. For example, a donor sells to a child for $50,000 property with a basis to the donor of $40,000 and a fair market value of $100,000. Thus, the donor makes a gift to the child of $50,000 ($100,000 fair market value less $50,000 amount realized), which is 50 percent of the value of the property. The amount realized on the part-sale, part gift is 50 percent ($50,000/$100,000) of the value of the property. Under the proposal, the adjusted basis of the nongift (i.e., sold) portion of the property is $20,000 ($40,000 adjusted basis times 50 percent), and the donor/seller recognizes $30,000 of gain ($50,000 amount realized −$20,000 adjusted basis of portion sold). The child would take a basis of $70,000 ($50,000 paid plus $20,000 which is the gift portion of donor's basis).

The proposal would establish consistency among the rules for calculating basis in a charitable bargain sale and a part-sale, part-gift transaction. Moreover, under the proposed rule, the basis of property received in a part-sale, part-gift would accurately reflect the portion of the basis which is deemed sold and the portion of the basis which is deemed transferred by gift.

The dual basis rule would continue to apply if there is a loss transaction and the fair market value of the gift on the date of transfer was less than the donor's basis. For example, if the donor's basis in the above example just prior to the transfer was $140,000, then the donor would have a loss of $20,000 ($50,000 consideration less allocated basis of $70,000 (50 percent of $140,000)). The child's unadjusted basis would be $120,000 ($50,000 paid plus $70,000 which is the gift portion of the donor's basis); however, if the child sold the property at a loss, then the basis would be limited to $100,000 (i.e., fair market value). As under current law, there would be neither gain nor loss on the sale of the property by the child if the amount realized is less than the basis for gain and greater than the basis for loss.

4. Eliminate the stepped-up basis in community property owned by surviving spouse

Present Law

Property acquired from a decedent generally is assigned a new basis equal to the property's fair market value on the date of the decedent's death. In common-law (non-community-property) States, property jointly owned by both husband and wife at the time one spouse dies is treated as owned one-half by the deceased spouse and one-half by the surviving spouse. Therefore, the surviving spouse receives a step up in basis only as to the deceased spouse's half of property which passes to the surviving spouse. The half treated as owned by the surviving spouse is not eligible for a step up in basis at the death of the first spouse to die.

In community property States, each spouse is treated as owning one-half of the community property. However, under section 1014(b)(6), the surviving spouse is entitled to a step up in basis of property for the portion treated as owned by the surviving spouse as well as the portion owned by the decedent spouse. There are nine community property States and one State with an elective community property regime.[290]

Description of Proposal

The proposal would eliminate the step up in basis in the portion of community property which is owned by the surviving spouse prior to the deceased spouse's death. The portion of community property which passes from the deceased spouse, however, would continue to receive a stepped-up basis.

Effective Date

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

Prior Action

No prior action.

Analysis

The proposal identifies that, under the Federal estate tax law, surviving spouse's property which did not pass from a decedent spouse is treated differently in community-property States than in common-law States. Under present law, assets passing from a decedent spouse to a surviving spouse qualify for a step up in basis. Moreover, under section 1014(b)(6), the step up in basis also applies to a surviving spouse's one-half interest in community property if the other half interest was includible in the decedent spouse's gross estate. This provision grants a step up in basis in a surviving spouse's property which did not pass from a decedent spouse. In common-law (non-community-property) jurisdictions, a

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[290] Community-property States include Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Alaska has an elective regime.

surviving spouse's property which did not pass from a decedent spouse is not eligible for a step up in basis.

The step up in basis for community property provision was enacted in 1948. As stated in S. Rept. No. 1013, 80th Cong., 2d Sess., p. 26 (1948), "the usual case was that practically all the wealth of the married couple was the property of the husband." For example, if a husband died first, having owned "practically all the wealth," the surviving spouse would have had a stepped-up basis in most of the property because most of it would have, in fact, passed from the decedent spouse to the surviving spouse by bequest or inheritance. In a community-property State, however, a surviving spouse is deemed to own one-half of the community property, and, consequently, the surviving spouse's one-half interest in community property could not pass to the surviving spouse by bequest or inheritance. Only the decedent spouse's one-half interest would have passed to the surviving spouse from the decedent spouse; therefore, only one-half of the property was eligible for a step up in basis. Section 1014(b)(6), which provides a step up in basis for the surviving spouse's one-half of property, was intended to equalize the two State regimes and "give persons receiving community property the same basis for determining gain or loss on a sale of property after death as is given recipients of property passing under the common law" in that "the surviving spouse's interest in community property shall be deemed to have been acquired by bequest, devise, or inheritance' from the decedent." S. Rept. No. 1013, 80th Cong., 2d Sess., p. 29 (1948).

The Administration's position is that changes to the Federal estate tax treatment of jointly-held property in 1981 have undermined the premises upon which section 1014(b)(6) is based. For example, under section 2040(b), one-half of the value of any property held by the decedent and the decedent's spouse as tenants by the entirety or as joint tenants with right of survivorship (when the decedent and decedent's spouse are the only joint tenants) is included in the gross estate of the first spouse to die, regardless of the source of the consideration for the property. As a result, the basis in the part of the jointly held property included in the decedent spouse's estate will be stepped up to fair market value. The one-half interest which is not included in the decedent spouse's estate, however, is not eligible for a step up in basis. In community property States, however, the one-half interest in community property which is not included in a decedent spouse's estate may be eligible for a step up in basis. To the extent that surviving spouses in community-property States may receive a step up in basis for property which, in a common-law State, would not be eligible for a step up in basis, there is inconsistent treatment under present law.

The proposal would eliminate the inconsistent treatment among decedents in community-property and common-law States by eliminating the step up in basis for property which never passed from a decedent spouse to a surviving spouse. Surviving spouses' interests in property which would not have been eligible for a step up in basis in a common-law State would also not be eligible for a step up in basis in a community-property State. In this regard, the proposal establishes consistency in the application of the basis rules by ensuring that a step up in basis applies only to property which passes from the decedent spouse to a surviving spouse. Thus, in a community-property State, only the one-half share of the property which is deemed to have passed from a decedent spouse to a surviving spouse would be eligible for a step up in basis.

Under present law, separate property of one spouse receives similar treatment whether in a common-law State or community-property State. Property which was owned 100 percent by a decedent spouse which passes to a surviving spouse would be eligible for a step up in basis as to the entire property because it was included in the decedent spouse's estate, even if no tax is due. Similarly, if property was owned 100 percent by the surviving spouse, there would be no step up in basis because the property would not have passed from the decedent spouse. It should be noted, however, that the procedures for converting community-property to separate property may be difficult in some States. Under the proposal, community property would be treated less generously than non-jointly-held property in common law States where the property was owned by the first spouse to die.

5. Require that qualified terminable interest property for which a marital deduction is allowed be included in the surviving spouse's estate

Present Law

For estate and gift tax purposes, a marital deduction is allowed for qualified terminable interest property ("QTIP"). Such property generally is included in the surviving spouse's gross estate. The surviving spouse's estate is entitled to recover the portion of the estate tax attributable to such inclusion from the person receiving the property, unless the spouse directs otherwise by will (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 property in which the decedent had a qualifying income interest for life and for which a marital 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

The proposal is identical to a provision contained in the President's budget proposal for fiscal year 1999.

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.[291] Under both the gift and estate marital deduction, deductions are not allowed for so-called "terminable interests." Terminable interests generally are created where an interest in property passes to the spouse and another interest in the same property passes from the donor or decedent to some other person for less than full and adequate consideration. For example, an income interest to the spouse generally would not qualify for the marital deduction where the remainder interest is transferred to a third party. Special rules permit a marital deduction where the surviving spouse has an income interest if that spouse has a testamentary power of appointment or the remainder passes to the estate of the surviving spouse.

An exception to the terminable interest rule was added when the unlimited marital deduction was provided in 1981. Under this exception, a marital deduction is allowed for a transfer to a trust of "qualified terminable interest property," called "QTIP," in which the spouse has a qualifying income interest, so long as the transferor spouse's executor elects to include the trust in the spouse's gross estate for Federal estate tax purposes and subjects the QTIP to gift tax if the spouse disposes of the income interest.

The purpose and effect of the terminable interest and qualified terminable interest rules is to permit deferral of taxation on amounts transferred to spouses that are not consumed before the death of the second spouse, not to provide an exemption from estate and gift tax. In some cases, the estate of the first spouse to die has claimed a marital deduction as a QTIP and then, after the period of limitations for assessing tax on the first estate has lapsed, the estate of the second spouse to die argues against inclusion in the second estate due to a technical flaw in the QTIP eligibility or election in the first estate. If it is determined, after the limitations period on the first spouse's estate lapsed, that a prior QTIP election was in fact defective, the estate of the second spouse would assert that it is not required to include the QTIP in the second spouse's estate, thus excluding the QTIP from both spouses' estates.

Under the proposal, the estate of the second spouse to die would be required to include property with respect to which the estate of the first spouse to die claimed a marital deduction even if there was a technical flaw in the QTIP eligibility or election in the first estate. This would effectively estop a second spouse from claiming, after the limitations period on the first spouse's estate lapsed, that the QTIP election on behalf of the first spouse's estate was defective.

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[291] In addition, a marital deduction is allowed for both gift and estate tax purposes for transfers to spouses who are not citizens of the United States if the transfer is to a qualified domestic trust ("QDOT"). A QDOT is a trust which has at least one trustee that is a United States citizen or a domestic corporation and no distributions from corpus can be made without withholding from those distributions.

6. Eliminate non-business valuation discounts

Present Law

Generally, for Federal transfer tax purposes, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. In valuing a fractional interest in an non-publicly traded entity, taxpayers routinely claim discounts for factors such as minority ownership or lack of marketability. The concept of such valuation discounts is based upon the principle that a willing buyer would not pay a willing seller a proportionate share of the value of the entire business when purchasing a minority interest in a non-publicly traded business, because the buyer may not have the power to manage or control the operations of the business, and may not be able to readily sell his or her interest.

In the family estate planning area, a common planning technique is for an individual to contribute marketable assets to a family limited partnership or limited liability company and make gifts of minority interests in the entity to other family members. In valuing such gifts for transfer tax purposes, taxpayers often claim large discounts on the valuation of these gifts.

Description of Proposal

The proposal would eliminate valuation discounts except as they apply to active businesses. Interests in entities would be required to be valued for transfer tax purposes at a proportional share of the net asset value of the entity to the extent that the entity holds non-business assets (including cash, cash equivalents, foreign currency, publicly traded securities, real property, annuities, royalty-producing assets, non-income producing property such as art or collectibles, commodities, options, and swaps) at the time of the gift or death. To the extent the entity conducts an active business, the reasonable working capital needs of the business would be treated as part of the active business (i.e., not subject to the limits on valuation discounts). No inference is intended as to the propriety of these discounts under present law.

Effective Date

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

Prior Action

The proposal is substantially similar to a provision contained in the President's budget proposal for fiscal year 1999.

Analysis

It is well established that discounts may be appropriate in valuing minority interests in business entities. See, e.g., *Estate of Andrews v. Commissioner*, 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 to 70 percent in some cases. See, e.g., *Estate of Barudin v. Commissioner*, 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 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.[292] The extent of any minority discount depends upon the facts and circumstances related to the asset.

An asset's liquidity is its ability to be readily converted to cash. The issue of liquidity of assets relates to identifying those assets which are readily tradeable and, therefore, for which market values are readily ascertainable without great expense to the assets's owner. While people generally view passive assets such as stocks and bonds as liquid assets, not all passive assets are equally liquid, and some passive assets may be less liquid than active assets. For example, specialty brokers may be able to more readily generate offers to purchase a radio station in a major metropolitan area, than would a financial broker who attempts to generate offers for the purchase of a bond issued by a small rural school district.

Although the practice of claiming valuation discounts has been accepted in valuing active businesses, proponents of the proposal maintain that it is less clear whether such discounts are appropriate for entities holding non-business assets. For example, if an individual contributes his or her stock portfolio to an entity and transfers interests in the entity to his or her children, it has been questioned whether the stock portfolio is somehow worth less to the family, simply because its ownership is dispersed among several individuals. In such circumstances, where the underlying assets remain non-business assets, proponents may argue that issues of con-

[292] 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").

trol are much less important than in the context of making decisions to manage the operations of an ongoing active business. That is, the proposal would deem there to be no minority or other discount in the case of a family enterprise that holds non-business assets.

Opponents of this approach note that it is inconsistent with observed market outcomes to claim that a minority discount cannot exist when the non-business assets in question are liquid. For example, assume that a taxpayer holds a one-third share in a portfolio of New York Stock Exchange stocks and that her brother holds the two-thirds share. In this circumstance, the brother might be able to dictate the course of future investment, investment strategy, and timing of liquidation of the portfolio. Some may argue that such a circumstance could reasonably give rise to a minority discount on the value of the taxpayer's one-third holding even though the underlying assets are liquid.

In determining how much of a minority discount might be appropriate with respect to entities holding liquid assets, it may be helpful to consider the value placed on closed-end mutual funds. Closed-end mutual funds are traded regularly on the open market and, among funds that invest in domestic assets, are almost always traded at a discount from the net asset value of the underlying assets. 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, during the last half of 1997, the discount from net asset value of the Herzfeld Closed-End Average has ranged from between 12 and four percent of net asset value.[293] On the other hand, closed-end mutual funds also may be valued at a premium. While this is observed infrequently with closed-end mutual funds that invest in domestic equities, it may make it difficult to arrive at any generalized conclusions as to the proper valuation of interests in such entities.

To the extent that the proposal would cover assets such as real estate and art, the arguments that valuation discounts are inappropriate may not be as applicable.[294] For example, if individuals are transferred a portion of art collectibles, it may be appropriate for the value transferred to each individual to reflect a discount under certain circumstances.

[293] 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.

[294] For example, the Tax Court recently accepted a taxpayer's expert's valuation allowing a 44-percent combined discount with respect to the transfer of an undivided one-half interest in timberland, based on the taxpayer's lack of control and the marketing time and real estate commission cost involved in selling real property in that particular market, where the Commissioner's expert admitted that an undivided one-half interest in real property has a limited market and that a fractional interest may be discounted, but introduced no testimony or other evidence to rebut the taxpayer's expert's testimony as to the appropriate level of discount. *Estate of Williams v. Commissioner,* T.C. Memo. 1998–59.

7. Eliminate gift tax 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 of the property of which consists of a residence to be used as a personal residence by persons holding term interests in such trust."

Description of Proposal

The proposal would repeal the personal residence exception of section 2702(a)(3)(A)(ii). If a residence is used to fund a GRAT or a GRUT, then the trust would be required to pay out the required annuity or unitrust amount; otherwise, the grantor's retained interest would be valued at zero for gift tax purposes.

Effective Date

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

Prior Action

The proposal is identical to a provision contained in the President's budget proposal for fiscal year 1999.

Analysis

The present-law rules pertaining to personal residence trusts were enacted by Congress in 1990 as a specific statutory exception to the general rules of section 2702. Personal residence trusts are commonly used as a tax planning device to reduce transfer taxes by allowing an individual's home (or vacation home) to be transferred to his or her heirs at significant tax savings. For example, an individual may transfer his primary residence to a trust which provides that the grantor may continue to live in the house for fifteen years, at which time the trust assets (i.e., the home) will be transferred to his children. The grantor may retain a reversionary interest in the property (i.e., provide that, if the grantor does not survive the trust term, then the property would revert to his estate).[295] The trust agreement may further provide that the grantor may continue to live in the home after the fifteen-year period as long as he makes rental payments to his children at fair market

[295] Reversionary interests commonly are retained so that, if the grantor dies before the end of the trust term, then the property may be left to the grantor's spouse, thus qualifying for the marital deduction. Retention of a reversionary interest also has the effect of reducing the amount of the taxable gift.

value. If the requirements for a personal residence trust are satisfied, then the transfer is treated as a gift of the contingent remainder interest, which generally has a relatively small value as compared to the full fair market value of the residence.

The gift tax is imposed on the fair market value of the property transferred. In the case of a transfer such as the one described above, the value of the gift would be determined by taking the fair market value of the entire property, and subtracting from it the actuarially determined value of the grantor's retained income interest and the actuarially determined value of any contingent reversionary interest retained by the grantor. The actuarially determined value of any annuity, interest for life or a term of years, or any remainder or reversionary interest is based upon tables set forth by the IRS under section 7520. These tables set forth valuation rates for each type of interest (e.g., annuity, life interest, remainder interest) based upon applicable interest rates and the length of the term.

There are several advantages and disadvantages to the use of personal residence trusts. First, such trusts allow an individual to transfer his home to his heirs at a significantly reduced value for gift tax purposes. In addition, any future appreciation in the house is not subject to transfer taxes if the grantor survives the trust's term.[296] Lastly, if the grantor continues to live in the home after the trust term has expired, then the required rental payments to his heirs will reduce the size of his estate (and thus his estate taxes) even further. On the other hand, when a personal residence trust is utilized, the heirs receive a carryover basis in the residence rather than having the basis stepped up to its full fair market value on the date of death, as would be the case if the grantor held the property until death and transferred it outright to the heirs at that time. This disadvantage may be alleviated somewhat, however, by the provision in the Taxpayer Relief Act of 1997 that potentially exempts up to $500,000 of capital gain from tax when the home is sold, if the heirs meet the ownership and residence requirements of that provision.

The valuation rules of section 2702 are patterned after the rules set forth in section 2055 for determining whether a charitable deduction is allowed for split interests in property where an interest is given to a charity. When Congress enacted section 2055 in 1969, there were concerns that it would be inappropriate to give a charitable deduction except in cases where there was some assurance that the interest given to charity could be properly valued. Types of interests for which a deduction was allowed included annuities and unitrusts. Generally, an annuity pays a fixed amount each year while a unitrust pays out a certain fraction of the value of the trust annually. Thus, a charitable deduction is allowed in cases where, for example, an annuity is paid to charity with the remainder going to an individual, or an annuity is paid to an individual with the remainder going to charity, or a unitrust pays out to char-

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[296] If the grantor dies during the trust term, then the full fair market value of the house at the date of death will be brought back into his estate under section 2036, regardless of whether the grantor has retained a reversionary interest in the property. However, the estate will receive credit for any gift taxes paid (or use of the unified credit) with respect to the initial transfer to the personal residence trust.

ity 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 proposal argue that the use value of the residence retained by the grantor is a poor substitute for an annuity or unitrust interest, and that the actuarial tables overstate the value of the grantor's retained interest in the house. These conclusions are based in part on the fact that in a personal residence trust situation, the grantor ordinarily remains responsible for the insurance, maintenance, and property taxes on the residence, and, thus, the true rental value of the house should be less than the fair market rent. Such proponents also argue that, by completely exempting personal residence trusts from the requirements of section 2702, personal residence trusts are accorded even more beneficial treatment than are GRATs, GRUTs, or remainder interests after a GRAT or a GRUT, because, under those arrangements, it is not possible to reduce the value of the gift by retaining a contingent reversionary interest.

The proposal does not question whether a remainder interest in a personal residence can be appropriately valued for purposes of determining the amount of a charitable contribution, in that no modification of section 2055 is proposed. It is unclear how the same basic valuation rules could produce an acceptable result where a remainder interest is going to charity, yet an unacceptable result where the remainder interest is being transferred to private parties.

J. International Provisions

1. Treat certain foreign-source interest and dividend equivalents as U.S.-effectively connected income

Present Law

Nonresident alien individuals or foreign corporations (collectively, foreign persons) are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons (secs. 871(b) and 882). Foreign persons also are subject to a 30-percent gross basis tax, collected by withholding, on certain U.S.-source income, such as interest, dividends and other fixed or determinable annual or periodical ("FDAP") income, that is not effectively connected with a U.S. trade or business. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable tax treaty. Foreign persons generally are not subject to U.S. tax on foreign-source income that is not effectively connected with a U.S. trade or business.

Detailed rules apply for purposes of determining whether income is treated as effectively connected with a U.S. trade or business (so-called "U.S.-effectively connected income") (sec. 864(c)). The rules differ depending on whether the income at issue is U.S-source or foreign-source income. Under these rules, U.S.-source FDAP income, such as U.S.-source interest and dividends, and U.S.-source capital gains are treated as U.S.-effectively connected income if such income is derived from assets used in or held for use in the active conduct of a trade or business, or from business activities conducted in the United States. All other types of U.S.-source income are treated as U.S.-effectively connected income.

In general, foreign-source income is not treated as U.S.-effectively connected income (sec. 864(c)(4)). However, certain foreign-source rents, royalties, dividends, interest, and income on sales of goods in the ordinary course of business are treated as U.S.-effectively connected income. In the case of foreign-source dividends and interest, such income generally is treated as U.S.-effectively connected income if the income is attributable to an office or other fixed place of business of the foreign person in the United States, and the foreign person derives the income in the active conduct of a banking, financing or similar business within the United States, or the foreign person is a corporation whose principal business is trading in stocks or securities for its own account. Income generally is not considered attributable to an office or other fixed place of business within the United States unless such office or fixed place of business is a material factor in the production of the income, and such office or fixed place of business regularly carries on activities of the type that generate such income. In addition, foreign-source dividend or interest income generally is not treated as U.S.-effectively connected income if the items are paid by a foreign corporation in which the recipient owns, directly, indirectly or constructively, more than 50 percent of the total combined voting power of the stock.

The Code provides sourcing rules for enumerated types of income, including interest, dividends, rents, royalties and personal services income (secs. 861 through 865). For example, interest income generally is sourced based on the residence of the obligor. Dividend income generally is sourced based on the residence of the corporation paying the dividend. Thus, interest paid on obligations of foreign persons and dividends paid by foreign corporations generally are treated as foreign-source income.

Other types of income are not specifically covered by the Code's sourcing rules. For example, fees for accepting or confirming letters of credit have been sourced under principles analogous to the interest sourcing rules (See *Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1982)). In addition, under regulations, payments in lieu of dividends and interest derived from securities lending transactions are sourced in the same manner as interest and dividends, including for purposes of determining whether such income is effectively connected to a U.S. trade or business (Treas. Reg. sec. 1.864–5(b)(2)(ii)). Moreover, income from notional principal contracts (such as interest rate swaps) generally is sourced based on the residence of the recipient of the income (Treas. Reg. sec. 1.863–7).

Description of Proposal

The proposal would expand the categories of foreign-source income that are treated as effectively connected with a U.S. trade or business to include interest equivalents and dividend equivalents. Such income would be treated as U.S.-effectively connected income in the same circumstances as foreign-source dividends and interest. Thus, foreign-source interest and dividend equivalents would be treated as U.S.-effectively connected income if the income is attributable to a U.S. office of the foreign person, and such income is derived by such foreign person in the active conduct of a banking, financing or similar business within the United States, or the foreign person is a corporation whose principal business is trading in stocks or securities for its own account.

For these purposes, the term "interest equivalent" would include letter of credit fees, guarantee fees and loan commitment fees (whether or not the loan is actually made). Dividend equivalents generally would mean payments in lieu of dividends derived from equity securities lending transactions. The proposal would not affect the determination of whether such interest or dividend equivalents are treated as U.S.-source or foreign-source income.

Effective Date

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

Prior Action

No prior action.

Analysis

The Administration's proposal analogizes two transactions that currently are treated differently for purposes of determining whether income is U.S.-effectively connected income; guarantees of foreign risk by a U.S. trade or business, and an extension of credit through the material activities of a U.S. trade or business. Under present law, interest received on a short-term loan to a foreign customer by the U.S. branch of a foreign corporation generally would be treated as U.S.-effectively connected income. However, fees received by such a U.S. branch with respect to its guarantee of an obligation of a foreign person may not be treated as U.S.-effectively connected income, even if the U.S. branch materially participated in the transaction.

Some argue that present law creates arbitrary distinctions between economically similar transactions that are equally related to a U.S. trade or business. The proposal reflects the view that the United States should be permitted to tax certain income generated from material business activities that take place in the United States through a U.S. office, regardless of the source of such income. It is argued that the rules for determining whether income that is sourced by analogy to interest and dividends is U.S.-effectively connected income should be the same as the rules for determining whether interest and dividends are U.S.-effectively connected income.

Some, however, might argue that guarantee fees, letter of credit fees, as well as loan commitment fees (for loans not actually made) are not items that are equivalent to interest.[297] On the other hand, it could be argued that such items may be viewed as sufficiently analogous to interest to warrant taxation under similar circumstances.

2. Recapture overall foreign losses when controlled foreign corporation stock is disposed

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. The amount of foreign tax credits generally is limited to the portion of the taxpayer's U.S. tax which the taxpayer's foreign-source taxable income (i.e., foreign-source gross income less allocable expenses or deductions) bears to the taxpayer's worldwide taxable income for the year (sec. 904(a)). Separate limitations are applied to specific categories of income.

Special recapture rules apply in the case of foreign losses for purposes of applying the foreign tax credit limitation (sec. 904(f)). Under these rules, losses for any taxable year in a limitation category which exceed the aggregate amount of foreign income earned in other limitation categories (a so-called "overall foreign loss") are recaptured by resourcing foreign-source income earned in a subsequent year as U.S.-source income (sec. 904(f)(1)). The amount resourced as U.S.-source income generally is limited to the lesser of the amount of the overall foreign losses not previously recaptured, or 50 percent of the taxpayer's foreign-source income in a given year (the "50-percent limit"). Taxpayers may elect to recapture a larger percentage of such losses.

A special recapture rule applies to ensure the recapture of an overall foreign loss where property which was used in a trade or business predominantly outside the United States is disposed of prior to the time the loss has been recaptured (sec. 904(f)(3)). In this regard, dispositions of trade or business property used predominantly outside the United States are treated as having been recognized as foreign-source income (regardless of whether gain would otherwise be recognized upon disposition of the assets), in an amount equal to the lesser of the excess of the fair market value of such property over its adjusted basis, or the amount of unrecaptured overall foreign losses. Such foreign-source income is resourced as U.S.-source income without regard to the 50-percent limit. For example, if a U.S. corporation transfers its foreign branch business assets to a foreign corporation in a nontaxable section 351 transaction, the taxpayer would be treated for purposes of the recapture rules as having recognized foreign-source income in the year of the transfer in an amount equal to the excess of the fair market value of the property disposed over its adjusted basis (or the amount of unrecaptured foreign losses, if smaller). Such in-

[297] See, e.g., section 954(c)(1)(E), which treats loan commitment fees and similar amounts as interest equivalents and, thus, as subpart F foreign personal holding company income, only for loans actually made.

come would be recaptured as U.S.-source income to the extent of any prior unrecaptured overall foreign losses.[298]

Detailed rules apply in allocating and apportioning deductions and losses for foreign tax credit limitation purposes. In the case of interest expense, such amounts generally are apportioned to all gross income under an asset method, under which the taxpayer's assets are characterized as producing income in statutory or residual groupings (i.e., foreign-source income in the various limitation categories or U.S.-source income) (sec. 864(e) and Temp. Treas. Reg. sec. 1.861–9T). Interest expense is apportioned among these groupings based on the relative asset values in each. Taxpayers may elect to value assets based on either tax book value or fair market value.

Each corporation that is a member of an affiliated group is required to apportion its interest expense using apportionment fractions determined by reference to all assets of the affiliated group. For this purpose, an affiliated group generally is defined to include only domestic corporations. Stock in a foreign subsidiary, however, is treated as a foreign asset that may attract the allocation of U.S. interest expense for these purposes. If tax basis is used to value assets, the adjusted basis of the stock of certain 10-percent or greater owned foreign corporations or other non-affiliated corporations must be increased by the amount of earnings and profits of such corporation accumulated during the period the U.S. shareholder held the stock.

Description of Proposal

The proposal would apply the special recapture rule for overall foreign losses that currently applies to dispositions of foreign trade or business assets to the disposition of controlled foreign corporation stock. Thus, dispositions of controlled foreign corporation stock would be recognized as foreign-source income in an amount equal to the lesser of the fair market value of the stock over its adjusted basis, or the amount of prior unrecaptured overall foreign losses. Such income would be resourced as U.S.-source income for foreign tax credit limitation purposes without regard to the 50-percent limit.

Effective Date

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

Prior Action

No prior action.

Analysis

Dispositions of stock of a corporation generally are not subject to the special recapture rules for overall foreign losses under section 904(f)(3). Ownership of stock in a foreign subsidiary can lead to, or increase, an overall foreign loss as a result of interest expenses allocated against foreign-source income under the interest expense

[298] Coordination rules apply in the case of losses recaptured under the branch loss recapture rules (sec. 367(a)(3)(C)).

allocation rules. The recapture of overall foreign losses created by such interest expense allocations may be avoided if, for example, the stock of the foreign subsidiary subsequently were transferred to unaffiliated parties in non-taxable transactions. The proposal would recapture such overall foreign losses where stock of a controlled foreign corporation is disposed, regardless of whether such stock is disposed in a non-taxable transaction.

Some have observed that the interest expense allocation rules can operate to restrict a taxpayer's ability to claim foreign tax credits. Expanding the special recapture rules to include dispositions of controlled foreign stock could be viewed as further limiting the ability of taxpayers to claim relief from potential double taxation.

3. Amend 80/20 company rules

Present Law

In general, U.S.-source interest and dividends paid to nonresident alien individuals and foreign corporations ("foreign persons") that are not effectively connected with a U.S. trade or business are subject to a U.S. withholding tax on the gross amount of such income at a rate of 30 percent (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. For this purpose, a group would be defined to include the U.S. corporation making the payment, as well as any subsidiary in which that corporation owns, directly or indirectly, at least 50 percent of the stock.

Effective Date

The proposal would apply to interest or dividends paid or accrued more than 30 days after the date of enactment.

Prior Action

A similar proposal was included in the President's fiscal year 1999 budget proposal.

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.

Advocates of the proposal argue that applying the 80/20 test on a group basis will significantly restrict the improper avoidance of U.S. withholding tax through manipulation of the three-year lookback rule. For this purpose, the group would be narrowly defined to include only the tested U.S. corporation and 50-percent owned subsidiaries of such corporation.

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. 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

The proposal was included in the President's fiscal year 1999 budget proposal.

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.

5. 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 (directly, indirectly or constructively) by U.S. shareholders that are individuals or corporations required to include in gross income the subpart F income of the CFC. 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

The proposal was included in the President's fiscal year 1999 budget proposal.

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 (directly, indirectly or constructively).

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.

6. Replace sales-source rules with activity-based rules

Present Law

U.S. persons are subject to U.S. tax on their worldwide income. Foreign taxes may be credited against U.S. tax on foreign-source income of the taxpayer. For purposes of computing the foreign tax credit, the taxpayer's income from U.S. sources and from foreign sources must be determined.

Income from the sale or exchange of inventory property that is produced (in whole or in part) within the United States and sold or exchanged outside the United States, or produced (in whole or in part) outside the United States and sold or exchanged within the United States, is treated as partly from U.S. sources and partly from foreign sources. Treasury regulations provide that 50 percent of such income is treated as attributable to production activities and 50 percent is treated as attributable to sales activities. Alternatively, the taxpayer may elect to determine the portion of such income that is attributable to production activities based upon an available independent factory price (i.e., the price at which the taxpayer makes a sale to a wholly independent distributor in a transaction that reasonably reflects the income earned from the production activity). With advance permission of the 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 and 1999 budget proposals.

Analysis

The 50/50 source rule of present law may be viewed as drawing an arbitrary line in determining the portion of income that is treated as attributable to production activities and the portion that is treated as attributable to sales activities. The proposal could be viewed as making this determination more closely reflect the economic components of the export sale. Some further argue that the present-law rule is advantageous only to U.S. companies that also have operations in high-tax foreign countries. In many cases, the income from a taxpayer's export sales is not subject to tax in the foreign jurisdiction and therefore does not give rise to foreign tax credits. The present-law treatment of 50 percent of the income from a taxpayer's export sales of property it manufactured in the United

States as foreign-source income therefore has the effect of allowing the taxpayer to use excess foreign tax credits, if any, that arise with respect to other operations. It is argued that the proposal would prevent what might be viewed as the inappropriate use of such excess foreign tax credits.

Others argue that the 50/50 source rule of present law is important to the U.S. economy and should be retained. It is further argued that the rule is needed to counter-balance various present-law restrictions on the foreign tax credit that can operate to deny the taxpayer a credit for foreign taxes paid with respect to foreign operations, thereby causing the taxpayer to be subject to double tax on such income. Moreover, the 50/50 source rule of present law can be viewed as having the advantage of administrative simplicity; the proposal to apportion income between the taxpayer's production activities and its sales activities based on actual economic activity has the potential to raise complex factual issues similar to those raised under the section 482 transfer pricing rules that apply in the case of transactions between related parties.

7. 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 and 1999 budget proposals. The proposal in the fiscal year 1998 budget proposal also included an additional modification with respect to the treatment of foreign oil and gas income under subpart F of the Code which is not included in this proposal.

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.

K. Pension Provisions

1. Increase elective withholding rate for nonperiodic distributions from deferred compensation plans

Present Law

Present law provides that income tax withholding is required on designated distributions from employer deferred compensation plans (whether or not such plans are tax qualified), individual retirement arrangements ("IRAs"), and commercial annuities unless the payee elects not to have withholding apply. A designated distribution does not include any payment (1) that is wages, (2) the portion of which it is reasonable to believe is not includible in gross income,[299] (3) that is subject to withholding of tax on nonresident aliens and foreign corporations (or would be subject to such withholding but for a tax treaty), or (4) that is a dividend paid on certain employer securities (as defined in sec. 404(k)(2)).

Tax is generally withheld on the taxable portion of any periodic payment as if the payment is wages to the payee. A periodic payment is a designated distribution that is an annuity or similar periodic payment.

In the case of a nonperiodic distribution, tax generally is withheld at a flat 10-percent rate unless the payee makes an election not to have withholding apply. A nonperiodic distribution is any distribution that is not a periodic distribution. Under current administrative rules, an individual receiving a nonperiodic distribution can designate an amount to be withheld in addition to the 10-percent otherwise required to be withheld.

Under present law, in the case of a nonperiodic distribution that is an eligible rollover distribution, tax is withheld at a 20-percent rate unless the payee elects to have the distribution rolled directly over to an eligible retirement plan (i.e., an IRA, a qualified plan (sec. 401(a)) that is a defined contribution plan permitting direct deposits of rollover contributions, or a qualified annuity plan (sec. 403(a)). In general, an eligible rollover distribution includes any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan or qualified annuity plan. An eligible rollover distribution does not include any distribution that is part of a series of substantially equal periodic payments made (1) for the life (or life expectancy) of the employee or for the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or (2) over the a specified period of 10 years or more. An eligible rollover distribution also does not include any distribution required under the minimum distribution rules of section 401(a)(9), hardship distributions from sec-

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

tion 401(k) plans, or the portion of a distribution that is not includible in income. The payee of an eligible rollover distribution can only elect not to have withholding apply by making the direct rollover election.

Description of Proposal

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

Effective Date

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

Prior Action

No prior action.

Analysis

10-percent withholding rate

The present-law rules require a recipient of a nonperiodic distribution (other than an eligible rollover distribution) to have withholding on the nonperiodic distribution at a 10-percent rate or to elect to have no withholding apply. Because this 10-percent withholding rate is less than the lowest individual income tax rate of 15 percent, the rate of withholding will be too low in the case of an individual who would like to have the proper amount withheld from his or her distribution. Such an individual may be required to make estimated tax payments if he or she does not have sufficient wage income from which an adequate amount can be withheld.

An increase in the 10-percent withholding rate will generally ensure that an individual who wants to have withholding apply to a nonperiodic distribution (other than an eligible rollover distribution) will be more likely to have the proper amount withheld. However, an increase in the rate of withholding may also have the effect of causing some individuals who otherwise would not elect out of withholding to make the election out.

Under the present-law rules, distributions from qualified plans will be subject to either the elective withholding rules for periodic distributions or the 20-percent mandatory withholding rate on eligible rollover distributions for which a plan participant does not make a direct rollover election. Thus, the 10-percent elective withholding rate for nonperiodic distributions is primarily applicable only to distributions from nonqualified deferred compensation arrangements, IRAs, commercial annuities and certain hardship distributions from section 401(k) plans. Some may question whether withholding on distributions from such arrangements or annuities should be elective or mandatory. In addition, individuals receiving distributions from such arrangements will often be subject to at least the 28 percent marginal income tax rate, which suggests that the 15-percent rate proposed by the Administration may still be too low to ensure that an adequate amount of tax is withheld.

Withholding with respect to eligible rollover distributions

The rationale for the 20-percent withholding rate on eligible rollover distributions from qualified pension plans is to encourage individuals to elect the direct rollover option and, thereby, to keep retirement plan assets saved for retirement. It may be appropriate to consider, in connection with a proposal to modify the 10-percent elective withholding rate, whether this 20-percent rate is sufficient incentive to individuals to make the direct rollover election.

Roth IRAs

Under present law, the rule that provides that the amount of a distribution that is subject to withholding does not include any portion that it is reasonable to believe is not includible in gross income does not apply to IRAs. Thus, under the present-law rules, all distributions from IRAs are subject to withholding unless the recipient elects not to have withholding apply. In the case of a qualified distribution from a Roth IRA, the payor is required to have the recipient make the election not to have withholding apply even though the payor has reason to believe that the distribution is not includible in gross income. Thus, consideration should be given to including Roth IRAs under the rule that provides that withholding does not apply if it is reasonable to believe the distribution is not includible in gross income.

2. Increase section 4973 excise tax on excess IRA contributions

Present Law

Excise tax on excess contributions

Under present law, an excise tax is imposed on an individual equal to six percent of the amount of any excess contributions to such individual's (1) traditional individual retirement arrangement ("IRA") (sec. 408), (2) Roth IRA (sec. 408A), (3) medical savings account (sec. 220), (4) custodial account treated as an annuity contract under section 403(b)(7), or (5) education IRA (sec. 530).[300] The excise tax generally continues to apply in each year until the excess contributions have been distributed to the individual. However, the excise tax cannot exceed 6 percent of the value of such account or annuity at the end of the taxable year.

In general, an excess contribution includes any contribution to an account or annuity that exceeds the applicable contribution limit for such account or annuity for the taxable year. An excess contribution generally does not include any amount that is distributed to the individual before the due date (including extensions) of the individual's tax return for the taxable year. Thus, present law provides a mechanism by which an individual can correct any excess contributions without triggering the excise tax.

[300] Code section 4973.

Distributions from Roth IRAs

Under present law, a qualified distribution from a Roth IRA is not includible in gross income (sec. 408A(d)). A qualified distribution generally includes any distribution (1) on or after the date on which the Roth IRA owner attains age 59–1/2, (2) made to a beneficiary on or after the death of the Roth IRA owner, (3) attributable to the Roth IRA owner's becoming disabled, or (4) qualified first-time homebuyer distributions (sec. 72(t)(8)). A distribution from a Roth IRA is not a qualified distribution if it is made within the first five taxable years beginning with the taxable year for which the individual made a contribution to a Roth IRA (or such individual's spouse made a contribution to a Roth IRA) established for the individual.

A distribution from a Roth IRA that is not a qualified distribution is required to be included in income to the extent such distribution is attributable to earnings on the taxpayer's Roth IRA contributions. A distribution is not a qualified distribution if it is a return of excess contributions that is not subject to the excise tax (i.e., if it is a distribution of excess contributions and net income allocated to such contributions made on or before the due date for the individual's tax return for the year, including extensions). However, if an excess contribution to a Roth IRA is subject to the excise tax and is subsequently withdrawn, such excess contribution could be a qualified distribution from the Roth IRA that is not includible in gross income.

Description of Proposal

The proposal would increase the section 4973 excise tax on excess contributions to IRAs to 10 percent for each taxable year after the taxable year for which such excess contribution was made. The increase would not apply to excess contributions to medical savings accounts or education IRAs. Thus, the excise tax would be 6 percent for the taxable year for which such excess contribution was made and 10 percent for each succeeding taxable year.

Effective Date

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

Prior Action

No prior action.

Analysis

The increase in the excise tax on excess contributions is proposed to prevent taxpayers from making excess contributions to Roth IRAs, paying the excise tax on the excess contributions, and subsequently withdrawing amounts attributable to such excess contributions as a qualified distribution from a Roth IRA that is not includible in gross income. Under present law, if the rate of return on such excess contributions is sufficiently high, the taxpayer is better off by making the excess contributions and paying the excise tax.

Whether the increase in the excise tax on excess contributions will be sufficient to prevent taxpayers from intentionally making excess contributions to Roth IRAs will depend upon the rate of return the taxpayer expects to receive on such contributions. Depending on the rate of return, the taxpayer may still have an incentive to make the excess contributions.

An option that could be adopted in addition to, or in lieu of, the proposal would be to provide that a withdrawal from a Roth IRA that is attributable to an excess contribution is not a qualified distribution and, therefore, not excludable from gross income.

For the 1996 tax year, the amount of the excise tax on excess IRA contributions that was paid totaled approximately $2.5 million. This amount represents the amount of the excise tax collected only with respect to traditional IRAs. In 1997, medical savings accounts were included in the excise tax and in 1998, Roth IRAs and education IRAs were included.

3. Impose limitation on prefunding of welfare benefits

Present Law

Under present law, contributions to a welfare benefit fund generally are deductible when paid, but only to the extent permitted under the rules of Code sections 419 and 419A. The amount of an employer's deduction in any year for contributions to a welfare benefit fund cannot exceed the fund's qualified cost for the year. The term qualified cost means the sum of (1) the amount that would be deductible for benefits provided during the year if the employer paid them directly and was on the cash method of accounting, and (2) within limits, the amount of any addition to a qualified asset account for the year. A qualified asset account includes any account consisting of assets set aside for the payment of disability benefits, medical benefits, supplemental unemployment compensation or severance pay benefits, or life insurance benefits. The account limit for a qualified asset account for a taxable year is generally the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for benefits with respect to which the account is maintained and the administrative costs incurred with respect to those claims. Specific additional reserves are allowed for future provision of post-retirement medical and life insurance benefits.

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

Description of Proposal

Under the proposal, the present-law exception to the deduction limit for 10-or-more employer plans would be limited to plans that provide only medical, disability, and group-term life insurance benefits. This exception would no longer be available with respect to plans that provide supplemental unemployment compensation, severance pay, and disability benefits. Thus, the generally applicable deduction limits (sections 419 and 419A) would apply to plans providing these benefits.

In addition, the proposal states that rules would be added to prevent amounts that are deductible pursuant to the 10-or-more employer exception from being used to provide benefits other than medical, disability, and group-term life insurance.

Under the proposal, no inference is intended with respect to the validity of any 10-or-more employer arrangement under the provisions of present law.

Effective Date

The proposal would be effective with respect to contributions paid after the date of enactment.

Prior Action

No prior action.

Analysis

The exception to the present-law deduction limit for 10-or-more employer plans was originally adopted because, under such a plan, the relationship of a participating employer to the plan is more in the nature of the relationship of an insured to an insurer. However, this exception was not intended to apply if the liability of any employer under the plan is determined on the basis of experience rating because, under those circumstances, the employer's interest with respect to the plan is more similar to the relationship of a single employer to a welfare benefit fund than that of an insured to an insurer. If each employer contributing to the plan is, in effect, liable for losses incurred with respect to all other participating employers (e.g., its contributions will be used to pay benefits for other employers' employees), then it is unlikely that any one employer will have an incentive to contribute more than is necessary under the arrangement.

In some cases, the 10-or-more employer exception has been utilized in ways that are not consistent with the original intent of the exception. In Notice 95–34,[301] the IRS identified certain types of trust arrangements that do not satisfy the requirements of the 10-or-more employer exception. In general, these trust arrangements created separate accounts for each employer participating in the plan and had the effect of providing experience rating for these participating employers. In addition, the Tax Court ruled in 1997 that an arrangement that utilized such a separate accounting system did not qualify under the 10-or-more employer exception.[302]

It is not clear whether a separate account concept will be adequate to address the ways in which welfare benefit funds may be disguising experience rating. The Administration proposes to address some of the problems that have been identified by limiting the benefits for which the 10-or-more employer exception will be available. It is argued that it is particularly difficult to identify

[301] Notice 95–34, 1995–1 C.B. 309.

[302] *Robert D. Booth and Janice Booth* v. *Commissioner*, 108 T.C. No. 25 (June 17, 1997).

whether experience rating is occurring with respect to the provision of certain benefits, such as severance pay and certain death benefits, because of the complexity of the arrangements.

The potential abuses from these types of arrangements can be acute in the case of small closely-held businesses. The 10-or-more employer exception may be utilized to provide an alternative approach to funding retirement benefits without the dollar limitations and other rules applicable to qualified pension plans.

4. Subject signing bonuses to employment taxes

Present Law

Under present law, bonuses paid to individuals for signing contracts of employment are required to be included in gross income in the taxable year in which paid. However, if the contract does not contain a provision requiring the performance of future services, then the bonus payment does not constitute remuneration for services performed and, accordingly, does not constitute wages for income tax withholding purposes.[303]

In addition, under present law, taxes under the Federal Insurance Contributions Act ("FICA taxes") are imposed on wages paid to employees. Similar rules apply to taxes under the Federal Unemployment Tax Act ("FUTA taxes"). For these purposes, wages are defined in general as including all remuneration for employment.[304] The term by which such remuneration is defined (e.g., salaries, fees, bonuses, or commissions) is irrelevant;[305] if it is intended to provide remuneration for employment, a payment is treated as wages. For example, the IRS has held that amounts paid to a college on behalf of a professional baseball player under a "College Scholarship Plan" were wages for FICA tax purposes.[306] The Scholarship Plan was considered to be a part of the employment contract under which the player agreed to play baseball for three months for a specified monthly remuneration. Further, the baseball club was relieved of its obligation under the Scholarship Plan if the player failed to report for spring training at the direction of the club.

Description of Proposal

The proposal would provide that signing bonuses are subject to income tax withholding and are included in the definition of wages for FICA and FUTA purposes. The proposal would apply without regard to whether the signing bonus is conditioned upon the performance of services by the recipient. The proposal states that no inference is intended with respect to the application of the present-law withholding rules to such signing bonuses.

Effective Date

The proposal would be effective for signing bonuses paid after the date of enactment.

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[303] Rev. Rul. 58–145, 1958–1 C.B. 360.
[304] Code section 3121(a).
[305] Treas. Reg. sec. 31.3121(a)-1(c).
[306] Rev. Rul. 71–532, 1971–2 C.B. 356, modifying Rev. Rul. 69–424, 1969–2 C.B. 15.

Prior Action

No prior action.

Analysis

Under present law, the line between whether a signing bonus or similar payment negotiated as part of an employment contract is includible in wages for FICA and FUTA tax purposes and is subject to income tax withholding is determined by whether the payment is contingent upon the performance of future services. If an individual is not required to perform future services after receipt of the signing bonus or other type of payment, then such bonus or payment is not considered remuneration for employment. On the other hand, if the payor is not obligated to make the payment unless the individual agrees to perform future services for the payor, then the payment is considered remuneration for employment.

It can be argued that payments negotiated in connection with an employment contract are intrinsically linked to the performance of services for the payor. The payor does not make the payment to the individual for altruistic purposes. The payment is inherently related to the expectation that the individual will perform future services for the payor. Thus, it could be argued that any payment to an individual that is made as part of a contract of employment and that is not a reimbursement for expenses or similar payments should be treated as wages subject to income tax withholding and to FICA and FUTA taxes.

On the other hand, signing bonuses are often used, particularly in the case of professional athletics, as an inducement to individuals to sign a contract of employment, not necessarily as advance payment for the performance of future services. For example, most individuals who are selected in the Major League Baseball Amateur Draft are either graduating high school students or individuals who have completed two or three years of college. These individuals are not required under NCAA rules and regulations to declare their intention to forego eligibility to compete in college in order to be selected in the Amateur Draft. An individual who is selected in the Amateur Draft and does not reach an agreement to play in a major league organization may complete his college eligibility. The signing bonuses provided to these individuals could be characterized not so much as remuneration for future services as an incentive to forego eligibility as a college baseball player. There is at least a question whether such payments are, in fact, remuneration for employment and, therefore, should be subject to FICA and FUTA taxes.

Similarly, there is a question whether a signing bonus that is not paid under an employment contract should be subject to FICA and FUTA taxes. For example, if an individual is paid an amount in exchange for an agreement to negotiate an employment contract with only a single organization, then it can be argued that the bonus payment is not remuneration for future services. In such a situation, the payment is clearly not conditioned upon the expected performance of future services. On the other hand, if this type of payment is not considered remuneration for employment, then it would be a relatively simple matter to sever an employment contract into two components—a contract with a signing bonus that is an agreement to negotiate and a separate contract detailing the terms of employment. In such a case, payment under the first contract would then not be subject to FICA and FUTA taxes.

The issue of income tax withholding on signing bonuses is separable from the issue of treating such bonuses as wages for FICA and FUTA tax purposes. Because signing bonuses are included in gross income for the taxable year in which received, compliance could be improved by requiring that such bonuses be treated as wages for income tax withholding purposes. In addition, such an approach might reduce the number of individuals required to make estimated tax payments during a taxable year (and the number of individuals subject to a penalty for failure to make the required estimated tax payments).

L. Compliance Provisions

1. Expand reporting of cancellation of indebtedness income

Present Law

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

The information return must set forth the name, address, and taxpayer identification number of the person whose debt was discharged, the amount of debt discharged, the date on which the debt was discharged, and any other information that the IRS requires to be provided. The information return must be filed in the manner and at the time specified by the IRS. The same information also must be provided to the person whose debt is discharged by January 31 of the year following the discharge.

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

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

Description of Proposal

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

Effective Date

The proposal would be effective with respect to discharges of indebtedness on or after the date of enactment.

Prior Action

The proposal was included in H.R. 4250 (The Patient Protection Act of 1998), which passed the House of Representatives on July 24, 1998 (sec. 3304). That provision would have applied to discharges of indebtedness after December 31, 1998.

Analysis

Under present law, some taxpayers who have gross income from the discharge of indebtedness receive an information return on that income, while others do not; whether or not they do is based upon the business form of the entity discharging the debt. The proposal would eliminate this disparity by requiring all similarly situated entities to provide these information reports.

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, or (2) $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). Generally, the amount of an "understatement" of income tax is the excess of the tax required to be shown on the return over the tax shown on the return (reduced by any rebates of tax). The substantial understatement penalty does not apply if there was a reasonable cause for the understatement and the taxpayer acted in good faith with respect to the understatement (the "reasonable cause exception"). The determination as to whether the taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.

Description of Proposal

The proposal would treat a corporation's deficiency of more than $10 million as substantial for purposes of the substantial understatement penalty, regardless of whether it exceeds 10 percent of the taxpayer's total tax liability.

Effective Date

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

Prior Action

The proposal was included in the President's fiscal years 1998 and 1999 budget proposals.

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 certain gambling winnings

Present Law

In general, proceeds from a wagering transaction are subject to withholding at a rate of 28 percent if the proceeds exceed $5,000 and are at least 300 times as large as the amount wagered. The proceeds from a wagering transaction are determined by subtracting the amount wagered from the amount received. Any non-monetary proceeds that are received are taken into account at fair market value.

In the case of sweepstakes, wagering pools, or lotteries, proceeds from a wager are subject to withholding at a rate of 28 percent if the proceeds exceed $5,000, regardless of the odds of the wager.

No withholding tax is imposed on winnings from bingo 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 years 1998 and 1999 budget proposals.

Analysis

It is generally believed that imposing withholding on winnings from bingo and keno will improve tax compliance and enforcement.

4. Increase penalties for failure to file correct information returns

Present Law

Any person who fails to file a correct information return with the IRS on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the penalty is $15 per return, with a maximum penalty of $75,000 per calendar year. If a person files a correct information return after the date that is 30 days after the prescribed filing date but on or before August 1 of that year, the penalty is $30 per return, with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1, the amount of the penalty is $50 per return, with a maximum penalty of $250,000 per calendar year.

There is a special rule for de minimis failures to include the required, correct information. This exception applies to incorrect information returns that are corrected on or before August 1. Under the exception, if an information return is originally filed without all the required information or with incorrect information and the return is corrected on or before August 1, then the original return is treated as having been filed with all of the correct required information. The number of information returns that may qualify for this exception for any calendar year is limited to the greater of (1) 10 returns or (2) one-half of one percent of the total number of information returns that are required to be filed by the person during the calendar year.

In addition, there are special, lower maximum levels for this penalty for small businesses. For this purpose, a small business is any person having average annual gross receipts for the most recent three taxable years ending before the calendar year that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

If a failure to file a correct information return with the IRS is due to intentional disregard of the filing requirement, the penalty for each such failure is generally increased to the greater of $100 or ten percent of the amount required to be reported correctly, with no limitation on the maximum penalty per calendar year (sec. 6721(e)). The increase in the penalty applies regardless of whether a corrected information return is filed, the failure is de minimis, or the person subject to the penalty is a small business.

Description of Proposal

The proposal would increase the penalty for failure to file information returns correctly on or before August 1 from $50 for each return to the greater of $50 or 5 percent of the amount required to be reported correctly but not so reported. The $250,000 maximum penalty for failure to file correct information returns during any calendar year ($100,000 with respect to small businesses) would continue to apply under the proposal.

The proposal also would provide for an exception to this increase where substantial compliance has occurred. The proposal would provide that this exception would apply with respect to a calendar year if the aggregate amount that is timely and correctly reported for that calendar year is at least 97 percent of the aggregate amount required to be reported under that section of the Code for that calendar year. If this exception applies, the present-law penalty of $50 for each return would continue to apply.

The proposal would not affect the following provisions of present law: (1) the reduction in the $50 penalty where correction is made within a specified period; (2) the exception for de minimis failures; (3) the lower limitations for persons with gross receipts of not more than $5,000,000; (4) the increase in the penalty in cases of intentional disregard of the filing requirement; (5) the penalty for failure to furnish correct payee statements under section 6722; (6) the penalty for failure to comply with other information reporting requirements under section 6723; and (7) the reasonable cause and other special rules under section 6724.

Effective Date

The proposal would apply to information returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment.

Prior Action

The proposal was included in the President's fiscal year 1998 and 1999 budget proposals.

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.[307] 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.

M. Miscellaneous Revenue-Increase Provisions

1. Modify 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, the tax must be deposited by the last day of the first month after the end of the quarter. Smaller amounts are subject to less frequent deposit rules.

[307] Gross proceeds reports are useful to indicate that a potentially income-producing event has occurred, even though the amount reported on the information return bears no necessary relationship to the amount of income ultimately reported on the income tax return.

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, 2004.

Prior Action

A substantially similar proposal was included in the President's fiscal year 1998 and 1999 budget proposals.

Analysis

Proponents of the proposal argue that the proposed deposit requirements would: (1) provide a regular inflow of money to State funds to offset the regular payment of benefits; and (2) reduce losses to the Federal unemployment trust funds caused by employer delinquencies. Opponents respond that the State trust funds already have sufficient funds for the payment of benefits and find no evidence that more frequent deposits reduce employer delinquencies. Further, opponents contend that the proposal's administrative burden significantly outweighs its benefits.

2. 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 excise tax during the period after the date of the proposal's enactment and before October 1, 2009. The proposal also would increase the $1 billion limit on the unobligated balance in the Oil Spill Liability Trust Fund to $5 billion.

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

The President's fiscal year 1998 and 1999 budget proposals included a similar proposal.

Analysis

Some view the Oil Spill Liability Trust Fund excise tax as a tax on oil producers and consumers to fund an insurance pool against potential environmental risks that arise from the transport of petroleum. In this view, the tax is an insurance premium in a mandated scheme of risk pooling. While the first liability for damage from an oil spill remains with the owner of oil, the tax funds a Trust Fund that may be drawn upon to meet unrecovered claims that may arise from an oil spill either upon the high seas or from ruptured domestic pipelines. The tax and the Trust Fund represent a social insurance scheme with risks spread across all consumers of petroleum. The analogy to insurance is imperfect, however. The tax assessed reflects an imperfect pricing of risks. For example, the prior-law Oil Spill Liability Trust Fund tax was imposed at the same rate regardless of whether the importer employed more difficult to rupture double-hulled or single-hulled tankers.

Proponents of reimposing the Oil Spill Liability Trust Fund excise tax suggest that the revenues would provide a cushion for future Trust Fund program activities. However, the Congressional authorizing committees have not notified the tax-writing committees of either a shortfall in the amounts required for currently authorized expenditures or of plans to expand or extend those authorizations. Opponents of reimposing the taxes suggest that this action should be undertaken only in combination with such authorizing legislation.

The unobligated balance in the Oil Spill Liability Trust Fund of the close of the 1998 fiscal year was $1.076 billion.

3. Simplify 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 sibling (or descendant of the taxpayer's 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, 1999.

Prior Action

A similar proposal was included in the President's fiscal year 1999 budget proposal.

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.

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.

4. Repeal percentage depletion for non-fuel minerals mined on Federal and formerly Federal lands

Present Law

Taxpayers are allowed to deduct a reasonable allowance for depletion relating to the acquisition and certain related costs of mines or other hard mineral deposits. The depletion deduction for any taxable year is calculated under either the cost depletion method or the percentage depletion method, whichever results in the greater allowance for depletion for the year.

Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the property which is equal to the ratio of the units sold from that property during the taxable year, to the estimated total units remaining at the beginning of that year.

Under the percentage depletion method, a deduction is allowed in each taxable year for a statutory percentage of the taxpayer's gross income from the property. The statutory percentage for gold, silver, copper, and iron ore is 15 percent; the statutory percentage for uranium, lead, tin, nickel, tungsten, zinc, and most other hard rock minerals is 22 percent. The percentage depletion deduction for these minerals may not exceed 50 percent of the net income from the property for the taxable year (computed without allowance for depletion). Percentage depletion is not limited to the taxpayer's basis in the property; thus, the aggregate amount of percentage depletion deductions claimed may exceed the amount expended by the taxpayer to acquire and develop the property.

The Mining Law of 1872 permits U.S. citizens and businesses to prospect freely for hard rock minerals on Federal lands, and allows them to mine the land if an economically recoverable deposit is found. No Federal rents or royalties are imposed upon the sale of the extracted minerals. A prospecting entity may establish a claim to an area that it believes may contain a mineral deposit of value and preserve its right to that claim by paying an annual holding fee of $100 per claim. Once a claimed mineral deposit is determined to be economically recoverable, and at least $500 of development work has been performed, the claim holder may apply for a "patent" to obtain title to the surface and mineral rights. If approved, the claimant can obtain full title to the land for $2.50 or $5.00 per acre.

Description of Proposal

The proposal would repeal the present-law percentage depletion provisions for non-fuel minerals mined on Federal lands where the mining rights were originally acquired under the Mining Law of 1872, and on private lands acquired under the 1872 law.

Effective Date

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

Prior Action

A similar proposal was included in the President's fiscal year 1997, 1998, and 1999 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.

5. Impose excise tax on purchase of structured settlements

Present Law

Present law provides tax-favored treatment for structured settlement arrangements for the payment of damages on account of personal injury or sickness.

Under present law, an exclusion from gross income is provided for amounts received for agreeing to a qualified assignment to the extent that the amount received does not exceed the aggregate cost of any qualified funding asset (sec. 130). A qualified assignment means any assignment of a liability to make periodic payments as damages (whether by suit or agreement) on account of a personal injury or sickness (in a case involving physical injury or physical sickness), provided the liability is assumed from a person who is a party to the suit or agreement, and the terms of the assignment satisfy certain requirements. Generally, these requirements are that (1) the periodic payments are fixed as to amount and time; (2) the payments cannot be accelerated, deferred, increased, or decreased by the recipient; (3) the assignee's obligation is no greater than that of the assignor; and (4) the payments are excludable by the recipient under section 104(a)(2) as damages on account of personal injuries or sickness.

A qualified funding asset means an annuity contract issued by an insurance company licensed in the U.S., or any obligation of the United States, provided the annuity contract or obligation meets statutory requirements. An annuity that is a qualified funding asset is not subject to the rule requiring current inclusion of the income on the contract which generally applies to annuity contract holders that are not natural persons (e.g., corporations) (sec. 72(u)(3)(C)). In addition, when the payments on the annuity are received by the structured settlement company and included in income, the company generally may deduct the corresponding payments to the injured person, who, in turn, excludes the payments from his or her income (sec. 104). Thus, neither the amount received for agreeing to the qualified assignment of the liability to pay damages, nor the income on the annuity that funds the liability to pay damages, generally is subject to tax.

Present law provides that the payments to the injured person under the qualified assignment cannot be accelerated, deferred, increased, or decreased by the recipient. Consistent with these requirements, it is understood that contracts under structured settlement arrangements generally contain anti-assignment clauses. It is understood, however, that injured persons may nonetheless be willing to accept discounted lump sum payments from certain "factoring" companies in exchange for their payment streams. The tax effect on the parties of these transactions may not be completely clear under present law.

Description of Proposal

The proposal would impose an excise tax on any person acquiring a payment stream under a structured settlement arrangement. The amount of the excise tax would be 40 percent of the difference between (1) the amount paid by the acquirer to the injured person and (2) the undiscounted value of the acquired income stream. The excise tax would not be imposed if the acquisition were pursuant to a court order finding that the extraordinary and unanticipated needs of the original recipient of the payment stream render the acquisition desirable.

Effective Date

The proposal would be effective for acquisitions occurring after the date of enactment. No inference would be intended as the contractual validity of the acquisition transaction or its effect on the tax treatment of any party other than the acquirer.

Prior Action

The proposal[308] is similar to a provision contained in the President's budget proposal for fiscal year 1999, except that under that proposal, the amount of the excise tax would have been 20 percent of the consideration for acquiring the payment stream.

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.

By imposing the excise tax on the amount of the discount, rather than on the entire amount of the payment stream, it could be said that this proposal is more targeted than the prior Administration proposal to the aspect of the transaction that could financially disadvantage the injured person: the amount of the discount. It could nevertheless be argued that acquirers still have an economic incentive to acquire payment streams, so long as the tax on the discount is less than the rate which would discourage the acquisition transactions completely. Thus, if 40 percent is not the tax rate at which

[308] This proposal is similar to H.R. 263, "The Structured Settlement Protection Act," (106th Cong., 1st Sess., introduced by Mr. Shaw and others). H.R. 263 provides for a 50-percent tax on the amount equal to the excess of (1) the aggregate undiscounted amount of structured settlement payments being acquired, over (2) the total amount actually paid by the acquirer to the seller.

transactions could no longer be profitable for the acquirers, it could be said that the provision does not achieve the purpose of protecting the injured person by preventing the sale of the payment stream. Conversely, if 40 percent is that tax rate, then the proposal could be assessed as effective at achieving that purpose. If transactions were to continue after imposition of the tax, sellers of payment streams would be worse off than before the tax, because acquirers would discount more deeply the purchase of the payment stream to achieve the same profit level they did before the tax. Critics could argue that if the tax rate is set at a level that does not totally discourage the transactions, then the proposal would fail to achieve its goal of protecting the original recipients of payment streams.

An additional result of the proposal may be to limit the uncertainty arising under present law from the acquisition with respect to the tax treatment of payors under existing structured settlement arrangements. It could be argued that limiting or stopping the acquisition transactions through imposition of tax on them is not the most efficient way to provide certainty in the tax law. Other alternatives might be explicitly to provide that the acquisition of the payment stream either does, or does not, violate the requirement of present law section 130 that the payments cannot be accelerated, deferred, increased, or decreased by the recipient.

It could also be argued that it is not the function of the tax law to prevent injured persons or their legal representatives from transferring rights to payment. Arguably, consumer protection and similar regulation is more properly the role of the States than of the Federal government. It could further be argued that it is not economically efficient for tax rules to hinder the operation of a market in structured settlement streams.

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.

6. Require taxpayers to include rental income of residence in income without regard to period of rental

Present Law

Gross income for purposes of the Internal Revenue Code generally includes all income from whatever source derived, including rents. The Code (sec. 280A(g)) provides a de minimis exception to this rule where a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year. In this case, the income from such rental is not included in gross income and no deductions arising from such rental use are allowed as a deduction.

Description of Proposal

The proposal would repeal the 15-day rules of section 280A(g). A taxpayer would include in gross income rental income from the rental of the taxpayer's residence regardless of the period of rental. Also, a taxpayer could deduct a pro rata share of the expenses attributable to the rental of such property. The proposal does not change the present-law treatment of expenses allowable to the taxpayer without regard to the rental of the property (e.g., certain interest, taxes and casualty losses).

Effective Date

The proposal would apply to taxable years beginning after December 31, 1999.

Prior Action

The House version of the Taxpayer Relief Act of 1997 contained a similar proposal, which was not included in the conference agreement.

Analysis

Present law allows certain taxpayers to exclude from income rental payments for the short-term rental of the taxpayer's residence. Proponents of the proposal believe that such amounts should be included in income of the taxpayers, like any other source of income. Opponents of the proposal argue that any additional tax revenue from the taxation of the rental payments from the short-term rental of a residence is outweighed by the imposition of the additional complexity placed on affected taxpayers by eliminating the de minimis exception from section 280A.

III. OTHER PROVISIONS THAT AFFECT 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 (sec. 4611(c)(2)(A));

(2) An excise tax on certain hazardous chemicals, imposed at rates that varied from $0.22 to $4.87 per ton (sec. 4661);

(3) An excise tax on imported substances made with the chemicals subject to the tax in (2), above (sec. 4671); and

(4) An income tax on corporations calculated using the alternative minimum tax rules (sec. 59A).

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, 2009. The corporate environmental income tax would be reinstated for taxable years beginning after December 31, 1998, and before January 1, 2010.

Revenues from reinstatement of these taxes would be deposited in the Superfund.

Effective Date

The proposal would be effective on the date of enactment.

Prior Action

The President's fiscal year 1998 and 1999 budget proposals included a similar proposal.

Analysis

The Superfund provides for certain environmental remediation expenses. The prior-law taxes were imposed on petroleum products, chemical products, and more generally on large businesses. Thus, the taxes were imposed on those taxpayers who generally were believed to represent the parties liable for past environmental damage rather than on taxpayers perceived to benefit from the expenditure program. Depending on their incidence, these taxes may inexactly recoup damages from parties held responsible for past environmental damage. For example, the burden may fall on the current owners of enterprises rather than those who were the owners at the time the damage occurred. On the other hand, to the extent that taxable products continue to create environmental harm, the taxes may discourage overuse of such products.

Proponents of reimposing the Superfund excise taxes suggest that the revenues can provide a cushion for ongoing Superfund program costs, and that reimposition of these taxes is a necessary complement to reauthorization and possible modification of the Superfund program. Opponents suggest that the taxes should be reimposed only as part of pending program reform legislation. These persons suggest, in particular, that proposals to address issues associated with so-called "retroactive liability" may require budgetary offsets which could be provided by reimposing the Superfund taxes as a component of such authorizing legislation.

The current unobligated balance in the Superfund at the close of the 1998 fiscal year was $2.154 billion.

B. Convert a Portion of the Excise Taxes Deposited in the Airport and Airway Trust Fund to Cost-Based User Fees Assessed for Federal Aviation Administration Services

Present Law

Airport and Airway Trust Fund excise taxes with scheduled expiration dates

Excise taxes are imposed on commercial and noncommercial [309] 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.[310] These tax rates currently are being phased-in, as follows: [311] 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 (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

[309] 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).

[310] A flight segment is transportation involving a single take-off and a single landing.

[311] For the period October 1, 1997 through September 30, 1998, the tax rates were 9 percent of the fare, plus $1 per domestic flight segment.

country are subject to a $12.20 tax per arrival or departure. This rate, which was $12.00 through December 31, 1998, is indexed annually for inflation.

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

Domestic commercial transportation of cargo by air is subject to a 6.25-percent excise tax.

Noncommercial aviation

Noncommercial aviation is subject to taxes on fuels consumed. Aviation gasoline is taxed at 15 cents per gallon and aviation jet fuel is taxed at 17.5 cents per gallon.

Permanent aviation fuels excise tax

In addition to the taxes described above, aviation gasoline and jet fuel is subject to a permanent 4.3-cents-per-gallon excise tax rate. Receipts from this tax (since October 1, 1997), like the aviation taxes with scheduled expiration dates, are deposited in the Airport Trust Fund.

Airport Trust Fund expenditures

For the past several fiscal years, Airport Trust Fund revenues have provided funds for approximately 60 percent of Federal Aviation Administration ("FAA") program costs.[312]

Description of Proposal

The proposal states that legislation to reduce aviation excise taxes and to replace those taxes with cost-based user fees will be proposed at a later date. Under the proposal, the aviation excise taxes would be reduced beginning in fiscal year 2000. The proposal envisions that excise tax rates and fees would be set at levels sufficient to yield monies equal to the total budget resources requested for the FAA for the succeeding fiscal year. 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 and the proposal also is similar to a proposal contained

[312] In fiscal 1998, Airport Trust Fund expenditures funded $1.5 billion in FAA grants-in-aid for airports, $2.2 billion in FAA facilities and equipment purchases, $0.2 billion in FAA research, engineering, and development, and $1.9 billion in general operation of the FAA, for a total Airport Trust Fund outlay of $5.869 billion out of total FAA outlays of $9.243 billion, or 63.5 percent. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2000: Appendix*, p. 741.

in the President's fiscal year 1999 budget, for which details were not submitted to the Congress. The structure and level of aviation excise taxes to support the FAA were addressed in the Taxpayer Relief Act of 1997. That Act enacted the current excise tax structure, provided that the taxes with scheduled expiration dates would be imposed through September 30, 2007, and transferred receipts from the permanent 4.3-cents-per-gallon aviation fuels tax (previously retained in the General Fund) to the Airport Trust Fund.

Analysis

Because details of the proposal have not been transmitted to the Congress, it is not possible to comment on specifics; however, several general issues regarding substitution of aviation user fees for excise taxes which were raised before the Congress during consideration of the 1997 Act may be noted.[313]

Budget Act scorekeeping

The current excise taxes imposed to finance FAA activities are classified as Federal revenues, with gross receipts from the taxes being deposited in the Airport Trust Fund. Because of interactions with the Federal income tax, net revenues to the Federal Government are less than the gross receipts from these taxes (i.e., "net revenues" equal approximately 75 percent of gross excises taxes). Spending from the Airport Trust Fund is classified as discretionary domestic spending, subject to aggregate annual appropriation limits ("caps") that apply to this spending as well as other types of discretionary domestic spending. These caps most recently were set as part of the 1997 balanced budget agreement. Because spending from the Airport Trust Fund is subject to the discretionary domestic spending caps, deposit of amounts in excess of net revenues from these taxes in the Airport Trust Fund does not impact Federal budget scorekeeping.

Proponents of changing FAA financing to user fees typically argue that current spending levels are too low because of the general discretionary spending caps. These persons suggest that, if the FAA were permitted to impose cost-based user fees, it could spend the entire amount collected outside of the regular budgetary process. However, if FAA financing and spending were restructured using user fees and expenditures not requiring appropriation, the discretionary domestic spending caps established by the 1997 balanced budget agreement would have to be reduced to prevent increases in other programs that might produce deficit spending. Further, if the user fees were classified as Federal revenues and the FAA were allowed to spend more than the net revenues produced (as opposed to the gross receipts), from a budgetary standpoint, the agency would be engaged in deficit spending.

Under the current financing and spending structure, Airport Trust Fund spending levels may be less than net excise tax revenues. Any excess net revenues received are included in calculations of the Federal deficit or surplus under the Budget Enforcement

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[313] 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.

Act. If the excise taxes were repealed, and were not replaced by similarly treated revenue sources equal at least to the excess of collections over expenditures, Federal deficit or surplus calculations would be affected.

Tax 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.[314] 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 specific services with respect to which the fee is charged. Fees are not imposed on the general public; there must be a reasonable connection between the payors of the fee and the agency or function receiving the fee. Those paying a fee must have the choice of not utilizing the governmental service or avoiding the regulated activity and thereby avoiding the charge. If the FAA were authorized to establish and collect cost-based user fees, the fees would have to satisfy these criteria to avoid being subject to challenge as unconstitutional delegations of the taxing power. When the Congress modified and extended the aviation excise taxes in 1997, the FAA was reported to have no comprehensive cost accounting system upon which it could base such fees. Further, over 50 percent of FAA costs were identified in the then most recently conducted cost allocation study as "common" costs to many sectors, requiring allocation rules. Such allocation rules may be viewed by some as imprecise and subject to challenge.[315]

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

[314] 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. . . ."

[315] 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.

the bridge has been built, is quite small in comparison. This means that the provision of many transportation services is often characterized by "economies of scale." Provision of a good or service is said to be characterized by economies of scale when the average cost of providing the good or service exceeds the marginal cost of providing that good or service. When this occurs, the average cost of providing the good or service is falling with each additional unit of the good or service provided. Economists proffer setting prices or taxes equal to marginal cost to obtain economically efficient outcomes. However, in the presence of substantial economies of scale, the marginal cost is less than the average cost of providing the transportation service and the revenues collected from equating taxes to marginal costs would not cover the full expenditure required to provide the service. That is, provision of the service may require a subsidy beyond the revenues provided by the economically efficient tax.[316]

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 wellbeing (efficiency) would increase. Thus, the principle of cost allocation involves a trade-off between economic efficiency and cost recovery.[317]

Congressional oversight

The current financing and Airport Trust Fund spending process involves oversight of at least four Congressional committees in each House of Congress. Taxes are imposed and dedicated to the Airport Trust Fund by the tax-writing committees. Overall expenditure levels for domestic spending are set by the budget committees. Specific expenditure purposes are authorized by the House Committee on Transportation and Infrastructure and the Senate Committee on Commerce, Science and Transportation. Further, expenditures are appropriated by the appropriations committees of each House. Proponents of changing FAA financing and spending authority as proposed by the Administration suggest that such extensive Congressional oversight is unnecessary. At a minimum, the Administration's proposal could eliminate or reduce the oversight roles of the tax-writing and appropriations committees. Others suggest that the involvement of multiple Congressional committees promotes better prioritization of actual FAA spending needs within the framework

[316] 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.

[317] 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.

of the overall system of Federal revenues and outlays and a more efficient use of FAA resources.

The balance in the Airport and Airway Trust Fund at the close of the 1998 fiscal year was $9.1 billion.

C. Increase Excise Taxes on Tobacco Products

Present Law

Excise taxes on tobacco products

Excise taxes are imposed on cigarettes, cigars, chewing tobacco and snuff, pipe tobacco, and cigarette papers and tubes (Code sec. 5701). In addition, tax will be extended to "roll-your-own tobacco" at the same rates as pipe tobacco, effective on January 1, 2000. These taxes are imposed upon removal[318] of the taxable tobacco products by the manufacturer, or on importation into the United States.[319] The current tax rates are shown in the table below.

Tobacco product	*Tax rate*
Cigarettes:	
Small cigarettes	$12.00 (24 cents per pack of 20).
Large cigarettes	$25.20 per thousand.
Cigars:	
Small cigars	$1.125 per thousand.
Large cigars	12.75% of manufacturer's price, up to $30 per thousand.
Chewing tobacco	$0.12 per pound (¾¢ per ounce container).
Snuff	$0.36 per pound.
Pipe Tobacco	$0.675 per pound.
Cigarette papers	$0.0075 per 50 papers or fraction thereof.
Cigarette tubes	$0.015 per 50 tubes or fraction thereof.

Effective on January 1, 2000, the tax rate on small cigarettes is scheduled to increase by $5 per thousand (to 34 cents per pack of 20 small cigarettes). The tax rates on other taxable tobacco products will increase by a proportionate amount. For example, the tax on chewing tobacco will increase to 17 cents per pound (1.06 cents per one ounce container).

Effective on January 1, 2002, a further increase of $2.50 per thousand (to 39 cents per pack of 20 small cigarettes) is scheduled to become effective. Tax rates on other taxable tobacco products will increase proportionately on that date as well.

Generally, excise taxes on tobacco products that are sold or distributed for sale during any semimonthly period must be paid by the 14th day after the last day of such semimonthly period (sec. 5703(b)(2)(A)). However, taxes on tobacco products removed during the period beginning on September 16 and ending on September 26 must be paid no later than September 29 (sec. 5703(b)(2)(D)). A similar rule applies to the excise taxes on certain other items, in-

[318] Taxable tobacco products are removed when they are taken from the factory, from internal revenue bond, or are released from customs custody. Removal also occurs at the time such articles are smuggled or otherwise unlawfully imported into the United States (sec. 5702(k)).

[319] The term United States includes the 50 States and the District of Columbia.

cluding alcoholic beverages, during the same September 16th through 26th period (sec. 5061(d)(4)).

Description of Proposal

The proposal would accelerate the scheduled ten and five cents per pack increases in the excise tax on small cigarettes, and further increase the tax rate on small cigarettes by $0.55 per pack, effective October 1, 1999. The scheduled increases in excise tax rates on other tobacco products likewise would be accelerated and increased proportionately.

The following table shows the excise tax rates that would be effective as of October 1, 1999 under the proposal.

Tobacco product	*Tax rate*
Cigarettes:	
Small cigarettes	$47.00 per thousand (94 cents per pack of 20).
Large cigarettes	$98.70 per thousand.
Cigars:	
Small cigars	$4.406 per thousand.
Large cigars	49.99% of manufacturer's price, up to $98.75 per thousand.
Chewing tobacco	$0.47 per pound (2.9¢ per ounce container).
Snuff	$1.41 per pound.
Pipe Tobacco	$2.64 per pound.
Cigarette papers	$0.029 per 50 papers or fraction thereof.
Cigarette tubes	$0.059 per 50 tubes or fraction thereof.

A floor stocks tax would be imposed to conform the tax on tobacco products held for sale on the effective date with the tax on tobacco products that are acquired for sale after the effective date.

In addition, the special rules that require that require payment by September 29 of taxes on tobacco products and alcoholic beverages that are removed during the period that begins on September 16 and ends on September 26 would not apply during 1999.

Effective Date

The proposal to increase the tobacco excise tax would be effective on October 1, 1999. The proposal to suspend application of the special rules relating to the deposit of excise taxes on tobacco and alcoholic beverages removed between September 16 and September 26 would apply during 1999.

Prior Action

The Taxpayer Relief Act of 1997, as reported by the Senate Committee on Finance and passed by the Senate, would have increased the tax on small cigarettes by $10 per thousand (20 cents per pack of 20 cigarettes) effective October 1, 1997, with a proportionate increase in the tax rates on other taxable tobacco products. A floor stocks tax would have been provided.

Analysis

Raising taxes on tobacco products will discourage the use of such products, particularly by children and teenagers. This may help many Americans avoid the hazards associated with long-term tobacco use. However, the burden of increased tobacco taxes is expected to fall most heavily on those smokers with lower incomes. Increasing the price of tobacco products through additional taxes may also adversely affect tobacco farmers.

D. Change Harbor Maintenance Excise Tax to Cost-Based User Fee

Present Law

Under present law, an excise tax (''harbor maintenance tax'') of 0.125 percent is imposed on the value of commercial cargo (including the value of passenger fares) loaded or unloaded at U.S. ports (sec. 4461). The statute provides that the tax applies equally to imported and exported cargo. The tax does not apply to cargo donated for overseas use. The tax also does not apply to cargo (other than cargo destined for a foreign port) shipped between the U.S. mainland and Alaska (other than crude oil), Hawaii, or a U.S. possession. In addition, the tax does not apply to passenger ferry boats operating between points within the United States or between the United States and Canada or Mexico.

Revenues from the harbor maintenance excise tax go to the Harbor Maintenance Trust Fund (''Harbor Trust Fund''), generally to finance costs of operating and maintaining U.S. ports.

Art. I, sec. 9, cl. 5 of the United States Constitution provides that ''No Tax or Duty shall be laid on Articles exported from any State.'' In 1998, the U.S. Supreme Court ruled that the harbor maintenance tax, as applied to goods loaded at U.S. ports for export, violated the Constitution's export clause (Art. I, sec. 9, cl. 5), as such tax did not qualify as a user fee. *United States* v. *United States Shoe Corp.*, 118 S. Ct. 1290 (1998).

Description of Proposal

The proposal would replace the current *ad valorem* harbor maintenance excise tax with a cost-based user fee referred to as the ''harbor services user fee.'' The user fee would be available to finance harbor construction, operation, and maintenance activities performed by the Army Corps of Engineers, the costs of operating and maintaining the Saint Lawrence Seaway, and the costs of administering the fee.[320]

Effective Date

The proposal would apply after the date of enactment.

Prior Action

No prior action.

[320] The details regarding the administration, application, and operation of the proposed user fee were not provided to the Congress in the President's fiscal year 2000 budget proposal.

Analysis

In general, a true user fee is a charge levied on a class that directly avails itself of a governmental program, and is used solely to finance that program rather than to finance the costs of government generally. The amount of the fee charged to any payor generally may not exceed the costs of providing the services with respect to which the fee is charged. Fees are not imposed on the general public; there must be a reasonable connection between the payors of the fee and the agency or function receiving the fee.[321]

In *United States* v. *United States Shoe Corp.*, 118 S. Ct. 1290 (1998), the U.S. Supreme Court ruled that the harbor maintenance excise tax of section 4461 was an *ad valorem* tax on exports which violated the Export Clause of the Constitution (Art. I., sec. 9, cl. 5). In so holding, the Court noted that the section 4461 expressly "imposed a tax on any port use," which was determined solely on an *ad valorem* basis. The Supreme Court did recognize that exporters could legally be subject to user fees which help defray the cost of harbor development and maintenance, so long as these fees "fairly match the exporters" use of port services and facilities" and lack the attributes of a generally applicable tax or duty. The charges must be designed as compensation for government-supplied services, facilities, or benefits.

E. Additional Provisions Requiring Amendment of the Internal Revenue Code

1. Increase amount of rum excise tax that is covered over to Puerto Rico and the U.S. Virgin Islands

Present Law

A $13.50 per proof gallon[322] excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States (sec. 5001). The excise tax does not apply to distilled spirits that are exported from the United States or to distilled spirits that are consumed in U.S. possessions (e.g., Puerto Rico and the Virgin Islands).

The Code provides for coverover (payment) of $10.50 per proof gallon of the excise tax imposed on rum imported (or brought) into the United States (without regard to the country of origin) to Puerto Rico and the Virgin Islands (sec. 7652). During the 5-year period ending on September 30, 1998, the amount covered over was $11.35 per proof gallon. This temporary increase was enacted in 1993 as transitional relief accompanying a reduction in certain tax benefits for corporations operating in Puerto Rico and the Virgin Islands (sec. 936).

Amounts covered over to Puerto Rico and the Virgin Islands are deposited in the treasuries of the two possessions.

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[321] For a discussion of the constitutional limitations on and congressional jurisdiction over fees and taxes, see Joint Committee on Taxation, *Present Law and Background Information on Federal Transportation Excise Taxes and Trust Fund Expenditure Programs* (JCS–10–96), November 14, 1996, and Joint Committee on Taxation, *Background and Present Law Relating to Funding Mechanisms of the "E-Rate" Telecommunications Program* (JCX–59–98), July 31, 1998.

[322] A proof gallon is a liquid gallon consisting of 50 percent alcohol.

Description of Proposal

The President's budget states that a proposal will be made to increase the rum excise tax coverover rate from $10.50 to $13.50 per proof gallon for Puerto Rico and the Virgin Islands during the 5-year period beginning on October 1, 1999.

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

Effective Date

The proposal would be effective for rum imported (or brought) into the United States after September 30, 1999, and before October 1, 2004.

2. Allow members of the clergy to revoke exemption from Social Security and Medicare coverage

Under present law, ministers of a church who are opposed to participating in the Social Security and Medicare programs on religious principles may reject coverage by filing with the Internal Revenue Service before the tax filing date for their second year of work in the ministry. This proposal would provide an opportunity for members of the clergy to revoke their exemptions from Social Security and Medicare coverage.

3. Restore premiums for the United Mine Workers of America Combined Benefit Fund

The proposal would restore the previous calculation of premiums charged to coal companies that employed the retired miners that have been assigned to them. The proposal would reserve the court decision of *National Coal* v. *Chater*.

4. Disclosure of tax return information for administration of certain veterans programs

Present Law

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). No tax information may be furnished by the Internal Revenue Service ("IRS") to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Among the disclosures permitted under the Code is disclosure to the Department of Veterans Affairs ("DVA") of self-employment tax information and certain tax information supplied to the IRS and Social Security Administration by third parties. Disclosure is permitted to assist DVA in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension, health care, and other programs (sec. 6103(1)(7)(D)(viii)). The income tax returns filed by the veterans themselves are not disclosed to DVA.

The DVA is required to comply with the safeguards currently contained in the Code and in section 1137(c) of the Social Security Act (governing the use of disclosed tax information). These safeguards include independent verification of tax data, notification to the individual concerned, and the opportunity to contest agency findings based on such information.

The DVA disclosure provision is scheduled to expire after September 30, 2003.[323]

Description of Proposal

The proposal would extend the DVA disclosure provision.[324]

Effective Date

The proposal would be effective after September 30, 2003.

Analysis

Some might argue that it is appropriate to permit the disclosure of otherwise confidential tax information to ensure the correctness of these government benefit payments. Others might respond that tax information should be used only for tax purposes and should not be subject to widespread redisclosure by the IRS.

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[323] The Appendix to the Fiscal Year 2000 Budget incorrectly states that this provision will expire in 2002 (p. 870).

[324] It is not clear from the budget documents whether this provision would be permanently extended or whether it would be extended only through the end of the current budget window. It is also not clear from the budget documents whether the entire DVA provision would be extended, or only the portion relating to determining eligibility for pension benefits (this is the only portion mentioned on p. 870 of the Appendix to the Fiscal Year 2000 Budget).