[JOINT COMMITTEE PRINT]

DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1996 BUDGET PROPOSAL (H.R. 980 AND H.R. 981 AND S. 452 AND S. 453)

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, provides a description of the revenue provisions contained in the President's fiscal year 1996 budget proposal.[2]

The President's fiscal year 1996 budget proposal was submitted to the Congress on February 6, 1995. The publication of this pamphlet has been held until today so that the pamphlet could incorporate descriptions of the technical details prescribed by the statutory language of the introduced bills. The "Middle-Class Bill of Rights Tax Relief Act of 1995" was introduced on February 16, 1995 as H.R. 980 by Representatives Gephardt and Gibbons and as S. 452 by Senators Moynihan and Daschle. Also, the "Tax Compliance Act of 1995" was introduced on February 16, 1995 as H.R. 981 by Representatives Gephardt and Gibbons and as S. 453 by Senators Moynihan and Daschle.

Part I of the pamphlet describes the tax provisions in H.R. 980 and S. 452. Part II describes the tax provisions in H.R. 981 and S. 453. Part III describes two other tax proposals included in the President's fiscal year 1996 budget, but which have not yet been transmitted to the Congress: extension of the taxes for the Hazardous Substance Superfund and a restructuring of the vaccine excise taxes for the Vaccine Injury Compensation Trust Fund.

This pamphlet does not describe certain fee proposals included in the President's fiscal year 1996 budget that may be considered as revenue measures.

In addition, the President's fiscal year 1996 budget indicates that the Administration supports in concept "revenue-neutral initiatives" relating to improved tax administration and compliance (including simplification, technical corrections, and taxpayer compliance measures) and extension of certain expiring tax provisions. The President's budget does not include specific proposals on these matters, nor are they described in this pamphlet.

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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 1996 Budget Proposal (H.R. 980 and H.R. 981 and S. 452 and S. 453)* (JCS–5–95), February 17, 1995.

[2] Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1996*, as released on February 6, 1995. See also Department of the Treasury, *General Explanations of the Administration's Revenue Proposals*, February 1995.

I. DESCRIPTION OF H.R. 980 AND S. 452 ("MIDDLE-CLASS BILL OF RIGHTS TAX RELIEF ACT OF 1995")

A. Tax Credit for Families with Young Children

(Sec. 101 of the bill and sec. 101(c) of H.R. 981 and S. 453)

Present Law

In general

Taxpayers generally may claim a personal exemption for each dependent, including dependent children. The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income (AGI) in arriving at taxable income. The amount of each personal exemption is $2,500 for 1995, and is adjusted annually for inflation. The amount of the personal exemption is phased out for taxpayers with AGI in excess of $114,700 for single taxpayers, $143,350 for heads of household, and $172,050 for married couples filing joint returns.

In addition, eligible low-income workers are able to claim a refundable earned income tax credit (EITC). The amount of the credit an eligible taxpayer may claim depends upon whether the taxpayer has more than one, one, or no qualifying children and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income threshold. The maximum amount of the credit is the product of the credit rate and the earned income threshold. In 1995, the maximum credit is $3,110 for taxpayers with more than one qualifying child, $2,094 for taxpayers with one qualifying child, and $314 for taxpayers with no qualifying children. For taxpayers with earned income (or AGI, if greater) in excess of a phaseout threshold, the credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the phaseout threshold. In 1995 the phaseout threshold is $11,290 for both taxpayers with more than one qualifying child and taxpayers with one qualifying child, and $5,130 for taxpayers with no qualifying children. The credit is not allowed if earned income (or AGI, if greater) exceeds the phaseout limit. In 1995, the EITC is phased out at $26,673 for taxpayers with more than one qualifying child, $24,396 for taxpayers with one qualifying child, and $9,230 for taxpayers with no qualifying children.

Mathematical errors

The IRS may summarily assess additional tax due as a result of a mathematical error without sending the taxpayer a notice of deficiency and an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the

asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. This procedure is the only one a taxpayer may use for contesting an assessment arising out of a mathematical or clerical error.

Description of Proposal

The proposal would provide taxpayers with a maximum credit of $300 for each eligible child for taxable years 1996, 1997 and 1998. The maximum amount of the credit would be increased to $500 for each eligible child for taxable years beginning after December 31, 1998.

The credit would be phased out ratably for taxpayers with AGI over $60,000 and would be fully phased out at AGI of $75,000. In the case of a taxable year beginning after calendar year 1999, the maximum credit and the beginning point of the phaseout range would be indexed annually for inflation. For each year in which the maximum amount of the credit exceeds $500, the size of the phaseout range would be increased from $15,000 (i.e., $75,000 minus $60,000) to 30 times the maximum amount of the credit in that year. For purposes of all these AGI tests, the taxpayer's AGI would be increased by any 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).

To be an eligible child, an individual would have to satisfy a dependency test, a relationship test, an age test, and an identification test.

An individual would satisfy the dependency test if the individual is a dependent of the taxpayer with respect to whom the taxpayer is entitled to claim a dependency deduction.

An individual would satisfy the relationship test if the individual is a son, stepson, daughter or stepdaughter of the taxpayer, a descendant of a son or daughter, or a foster or adopted child of the taxpayer. A foster child would have to have as his principal place of abode the home of the taxpayer and be a member of the taxpayer's household. An adopted child would include a child who is legally adopted by the taxpayer or who is placed with the taxpayer by an authorized placement agency for legal adoption by the taxpayer.

An individual would satisfy the age test if the individual has not attained the age of 13 as of the close of the calendar year in which the taxable year of the taxpayer begins.

An individual would satisfy the identification test if the individual's taxpayer identification number is included on the taxpayer's return for such taxable year. Rules similar to those made applicable by the Administration proposals to the EITC would apply. If a taxpayer fails to provide a correct taxpayer identification number,

such omission would be treated as a mathematical or clerical error and thus any notification that the taxpayer owes additional tax because of that omission would not be treated as a notice of deficiency.

The maximum amount of the credit for each taxable year could not exceed an amount equal to the sum of: (1) the taxpayer's regular income tax liability (net of applicable credits) less (2) the sum of the taxpayer's tentative minimum tax liability and earned income tax credit allowed.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995.

B. Education and Job Training Tax Deduction

(Sec. 102 of the bill)

Present Law

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

Education expenses that are reimbursed by the employer are excludable from the employee's gross income as a working condition fringe benefit (sec. 132(d)) if the education qualifies as work related under section 162. A special rule allowed an employee to exclude from gross income up to $5,250 paid by his or her employer for educational assistance, regardless of whether the education maintained or improved a skill required by the employee's current position (sec. 127). This special rule for employer-provided educational assistance expired after 1994.

Another special rule, section 135, provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[3] "Qualified higher education expenses" include tuition and required fees for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools. The exclusion provided by section 135 is phased out for certain higher income taxpayers, determined by the taxpayer's AGI during the year the bond is redeemed. To prevent taxpayers from effectively avoiding the income phaseout limitation (through issuance of bonds directly in the child's name), section 135(c)(1)(B) pro-

[3] If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bears to the aggregate redemption amount (sec. 135(b)).

vides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or 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 education below the graduate level provided to employees of certain educational organizations.

Description of Proposal

A taxpayer would be allowed an above-the-line deduction for qualified educational expenses paid during the taxable year for the education or training of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents at an institution of higher education. The deduction would be allowed in computing a taxpayer's AGI, and could be claimed regardless of whether the taxpayer itemizes deductions. In 1996, 1997, and 1998, the maximum deduction allowed per taxpayer return would be $5,000. In 1999 and thereafter, the maximum deduction would be increased to $10,000. The deduction would be phased out ratably for taxpayers with modified AGI between $70,000 and $90,000 ($100,000 and $120,000 for joint returns). Modified AGI would include taxable Social Security benefits and amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). Beginning in 2000, the income phase-out range would be indexed for inflation.

Qualified educational expenses would be defined as tuition and fees required for the enrollment or attendance of an eligible student (e.g., registration fees, laboratory fees, and extra charges for particular courses) at an institution of higher education. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, and similar personal expenses unrelated to a student's academic course of instruction would not be deductible. The expenses of education involving sports, games, or hobbies would not be qualified educational expenses unless the education is part of a degree program (or relates to the student's current profession).

An "eligible student" would be one who is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an institution of higher education. The student must pursue a course of study on at least a half-time basis or must be enrolled in a course which enables the student to improve current job skills or to acquire new job skills. In addition, the student cannot be enrolled in an elementary or secondary school, and cannot be a nonresident alien. Educational institutions would determine what constituted a half-time basis for individual programs.

The term "institution of higher education" would be defined by reference to section 481 of the Higher Education Act of 1965. Such institutions must have entered into an agreement with the Department of Education to participate in the student loan program. This definition includes colleges and universities, and certain vocational and proprietary institutions.

Any amount taken into account as a qualified educational expense would be reduced by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the deduction. Thus, qualified educational expenses would be reduced by scholarship or fellowship grants excludable from gross income under section 117 (even if the grants are used to pay expenses other than qualified educational expenses) and any educational assistance received as veterans' benefits. Similarly, qualified educational expenses would be reduced by proceeds from Series EE savings bonds that are excludable by the taxpayer under present-law section 135. However, no reduction would be required for a gift, bequest, devise or inheritance within the meaning of section 102(a).

Qualified educational expenses would be deductible in the year the expenses are paid, subject to the requirement that the education commences or continues during that year or during the first three months of the next year. Qualified educational expenses paid with the proceeds of a loan generally would be deductible (rather than repayment of the loan itself). Normal tax benefit rules would apply to refunds (and reimbursements through insurance) of previously deducted tuition and fees.

The proposal would not affect deductions claimed under any other section of the Code, except that any amount deducted under another section of the Code could not also be deducted under this provision. A student would not be eligible to claim a deduction under this provision on his or her own tax return if that student could be claimed as a dependent of another taxpayer.

Effective Date

The proposal would be effective for qualified educational expenses paid after December 31, 1995.

C. Individual Retirement Arrangements (IRAs)

(Secs. 201-203, 211, and 221-222 of the bill)

Present Law

In general

Under certain circumstances, an individual is allowed a deduction for contributions (within limits) to an individual retirement account or an individual retirement annuity (an IRA) (Code sec. 219). An individual generally is not subject to income tax on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA. No deduction is permitted with respect to contributions made to an IRA for a taxable year after the IRA owner attains age 70-½.

Under present law, the maximum deductible contribution that can be made to an IRA generally is the lesser of $2,000 or 100 percent of an individual's compensation (earned income in the case of self-employed individuals). In addition, a married taxpayer who files a joint return with his or her spouse can make an additional contribution of up to $250 to an IRA established for the benefit of the spouse, if the spouse has no compensation or elects to be treated as having no compensation. A single taxpayer is permitted to make the maximum deductible IRA contribution for a year if the individual is not an active participant in an employer-sponsored retirement plan for the year or the individual has adjusted gross income (AGI) of less than $25,000. A married taxpayer filing a joint return is permitted to make the maximum deductible IRA contribution for a year if neither spouse is an active participant in an employer-sponsored plan or the couple has combined adjusted gross income (AGI) of less than $40,000.

If a single taxpayer or either spouse (in the case of a married couple) is an active participant in an employer-sponsored retirement plan, the maximum IRA deduction is phased out over certain AGI levels. For single taxpayers, the maximum IRA deduction is phased out between $25,000 and $35,000 of AGI. For married taxpayers, the maximum deduction is phased out between $40,000 and $50,000 of AGI. In the case of a married taxpayer filing a separate return, the deduction is phased out between $0 and $10,000 of AGI.[4]

An individual is an active participant in an employer-sponsored retirement plan for the taxable year if the individual is an active participant for the plan year ending with or within the individual's taxable year. An employer-sponsored retirement plan means (1) a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a));

[4] A couple is not considered married for purposes of the IRA deduction rules if the individuals file separate returns and live apart from one another at all times during the taxable year. In such a case, each spouse is treated as a single individual.

(2) a qualified annuity plan (sec. 403(a)); (3) a simplified employee pension plan (sec. 408(k)); (4) a plan established for its employees by the U.S., by a State or political subdivision, or by any agency or instrumentality of the U.S. or a State or political subdivision (other than an unfunded deferred compensation plan of a State or local government (sec. 457)); (5) a plan described in section 501(c)(18); and (6) a tax-sheltered annuity (sec. 403(b)).

The determination of whether an individual is an active participant depends on the type of plan involved. In general, in the case of a defined benefit pension plan, an individual is treated as an active participant if the individual is eligible to participate in the plan. An individual is an active participant in a defined contribution plan only if any amounts are allocated to the account of the participant for the year. The extent to which a person is vested in his or her benefits under an employer-sponsored plan is not taken into account under the active participant rules.

Nondeductible IRA contributions

Individuals may make nondeductible IRA contributions to the extent deductible contributions are not allowed because of the AGI phaseout and active participant rules. A taxpayer may also elect to make nondeductible contributions in lieu of deductible contributions. Thus, any individual may make nondeductible contributions up to the excess of (1) the lesser of $2,000 or 100 percent of compensation over (2) the IRA deduction claimed by the individual. An individual making nondeductible contributions is required to report the amount of such contributions on his or her tax return. As is the case with earnings on deductible IRA contributions, earnings on nondeductible contributions are not subject to income tax until withdrawn.

Taxation of withdrawals

Amounts withdrawn from IRAs (other than amounts that represent a return of nondeductible contributions) are includible in income when withdrawn. If an individual withdraws an amount from an IRA during a taxable year and the individual has previously made both deductible and nondeductible IRA contributions, then the amount includible in income for the taxable year is the excess of the amount withdrawn over the portion of the amount withdrawn attributable to investment in the contract (i.e., nondeductible contributions). The amount attributable to nondeductible contributions is the portion of the amount withdrawn that bears the same ratio to the amount withdrawn as the total amount of nondeductible contributions bears to the total current value of all IRAs of the individual.

To discourage the use of amounts contributed to an IRA for nonretirement purposes, withdrawals from an IRA prior to age 59-½, death, or disability are generally subject to an additional 10-percent income tax (sec. 72(t)). The 10-percent tax is intended to recapture at least a portion of the tax benefit of the IRA. The 10-percent tax does not apply to withdrawals that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of the taxpayer and the taxpayer's designated bene-

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ficiary. A similar early withdrawal tax applies to withdrawals from qualified retirement plans. There is an exception to the 10-percent tax for distributions from qualified plans (but not IRAs) used to pay extraordinary medical expenses of the employee or the employee's spouse or dependents. Extraordinary medical expenses are those that would be deductible if the individual itemized deductions, i.e., expenses that exceed 7.5 percent of adjusted gross income.

Elective deferrals

Under a qualified cash or deferred arrangement (sec. 401(k)), an individual can elect to have compensation paid in cash or contributed to a tax-qualified pension plan. Amounts contributed at the election of the employee are referred to as elective deferrals. Like other qualified plan contributions, elective deferrals are not includible in income until withdrawn from the plan. Qualified cash or deferred arrangements are subject to the same rules applicable to qualified plans generally, and are also subject to additional requirements. One of these additional requirements is that the maximum amount of elective deferrals that can be made in a year by an individual is limited to $9,240 in 1995. This dollar limit is indexed for inflation in $500 increments. A similar limit applies to elective contributions under similar arrangements (e.g., tax-sheltered annuities).

Description of Proposal

Deductible IRA contributions

The proposal would increase the income limits at which the IRA deduction is phased out for active participants in employer-sponsored retirement plans. The maximum IRA deduction would be phased out between $80,000 and $100,000 of AGI for married taxpayers and between $50,000 and $70,000 of AGI for single taxpayers. These limits would be indexed for inflation in $5,000 increments, beginning after 1996.

The $2,000 IRA deduction limit would be indexed for inflation in $500 increments, beginning after 1996.

The IRA deduction limit would be coordinated with the limit on elective deferrals so that the maximum allowable IRA deduction for a year could not exceed the excess of the elective deferral limit over the amount of elective deferrals made by the individual.

The proposal would provide that the exception to the early withdrawal tax for distributions after age 59-½ does not apply to amounts that have been held in an IRA for less than 5 years.

Nondeductible tax-free IRAs

Individuals who are eligible to make deductible IRA contributions would also be eligible to make nondeductible contributions to a "Special IRA". Special IRAs generally would be treated the same as IRAs, but also would be subject to special rules. The IRA deduction limit and the limit on contributions to Special IRAs would be coordinated. Thus, the maximum contribution that could be made in a year to a Special IRA would be the excess of the IRA deduction limit applicable to the individual over the amount of deductible

IRA contributions. Distributions from Special IRAs would not be includible in income to the extent attributable to contributions that had been in the Special IRA for at least five years. Withdrawals of earnings from Special IRAs before five years would be subject to income tax, and would also be subject to the 10-percent tax on early withdrawals (even if made after reaching age 59-½), unless used for one of the qualified purposes described below.

An individual whose AGI for a year falls below the upper end of the eligibility thresholds for deductible IRAs could convert an existing IRA into a Special IRA without being subject to the 10-percent tax on early withdrawals. The amount transferred from the deductible IRA to the Special IRA generally would be includible in the individual's income in the year of the transfer. However, if a transfer is made before 1997, the amount to be included in the individual's income with respect to the transfer would be spread evenly over four taxable years.

Exceptions to the early withdrawal tax

The proposal would provide exemptions from the 10-percent early withdrawal tax for distributions from IRAs or Special IRAs used for certain purposes. Penalty-free withdrawals could be made for (1) qualified higher education expenses, (2) acquisition of a principal residence for a first-time homebuyer, and (3) distributions to individuals who have been receiving unemployment compensation for at least 12 consecutive weeks. The proposal also would extend to IRAs the exception for distributions from qualified plans for extraordinary medical expenses and would expand the scope of the exception.

Qualified higher education expenses generally would be tuition and fees at an institution of higher education for an eligible student who is the taxpayer, the taxpayer's spouse, the taxpayer's dependent, or any child or grandchild of the taxpayer (even if not a dependent for tax purposes). "Institution of higher education" and "eligible student" would be defined as under the proposed deduction for higher education expenses (see I. B., above).

First-time homebuyers would be individuals who did not own an interest in a principal residence during the three years prior to the purchase of a home and who were not in an extended period for rolling over the gain from the sale of a principal residence. Penalty-free IRA withdrawals could be made for the acquisition, construction, or reconstruction costs of a principal residence for a first-time homebuyer who is the taxpayer or the taxpayer's spouse, child, or grandchild.

An unemployed individual would be permitted to make a penalty-free IRA withdrawal if the individual has received unemployment compensation for at least 12 consecutive weeks during the taxable year in which the withdrawal is made or the preceding taxable year.

The proposal would extend to IRAs the present-law exception to the early withdrawal tax for distributions from tax-qualified plans for medical care expenses exceeding 7.5 percent of adjusted gross income. The proposal would extend the exception to apply to medical expenses of a child, grandchild, or ancester of the taxpayer or the taxpayer's spouse, regardless of whether such person would

otherwise qualify as the taxpayer's dependent. In addition, for this purpose, the definition of medical care would include qualified long-term care services for incapacitated individuals. Qualified long-term care services generally would be services that are required by an incapacitated individual, if the primary purpose of the services is to provide needed assistance with any activity of daily living or protection from threats to health and safety due to severe cognitive impairment. An incapacitated individual generally would be a person who is certified by a licensed professional within the preceding 12-month period as being unable to perform (without substantial assistance) at least two activities of daily living, or as having severe cognitive impairment.

Effective Date

The proposal would generally be effective for taxable years beginning after December 31, 1995.

II. DESCRIPTION OF H.R. 981 AND S. 453 ("TAX COMPLIANCE ACT OF 1995")

A. Earned Income Tax Credit Provisions

(Secs. 101–102 of the bill)

Present Law

EITC, in general

Eligible low-income workers are able to claim a refundable earned income tax credit (EITC). The amount of the credit an eligible taxpayer may claim depends upon whether the taxpayer has one, more than one, or no qualifying children and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income threshold. The maximum amount of the credit is the product of the credit rate and the earned income threshold. For taxpayers with earned income (or adjusted gross income, if greater) in excess of the phaseout threshold, the credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or adjusted gross income, if greater) in excess of the phaseout threshold. The credit is not allowed if earned income (or adjusted gross income, if greater) exceeds the phaseout limit.

The parameters for the EITC depend upon the number of qualifying children the taxpayer claims. For 1995 the parameters are as follows:

	Two or more qualifying children—	One qualifying child—	No qualifying children—
Credit rate (percent)	36.00	34.00	7.65
Phaseout rate (percent)	20.22	15.98	7.65
Earned income threshold	$8,640	$6,160	$4,100
Maximum credit	$3,110	$2,094	$314
Phaseout threshold	$11,290	$11,290	$5,130
Phaseout limit	$26,673	$24,396	$9,230

The earned income threshold and the phaseout threshold are indexed for inflation; because the phaseout limit depends on those amounts, the phaseout rate, and the credit rate, the phaseout limit will also increase if there is inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

The credit rates and phaseout rates for the EITC change over time under present law. For 1996 and after, the credit rate will be 40.00 percent and the phaseout rate will be 21.06 percent for taxpayers with two or more qualifying children. The credit rate and the phaseout rate for taxpayers with one qualifying child or no

qualifying children will be the same as those listed in the table above.

In order to claim the EITC, a taxpayer must either have a qualifying child or must meet other requirements. A qualifying child must meet a relationship test, an age test, an identification test, and a residence test. In order to claim the EITC without a qualifying child, a taxpayer must not be a dependent and must be over age 24 and under age 65.

To satisfy the identification test for a qualifying child, taxpayers must include on their tax return the name and age of each qualifying child. For returns filed with respect to tax year 1995, taxpayers must provide a taxpayer identification number (TIN) for all qualifying children who were born on or before October 31, 1995. For returns filed with respect to tax year 1996, taxpayers must provide TINs for all qualifying children born on or before November 30, 1996. For returns filed with respect to tax year 1997 and all subsequent years, taxpayers must provide TINs for all qualifying children, regardless of their age.

A taxpayer's TIN is generally that taxpayer's social security number. Some taxpayers are exempted from social security self-employment taxes because of their religious beliefs. These taxpayers do not have a social security number; instead, the Internal Revenue Service administratively assigns them a taxpayer identification number.

Nonresidents and the EITC

The EITC may be claimed by a taxpayer meeting the above requirements if the taxpayer is a U.S. citizen or a resident alien.

Section 7701(b) defines a resident alien for income tax purposes. Aliens who do not meet this definition are nonresident aliens. For income tax purposes, an individual is generally considered a resident if the individual:

(1) has entered the United States as a lawful permanent U.S. resident (the "green-card test"); or

(2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for 183 or more days during a three-year period weighted toward the present year (the "substantial-presence test"). (An individual who is present in the United States for fewer than 183 days and establishes that he has a closer connection with a foreign country than with the United States is generally not subject to tax as a resident alien on account of the substantial-presence test.)

The implementing legislation for the General Agreements on Tariffs and Trade (P.L. 103–465) made individuals who are nonresident aliens for any portion of the taxable year ineligible to claim the EITC for taxable years beginning after December 31, 1994, unless an election under Code section 6013(g) or (h) is in effect for the taxable year.

Under section 6013(g), a nonresident alien who is married to an individual who is either a citizen or resident alien of the United States at year end may elect to be treated as a resident for the entire year. The election applies to the year for which it is made and

all subsequent years until terminated. However, the election will be suspended if neither spouse is a U.S. citizen or resident at any time during a taxable year.

Under section 6013(h), an individual who (1) is a nonresident alien at the beginning of the year and a resident alien at the end of the year and (2) is married to an individual who is either a citizen or resident of the United States at year end may elect to be treated as a resident for the entire year. Thus, this election can be made by a foreign married couple who arrive in the United States during the taxable year and who are resident aliens at year end.

Mathematical errors

The IRS may summarily assess additional tax due as a result of a mathematical error without sending the taxpayer a notice of deficiency and an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. This procedure is the only one a taxpayer may use for contesting an assessment arising out of a mathematical or clerical error.

Description of Proposals

1. Earned income tax credit denied to individuals not authorized to be employed in the United States

Taxpayers would not be eligible for the EITC if they do not include their taxpayer identification number (and, if married, their spouse's taxpayer identification number) on their tax return. Solely for these purposes and for purposes of the present-law identification test for a qualifying child, a taxpayer identification number would be defined as a social security number issued to an individual by the Social Security Administration other than a number issued under section 205(c)(2)(B)(i)(II) (or that portion of 205(c)(2)(B)(i)(III) relating to it) of the Social Security Act (regarding the issuance of a number to an individual applying for or receiving Federally funded benefits). Thus, if an individual obtained a social security number solely because that individual is an applicant for or a recipient of Federally funded benefits, the individual would be ineligible to claim the EITC.

If a taxpayer fails to provide a correct taxpayer identification number, such omission would be treated as a mathematical or clerical error and thus any notification that the taxpayer owes additional tax because of that omission would not be treated as a notice of deficiency.

2. Earned income tax credit denied to individuals with substantial unearned income

A taxpayer would not be eligible for the EITC if the aggregate amount of interest and dividends includible in his income for the taxable year exceeds $2,500. For taxable years beginning after 1996, the $2,500 limit would be indexed for inflation with rounding to the nearest multiple of $50.

Effective Dates

The proposals would be effective for taxable years beginning after December 31, 1995.

B. Foreign Tax Provisions

1. Tax responsibilities of expatriation (sec. 201 of the bill)

Present Law

U.S. citizens and residents generally are subject to U.S. income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. business (sec. 871).

A U.S. citizen who becomes a nonresident alien [5] with a principal purpose to avoid Federal income tax may be subjected to an alternative taxing method for 10 years after expatriation (sec. 877). Under this alternative method, the expatriate is generally taxed on his or her U.S. source income (net of certain deductions), as well as on certain business profits, at rates applicable to U.S. citizens. Solely for this purpose, gains on the sale of property located in the United States and stocks and securities issued by U.S. persons are also treated as U.S. source income (sec. 877(c)). The alternative method applies only if it results in a higher U.S. tax liability than the amount otherwise determined for nonresident aliens. Whether tax avoidance is a principal purpose for the expatriation is determined by all of the relevant facts and circumstances (sec. 877(e)).[6] A similar rule applies in the case of an alien individual who is treated as a resident of the United States for three consecutive years, ceases to be a resident, and subsequently again becomes a resident within three years after the close of the initial residency period (sec. 7701(b)(10)).

Description of Proposal

Under the proposal, a U.S. citizen who relinquishes U.S. citizenship generally would be treated as having sold all of his or her property at fair market value immediately prior to the expatriation. Thus, gain or loss from the deemed sale would be subject to U.S. income tax. Further, any period for the deferral of tax or recognition of income or gain for U.S. tax purposes (e.g., due to the installment method) would terminate on the date of the deemed sale and the deferred tax would be due and payable on that date.

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[5] An individual who is neither a U.S. citizen nor a resident alien (i.e., a resident of the United States for income tax purposes) is described as a nonresident alien. An individual who is not a U.S. citizen is treated as a resident alien if such person (1) is a lawful permanent resident of the United States (i.e., holds a green card), or (2) satisfies the "substantial presence" test as a result of spending the requisite amount of time within the United States during specified periods. (See sec. 7701(b).)

[6] According to informal discussions with the State Department, 697 citizens expatriated in 1993 and 858 in 1994. It is not yet known how many of these former citizens, if any, will be subjected to tax under section 877.

The tax also would apply to "long-term residents" who cease to be subject to tax as residents of the United States. The proposal would define a long-term resident as an individual who had been a lawful permanent resident of the United States (i.e., a green-card holder), other than an individual who was taxed as a resident by another country under a treaty tie-breaker rule, in at least 10 of the prior 15 taxable years.[7]

Assets within the scope of the proposal generally would include all property interests that would be included in the individual's gross estate under the Federal estate tax if such individual were to die on the day of the deemed sale, plus certain trust interests that are not otherwise included in the gross estate. The first $600,000 of net gain recognized on the deemed sale would be exempt from tax. U.S. real property interests, which remain subject to U.S. taxing jurisdiction in the hands of nonresident aliens, generally would be excepted from the proposal.[8] The exception also would apply to interests in qualified retirement plans and, subject to a limit of $500,000, interests in certain foreign pension plans. The Internal Revenue Service would be authorized to allow a taxpayer to defer, for a period of no more than five years, payment of the tax attributable to the deemed sale of a closely-held business interest (as defined in sec. 6166(b)).

Solely for purposes of this provision, a special election would permit long-term residents to determine the tax basis of certain assets using their fair market value, rather than their historical cost. The election, if made, would apply to all assets within the scope of the proposal that were held on the date the individual first became a U.S. resident and the fair market value would be determined as of such date.

A U.S. citizen would be treated as having relinquished his or her citizenship on the date that the U.S. Department of State issues a certificate of loss of nationality, and would be subject to U.S. tax as a citizen of the United States until that time. In the case of a naturalized U.S. citizen whose citizenship is revoked, the individual would be treated as relinquishing his or her citizenship on the date that a U.S. court cancelled the certificate of naturalization, and would be subject to U.S. tax as a citizen of the United States until that time. A long-term resident who ceases to be taxed as a U.S. resident would be subject to the proposal at the time of such cessation.

Effective Date

The proposal would be effective for U.S. citizens who relinquish their U.S. citizenship on or after February 6, 1995, and for long-term residents who cease to be subject to tax as U.S. residents on or after February 6, 1995.

Present law would continue to apply to all others.

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[7] If a long-term resident surrenders his or her green card, such person may still be treated as a resident for U.S. income tax purposes if he or she has a "substantial presence" within the United States. (See sec. 7701(b)(3).) The proposal would not apply so long as such person continues to be treated as a tax resident under the substantial-presence test.

[8] The exception would apply to all U.S. real property interests, as defined in section 897(c)(1), except the stock of a U.S. real property holding corporation that does not satisfy the requirements of section 897(c)(2) on the date of the deemed sale.

2. Revised taxation of income from foreign trusts

a. Information reporting relating to foreign trusts (sec. 202 of the bill)

Present Law

Information reporting requirements

Any U.S. person who creates a foreign trust or transfers money or property to a foreign trust is required to report that event to the Internal Revenue Service (sec. 6048(a)). Current regulations require reporting of, among other things, the name, address and identification number (if any) of the transferor, the trust, the fiduciary and trust beneficiaries; the interest of each beneficiary; the location of the trust records and the value of each item transferred (Treas. reg. sec. 16.3-1(c)).

Similarly, any U.S. person who transfers property to a foreign trust that has one or more U.S. beneficiaries is required to report annually to the Internal Revenue Service (sec. 6048(c)).

Penalties for failure to report

Any person who fails to file a required report of the creation of or transfer to a foreign trust may be subjected to a penalty of 5 percent of the amount transferred to the foreign trust (sec. 6677). Similarly, any person who fails to file a required annual report with respect to a foreign trust with U.S. beneficiaries may be subjected to a penalty of 5 percent of the value of the corpus of the trust at the close of the taxable year. The maximum amount of the penalty imposed under either case may not exceed $1,000. A reasonable cause exception is available. These civil penalties are determined separately from any applicable criminal penalties.

Description of Proposal

The proposal would amend section 6048 to impose three types of reporting requirements with respect to foreign trusts if there is a U.S. grantor of the foreign trust or a distribution from the foreign trust to a U.S. person. The proposal would require various responsible parties, such as a U.S. grantor or a trustee of the foreign trust, to file the designated information reports with the Treasury Department upon the occurrence of certain events. A failure to comply with the reporting requirement would result in substantial monetary penalties under section 6677.

Information reporting requirements

First, the proposal would require the grantor, transferor, trustee or fiduciary (i.e., the "responsible party") to notify the Treasury Department of certain transfers of property to a foreign trust. Reporting requirements also would apply to certain events that cause the foreign trust to have a U.S. grantor and the death of a U.S. grantor. The required notice would identify the property transferred and report information regarding the trustee and beneficiaries of the foreign trust. The responsible party also would be required to inform all trustees of the foreign trust as to the information reporting

and related requirements, discussed below, that are imposed on the trust.

Second, if at any time during its taxable year a foreign trust has a U.S. grantor or makes a distribution to a U.S. person, the trustee would be required (1) to file a statement to report certain information, and (2) to authorize a U.S. person to accept service of process as the trust's limited agent in connection with any request by the Internal Revenue Service to examine records or to take testimony, or with respect to any summonses for such records or testimony in connection with the tax treatment of any items related to the trust. This limited agency relationship would not constitute an agency relationship for any other purpose under Federal or State law.

Further, an annual return also would be required to provide a full accounting of all the trust activities for the taxable year. Information would be furnished to U.S. grantors and beneficiaries for income reportable by such persons in a manner similar to the items on schedule K-1 of Form 1041 (which is required to be filed on behalf of a domestic trust).

Penalties for failure to report

Under the proposal, a failure to provide the required notice would result in a minimum penalty of $10,000. An additional $10,000 penalty would be imposed for continued failure for each 30-day period (or fraction thereof) beginning 90 days after the IRS notifies the responsible party of such failure. In certain cases involving the establishment of a foreign trust or a transfer of property to a foreign trust, the amount of the penalty would be not less than 35 percent of the gross value of the property involved. There would be no ceiling imposed on the amount of monetary penalty imposed. The monetary penalties would be imposed on the U.S. grantor or transferor in most cases. A foreign trustee would not be subject to any such penalties.

Upon a failure to properly file the section 6048 statement or the annual return, the Treasury Department would be authorized to determine, in its sole discretion, the U.S. tax consequences of any trust-related items or transactions with respect to a U.S. grantor or beneficiary. An example of such a determination might be the imputation of taxable income to a U.S. grantor based on the value of the property held by a foreign trust. Additionally, the grantor would be subject to a $10,000 penalty for each such failure. This penalty would be increased for continued noncompliance (in a manner similar to the penalty imposed on failure to file a proper notice). There would be no ceiling on the amount of monetary penalty imposed.

An exception would apply if the failure to comply with the reporting requirement is due to reasonable cause.

Effective Date

The notice requirement and applicable penalties generally would apply to reportable events occurring on or after February 6, 1995. The annual reporting requirements generally would apply to taxable years beginning after the date of enactment.

b. Outbound foreign grantor trusts (sec. 203 of the bill)

Present Law

Under the "grantor trust" rules, certain trusts are treated for tax purposes as if the grantor or another person is the owner of all or a portion of the trust (secs. 671-679). The individual income tax of the owner of a portion of a grantor trust is determined by including those items of income, deduction, and credit of the trust that are attributable to that portion of the trust assets (sec. 671). A trust is treated as a grantor trust if any of several specified powers is held by, or for the benefit of, the grantor; these powers generally include holding a significant reversionary interest in the income or corpus of the trust (sec. 673), certain powers to control beneficial enjoyment of the trust (sec. 674), certain administrative powers (sec. 675), the power to revoke the trust and revest assets in the grantor (sec. 676), and the power to distribute or accumulate income for the benefit of the grantor or the grantor's spouse (sec. 677). A person other than the grantor generally is treated as the owner of a portion of a trust if that person has the power to withdraw that portion of the trust assets or the income generated thereby, unless the grantor trust rules otherwise already apply to that portion of the trust (sec. 678).

A U.S. person who transfers property to a foreign trust generally is treated as the owner, under the grantor trust rules, of the portion of the trust comprising that property for any taxable year in which there is a U.S. beneficiary of any portion of the trust (sec. 679). This treatment generally does not apply, however, to transfers by reason of death; to transfers in the form of a sale or exchange of property at fair market value, where gain is recognized to the transferor; or to transfers made prior to the time the transferor became a U.S. person.

Description of Proposal

In general

The proposal would make several modifications to the rules of section 679 under which foreign trusts with U.S. beneficiaries are treated as grantor trusts.

Property transferred at death and migrating trusts

The proposal would repeal the exception from grantor trust treatment for property transferred to such a foreign trust at the death of the grantor. In the event of the death of a U.S. person who was treated as owner of the foreign trust, or the transfer of property to the foreign trust by reason of the death of a U.S. person, the beneficiaries of the trust would be treated as having transferred to the trust the assets represented by their respective interests in the trust. Similarly, if a U.S. trust becomes a foreign trust, the beneficiaries of the trust would be treated as having transferred to the trust the assets represented by their respective interests in the

trust.[9] Consequently, any such deemed grantors who are U.S. persons would be treated under the rules of section 679 as owners of their respective portions of the trust.

In such a case, the respective portions of the beneficiaries in the trust would be determined on the basis of all facts and circumstances relevant to their interests in the trust. These would include the terms of the trust instrument itself, any letter of wishes or similar document, historical patterns of trust distributions, the role of any trust protector or similar advisor, and anything else of relevance. In the event that any beneficiaries' interests in the trust cannot be determined on the basis of the facts and circumstances, the beneficiary with the closest degree of family relationship to the settlor would be presumed to hold the remaining interests in the trust. Each beneficiary would be required to disclose on his or her tax return the methodology used to determine that beneficiary's interest in the trust, and whether that beneficiary knows (or has reason to know) that any other beneficiary of the trust uses a different method.

Sale or exchange at market value

The proposal would limit the present exception from grantor trust treatment for property transferred to the trust in the form of a sale or exchange at fair market value, where gain is recognized to the transferor. In determining whether or not the trust paid fair market value to the transferor, obligations issued (or guaranteed) by the trust, by any grantor or beneficiary of the trust, or by any person related to a grantor or beneficiary generally would not be taken into account. The exception would apply only to actual sales or exchanges, but not to deemed sales pursuant to an election under section 1057.

It is understood that the extension of credit by unrelated persons in the course of legitimate commercial transactions generally would not be disregarded under this rule.

Transferors who become U.S. persons

The proposal would apply the rules of section 679 to certain foreign persons who transfer property to a foreign trust and subsequently become U.S. persons. A nonresident alien individual who transfers property, directly or indirectly, to a foreign trust and then becomes a resident of the United States within five years after the transfer generally would be treated as making a transfer to the foreign trust at the time the individual becomes a U.S. resident. The amount of the deemed transfer would be the portion of the trust (including undistributed earnings and appreciation) attributable to the property previously transferred. Consequently, the individual generally would be treated under the rules of section 679 as the owner of that portion of the trust in any taxable year in which the trust has U.S. beneficiaries.

[9] In a case where the domestic trust is established as part of a plan to transfer assets to a foreign trust, it is understood that the Commissioner would be permitted to treat a U.S. settlor of the domestic trust as the grantor of the foreign trust.

Effective Date

The proposal generally would apply to trusts created on or after February 6, 1995, and to the portion of any other trust that is attributable to property transferred to the trust on or after that date.

c. Inbound foreign grantor trusts (secs. 204–206 of the bill)

Present Law

Under the grantor trust rules, a grantor is treated as the owner of the trust's assets generally without regard to whether the grantor is a domestic or foreign person. Under these rules, U.S. trust beneficiaries can avoid U.S. tax on trust distributions, where a foreign grantor is treated as owner of the trust even though no tax may be imposed on the trust income by any jurisdiction (see Rev. Rul. 69–70, 1969–1 C.B. 182).

A special rule applies in the case of a grantor trust with a U.S. beneficiary, where the grantor trust rules otherwise would treat a foreign person as owner of a portion of the trust, and the U.S. beneficiary had made any gifts, directly or indirectly, to the foreign person. In such a case, the U.S. beneficiary generally is treated as the grantor and owner of that portion to the extent of the gifts to the foreign person (sec. 672(f)).

Present law also provides a special rule under which intermediaries or nominees interposed between certain foreign trusts and their beneficiaries can be disregarded. This special rule treats any amount paid from a foreign person to a U.S. person, where the amount was derived (directly or indirectly) from a foreign trust that was created by a U.S. person, as if paid to the recipient directly by the foreign trust (sec. 665(c)).

Description of Proposal

Foreign grantors not treated as owners

Under the proposal, the grantor trust rules generally would apply only to the extent that they resulted, directly or indirectly, in income inclusions to a citizen or resident of the United States, or to a domestic corporation.[10] Thus, the grantor trust rules generally would not apply to any portion of a trust where their effect would be to treat a foreign person as owner of that portion. The proposal provides an exception to this general rule for any investment trust that is treated as a trust for tax purposes. The grantor trust rules could treat a foreign grantor of a portion of such a trust as the owner of that portion of the trust assets, as under present law, but only if the grantor is also the sole beneficiary of that portion of the trust.

It is understood that a trust that is treated as a grantor trust under present law but would not be treated as a grantor trust under the proposal would be treated as if the trust assets were contributed to the trust by the foreign grantor, with no recognition of

[10] This would include treatment of a controlled foreign corporation as a grantor to the extent the trust income generates income inclusions to U.S. shareholders under subpart F.

gain or loss, on the date the trust ceases to be treated as a grantor trust.

In a case where the foreign grantor, who would be treated as owner of the trust but for the limitation of the grantor trust rules to domestic grantors, actually pays tax on the income of the trust under grantor trust rules in the foreign person's home country, the proposal generally would allow the U.S. beneficiaries who are subject to U.S. income tax on that income to be treated, for foreign tax credit purposes, as having paid the foreign taxes that were paid by the foreign grantor or trust. Any resulting foreign tax credits would be subject to applicable foreign tax credit limitations.

The proposal would provide a transition rule for any domestic trust that has a foreign grantor who is treated as the owner under present law. Such a trust, if it were to become a foreign trust before January 1, 1996, or if its assets were transferred to a foreign trust before that date, would be exempted from the excise tax on transfers to a foreign trust otherwise imposed by section 1491.

Indirect payments from foreign trusts

The proposal would treat any amount paid by a foreign person to a U.S. person, where the amount was derived (directly or indirectly) from a foreign trust of which the foreign person was not the settlor, as if paid by the foreign trust directly to the U.S. person. This rule would disregard the role of an intermediary or nominee that may be interposed between a foreign trust and a U.S. beneficiary. Unlike present law, however, the rule would apply whether or not the trust was created by a U.S. person. The rule would not apply to a withdrawal from a foreign trust by its grantor, with a subsequent gift or other payment to a U.S. person.

Gratuitous transfers from corporations and partnerships

The proposal would provide authority to the Treasury Department to recharacterize the tax treatment of purported gifts made by a foreign corporation or a domestic or foreign partnership to a person who is not a shareholder of the corporation or a partner of the partnership, in order to prevent the avoidance of tax. Any taxpayer that treats the receipt of such an amount as a gift for tax purposes would be required to attach a statement to his income tax return for the year of receipt, identifying the property received and describing fully the circumstances surrounding the gift. Gifts made for bona fide business or charitable purposes would not be subject to this rule. In addition, amounts received by any person that do not exceed $2,500 in a taxable year would be exempt from the rule.

Reporting of large foreign gifts

The proposal generally would require any U.S. person (other than certain tax-exempt organizations) that receives purported gifts or bequests from foreign sources totaling more than $100,000 during the taxable year to report them to the Internal Revenue Service. The definition of a gift to a U.S. person for this purpose would exclude qualified tuition or medical payments made on behalf of the U.S. person, as defined for gift tax purposes (sec. 2503(e)). If the U.S. person fails, without reasonable cause, to report foreign gifts as required, the Treasury Department may im-

pose penalties on the U.S. person and the Treasury Department would be authorized to determine, in its sole discretion, the tax treatment of the unreported gifts, based on information in the Treasury Department's possession or as it may obtain.

Effective Date

The proposal to limit the application of the grantor trust rules in the case of foreign grantors, and the proposed amendment to the rule concerning indirect payments from foreign trusts, would apply beginning on the date of enactment of the proposals.

The proposed treatment of gratuitous transfers from certain corporations and partnerships, and the proposed reporting rule with respect to the receipt of large foreign gifts, would apply to amounts received after the date of enactment of the proposals.

d. Foreign trusts that are not grantor trusts (sec. 207 of the bill)

Present Law

In cases where the grantor trust rules do not apply to a foreign trust, its U.S. beneficiaries generally are taxable on their respective shares of the income of the trust that is required to be distributed, as well as any other income of the trust that is paid, credited, or distributed to them (secs. 652, 662). Distributions from a trust in excess of the trust's distributable net income for the taxable year generally are treated as "accumulation distributions" (sec. 665(b)). Accumulation distributions from a foreign trust are taxed under the so-called "throw back" or "accumulation distribution" rules. Under these rules, a distribution by a foreign trust of previously accumulated income generally is taxed at the beneficiary's average top marginal rate for the prior 5 years, plus interest (secs. 666, 667)). Interest is computed at a fixed annual rate of 6 percent, with no compounding (sec. 668).

If adequate records of the trust are not available to determine the proper application of the rules relating to accumulation distributions to any distribution from a trust, the distribution is treated as an accumulation distribution out of income earned during the first year of the trust (sec. 666(d)).

The tax consequences of the use of trust assets by beneficiaries are somewhat uncertain under present law. Compare *H.B. Plant v. Commissioner*, 30 B.T.A. 133 (1934), *aff'd*, 76 F.2d 8 (2d Cir. 1935)(holding that a beneficiary's mere right to occupy trust property did not mean that the trust's payment of maintenance expenses should be treated as distributions to the beneficiary) with *Alfred I. duPont Testamentary Trust v. Commissioner*, 66 T.C. 761 (1976), *aff'd*, 574 F.2d 1332 (5th Cir. 1978)(calling into question the rationale of *Plant*, while reaching a similar conclusion).

Description of Proposal

Interest charge on accumulation distributions

The proposal would change the interest applicable to accumulation distributions from foreign trusts generally from simple interest at a fixed rate of 6 percent to compound interest determined in a

manner similar to the interest imposed on underpayments of tax under section 6621(a)(2). Simple interest on tax amounts determined under the accumulation distribution rules would continue to accrue at the rate of 6 percent until 1996. For periods beginning in 1996, however, compound interest based on the underpayment rate would be imposed not only on tax amounts determined under the accumulation distribution rules but also on the total simple interest for pre-1996 periods, if any.

The proposal would include two anti-abuse rules. First, the Treasury Department would be authorized to issue regulations that may be necessary or appropriate to carry out the purposes of the rules applicable to accumulation distributions, including regulations to prevent the avoidance of those purposes.

Second, any foreign trust that fails to comply with the proposal's information reporting requirements would be treated as not providing adequate records for purposes of the application of the rules relating to accumulation distributions.

In addition, the proposal would clarify the tax treatment applicable to an accumulation distribution that is received by a citizen or resident of the United States who was a nonresident alien during one or more of the years during which income was accumulated in the trust. Under the proposal, the full amount of the accumulation distribution would be treated as an accumulation distribution, but no interest would be imposed with respect to earnings attributable to trust years prior to the beginning of the beneficiary's U.S. citizenship or residence.

Use of trust property by grantors and beneficiaries

The proposal also would provide that the use of any property of a foreign trust by a grantor or a beneficiary, whether directly or indirectly, generally would be treated as a specific distribution, out of the trust's accumulated income, to that grantor or beneficiary of the fair market value of the use of the property. The amount of the deemed distribution would be reduced by amounts paid, if any, by the grantor or beneficiary for the use of the property. In the case of cash or cash equivalents loaned by the foreign trust to a grantor or beneficiary (or a person related to a grantor or beneficiary), the full amount of the loan would be treated as distributed to the grantor or beneficiary, even if the loan bears interest at an adequate rate and is subsequently repaid.

Use of any property of a foreign trust by any person related to a grantor or beneficiary would be treated as use by the grantor or beneficiary. If the person who uses the property is related to more than one grantor or beneficiary, the use would be attributed to the grantor or beneficiary most closely related to the person who uses the property.

The proposal would disregard the use of trust property by a grantor or beneficiary (and persons related to that grantor or beneficiary) for a taxable year if the total amount treated as distributed to that grantor or beneficiary on account of the use of trust property is less than $2,500.

Effective Date

The proposals would apply to taxable years beginning after the date of enactment of the proposals.

e. Residence of trusts (sec. 208 of the bill)

Present Law

An estate or trust is treated as foreign if it is not subject to U.S. income taxation on its income that is neither derived from U.S. sources nor effectively connected with the conduct of a trade or business within the United States (sec. 7701(a)(31)). Thus, if a trust is taxed in a manner similar to a nonresident alien individual, it is considered to be a foreign trust. Any other estate or trust is treated as domestic (sec. 7701(a)(30)).

The Code does not specify what characteristics must exist before a trust is treated as being comparable to a nonresident alien individual. However, IRS rulings and court cases indicate that this status depends on various factors, such as the residence of the trustee, the location of the trust assets, the country under whose laws the trust is created, the nationality of the grantor, and the nationality of the beneficiaries.[11] If an examination of these factors indicates that a trust has sufficient foreign contacts, it is deemed comparable to a nonresident alien individual and thus is a foreign trust.

Description of Proposal

The proposal would establish a two-part objective test for determining for tax purposes whether a trust is foreign or domestic. If both parts of the test are satisfied, the trust would be treated as domestic. Only the first part of the test would apply to estates.

Under the first part of the proposed test, in order for an estate or trust to be treated as domestic, a U.S. court (i.e., Federal, State, or local) must be able to exercise primary supervision over the administration of the estate or trust. It is expected that this test would be satisfied by any trust instrument that specifies that it is to be governed by the laws of any State. In addition, an estate or trust may be able to subject itself voluntarily to the jurisdiction of a U.S. court through registration of the estate or trust under a State law similar to Article VII of the American Law Institute's Uniform Probate Code.

Under the second part of the proposal's test, in order for a trust to be treated as domestic, one or more U.S. fiduciaries must have the authority to control all substantial decisions of the trust. It is expected that this test would be satisfied in any case where fiduciaries who are U.S. persons hold a majority of the fiduciary power (whether by vote or otherwise), and where no foreign fiduciary, such as a "trust protector" or other trust advisor, has the power to veto important decisions of the U.S. fiduciaries. It is further expected that, in applying this test, a reasonable period of time would be allowed for a trust to replace a U.S. fiduciary who resigns or dies before the trust would become treated as foreign.

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[11] For example, see Rev. Rul. 60-181, 1960-1 C.B. 257, and *B.W. Jones Trust v. Commissioner*, 46 B.T.A. 531 (1942), *aff'd*, 132 F.2d 914 (4th Cir. 1943).

Under the proposal, a foreign estate would be defined as an estate other than an estate that is determined to be domestic under the court-supervision test. A foreign trust would be defined as a trust other than a trust that is determined to be domestic under both the court-supervision test and the U.S. fiduciary test.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1996. In addition, if the trustee of a trust so elects, the proposal would apply to taxable years beginning after the date of enactment of the proposal.

C. Increase in Number of 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 (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994. As required by law, six empowerment zones are located in urban areas and three empowerment zones are located in rural areas.[12] Of the enterprise communities, 65 are located in urban areas and 30 are located in rural areas (sec. 1391). Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations (sec. 1392). The designated areas were selected from among over 500 areas nominated by State and local governments, which submitted proposed strategic plans to promote economic development in these areas.

The following tax incentives are available for certain businesses located in empowerment zones: (1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the zone; (2) an additional $20,000 of section 179 expensing for certain zone business property (accordingly, certain businesses operating in empowerment zones are allowed up to $37,500 of expensing); and (3) expanded tax-exempt financing for certain zone facilities. In contrast, the 95 enterprise communities are eligible for the expanded tax-exempt financing benefits, but not the other tax incentives available in the nine empowerment zones. In addition to these tax incentives, OBRA 1993 provided that Federal grants would be made to designated empowerment zones and enterprise communities.

The tax incentives for empowerment zones and enterprise communities generally will be available during the period that the designation remains in effect, i.e., a 10-year period.

Description of Proposal

The Secretary of HUD would be authorized to designate two additional empowerment zones located in urban areas (thereby increasing to eight the total number of empowerment zones located in urban areas). The two additional empowerment zones would be subject to the same eligibility criteria under present-law section

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

1392 that applied to the original six urban empowerment zones. In order to permit designation of two additional empowerment zones, the proposal would increase the present-law 750,000 aggregate population cap applicable to all empowerment zones located in urban areas to a cap of 1 million aggregate population for the eight urban empowerment zones. No additional Federal grants would be authorized.

Effective Date

The proposal would be effective on the date of enactment.

III. DESCRIPTION OF OTHER TAX PROPOSALS IN THE PRESIDENT'S FISCAL YEAR 1996 BUDGET

A. Extension of Hazardous Substance Superfund Taxes

Present Law

Four different taxes are imposed under present law to fund the Hazardous Substance Superfund ("Superfund") program. These are—

(1) An excise tax, imposed at a rate of 9.7 cents per barrel, on domestic or imported crude oil or refined petroleum products;

(2) An excise tax on listed hazardous chemicals, imposed at rates that vary from $0.22 to $4.87 per ton;

(3) An excise tax on imported substances that use as materials in their manufacture or production one or more of the hazardous chemicals described in (2) above; and

(4) A corporate environmental income tax equal to 0.12 percent of the amount of modified alternative minimum taxable income of a corporation that exceeds $2 million.

The Treasury Department is required to add to the list of imported taxable substances any substance if it determines that taxable chemicals constitute more than 50 percent of the weight or value of the materials used to produce such substance (determined on the basis of the predominant method of production). Treasury may remove from the list only those substances which meet neither test.

Amounts in the Superfund generally are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment as described in specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA").

The Superfund has limited general fund borrowing authority; all borrowings must be repaid no later than December 31, 1995. Spending from the Superfund is discretionary spending and is subject to the discretionary spending caps established in the Budget Enforcement Act of 1990.

In general, the Superfund taxes are scheduled to expire after December 31, 1995. However, present-law includes provisions for earlier termination of the taxes if the balance in the Superfund exceeds specified amounts on prescribed dates, or if more than $11.97 billion of revenues is credited to the Superfund before January 1, 1996.

Description of Proposal

The President's fiscal year 1996 budget proposal also would extend the present-law Superfund excise taxes on petroleum, chemicals, and imported substances through December 31, 2000, and the present-law corporate environmental income tax through taxable years beginning before January 1, 2001. Conforming amendments would be made to the rules (1) providing for earlier termination of the taxes if the Superfund unobligated balance exceeds certain levels or aggregate receipts exceed a prescribed maximum and (2) allowing limited general fund borrowing authority for the Superfund.

Effective Date

The proposal would be effective upon enactment.