# General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals

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PROVIDE TAX RELIEF

## Expand Education Initiatives

### COLLEGE OPPORTUNITY TAX CUT

#### Current Law

Individual taxpayers may claim a nonrefundable Hope Scholarship credit for qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or a claimed dependent, but only if such expenses are incurred during the first two years of post-secondary education and the student is enrolled on at least a half-time basis. The Hope Scholarship credit equals 100 percent of the first $1,000 of qualified expenses, plus 50 percent of the next $1,000 of qualified expenses. A taxpayer may claim a separate Hope Scholarship credit with respect to each eligible student. The Hope Scholarship credit phases out for taxpayers with modified adjusted gross income (AGI) from $40,000 to $50,000 ($80,000 to $100,000 for taxpayers filing joint returns). Modified AGI is AGI plus otherwise excludable foreign source income. The $1,000 amounts and the phase-out ranges are adjusted for inflation occurring after 2000.

In addition, individual taxpayers may claim a nonrefundable Lifetime Learning credit for qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or one or more dependents, but not including any expenses incurred on behalf of a student with respect to whom a Hope Scholarship credit is claimed for the same taxable year. Tuition and related expenses for post-secondary education are eligible for the Lifetime Learning credit for full- or part-time study at either the undergraduate or graduate level. The Lifetime Learning credit equals 20 percent of up to $5,000 of qualified tuition and related expenses incurred during the year ($10,000 of such expenses after 2002). In contrast to the Hope Scholarship credit (which is computed on a per-student basis), the Lifetime Learning credit is computed on a family basis. The phase-out ranges for the Lifetime Learning credit are the same as the phase-out ranges for the Hope Scholarship credit.

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses may be allowed under section 162 if the education or training either maintains or improves a skill required for the taxpayer's current job or meets the express requirements of the taxpayer's employer, or applicable law, imposed as a condition of employment. Education expenses are not deductible under section 162 if they relate to certain minimum educational requirements or if the education enables the taxpayer to begin working in a new trade or business. An employee's education expenses not reimbursed by an employer are deductible only to the extent that the expenses, along with other miscellaneous deductions, exceed two percent of the taxpayer's AGI.

**Reasons for Change**

Well-educated workers are essential to an economy experiencing technological change and facing global competition. Further reducing the after-tax cost of education for individuals and families through expanded tax credits and deductions will make college, graduate school and job training more affordable and provide tax relief to families burdened by the cost of post-secondary education.

**Proposal**

The Lifetime Learning credit would be expanded as follows: The credit rate would be increased from 20 percent to 28 percent. The modified AGI range over which the Lifetime Learning credit would be phased out would be raised, so that the credit would be phased out ratably between $50,000 and $60,000 for single filers, and between $100,000 and $120,000 for taxpayers filing joint returns. These phase-out ranges would be adjusted for inflation occurring after 2000.

In lieu of the Lifetime Learning credit, a taxpayer could elect to take a deduction for qualified tuition and related expenses. The deduction also would be limited to qualified expenses up to $10,000 ($5,000 in 2001 and 2002). This deduction would be "above-the-line" for all taxpayers – that is, the deduction could be claimed by taxpayers who do not itemize their deductions, and for taxpayers who do itemize, the deduction would not be subject to the two-percent threshold for miscellaneous deductions. As with the Lifetime Learning credit, the deduction would be phased out ratably between $50,000 and $60,000 of modified AGI (computed without regard to this deduction) and between $100,000 and $120,000 for joint returns. This 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 the proposal. Like the Lifetime Learning credit, the proposed deduction would be computed on a family-wide basis, taking into account qualified expenses incurred on behalf of the taxpayer, the taxpayer's spouse, and one or more claimed dependents, but not expenses incurred on behalf of any student with respect to whom a Hope Scholarship credit is claimed for the same taxable year.

Under the proposal, the phase-out ranges for the Hope Scholarship credit would not be changed. In cases where taxpayers claim a Hope Scholarship credit for one student and also claim a deduction in lieu of Lifetime Learning credit with respect to qualified expenses incurred on behalf of other students, the definition of modified AGI for purposes of the Hope Scholarship credit would reflect the deduction.

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

# PROVIDE INCENTIVES FOR PUBLIC SCHOOL CONSTRUCTION AND MODERNIZATION

## Current Law

Under current law, State and local governments fund public school construction by issuing bonds the interest on which generally is exempt from Federal income tax. In addition, State and local governments can issue "qualified zone academy bonds" to fund the improvement of certain eligible public schools. An eligible holder of a qualified zone academy bond receives annual Federal income tax credits. These annual credits compensate the holder for lending money and, therefore, are treated like taxable interest payments for Federal tax purposes. Eligible holders are banks, insurance companies, and corporations actively engaged in the business of lending money. The credit rate on a qualified zone academy bond is set on its day of sale by reference to credit rates established by the Department of the Treasury. The maximum term of a qualified zone academy bond issued during any month is determined by reference to the adjusted applicable Federal rate (AFR) published by the Internal Revenue Service for the month in which the bond is issued. The higher the AFR, the shorter the maximum term (rounded to whole years) so as to keep the extent of the Federal subsidy approximately equal to half the face amount of the bond.

Current law establishes authority to issue $400 million of qualified zone academy bonds for each year from 1998 through 2001. The annual cap is allocated among the States in proportion to their respective populations of individuals with incomes below the poverty line. Unused authority to issue qualified zone academy bonds may be carried forward for two years (three years for authority arising in 1998 and 1999) after the year for which the authority was established.

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

## Reasons for Change

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

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

## Proposal

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

### Qualified school modernization bonds

State and local governments, including U.S. possessions and Indian tribal governments, would be able to issue "qualified school modernization bonds" in the form of tax credit bonds to fund the construction, rehabilitation or repair of public schools. $11 billion of qualified school modernization bonds would be allocated among States and certain school districts in each of 2001 and 2002. Half of this annual cap would be allocated among the 100 school districts with the largest number of children living in poverty and up to 25 additional school districts that the Secretary of Education determines are in particular need of assistance. The other half of the cap would be allocated among States and Puerto Rico. A small portion of the total cap would be set aside for each U.S. possession (other than Puerto Rico) based on its share of the total U.S. poverty population. The allocation among qualifying school districts and among States would be based on the amounts of Federal assistance received under the Basic Grant Formula for Title I of the Elementary and Secondary Education Act of 1965. This assistance is based primarily upon the number of low-income children residing in the district, with an adjustment for differences in per-pupil expenditures. States could use any appropriate mechanism for distributing their allocation among school districts, not necessarily the Title I formula. In addition, $200 million in 2001 and 2002 would be allocated by the Secretary of the Interior for the construction, rehabilitation, and repair of 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 if three requirements were met. First, the Department of Education must approve the school modernization plan of the State or eligible school district. The plan must (1) demonstrate that a comprehensive survey has been undertaken of the construction and renovation needs in the jurisdiction, and (2) describe how the jurisdiction will ensure that bond proceeds are used for the purposes of this proposal. Second, the issuing government must receive a bond allocation for a school modernization bond. Third, 95 percent or more of the bond proceeds must be used to construct (as well as acquire land on which construction is to take place), rehabilitate, or repair elementary and secondary public school facilities. Modernization plans for Bureau of Indian Affairs-funded schools would be approved by the Department of the Interior. Unlike qualified

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

Qualified zone academy bonds.

The proposal would provide additional authority for qualified zone academy bonds in the amount of $1 billion in 2001 (in addition to the current law amount of $400 million) and $1.4 billion in 2002. The list of permissible uses of proceeds of qualified zone academy bonds would be expanded to include school construction. In addition, the proposal would make several changes to the existing qualified zone academy bond statute, applicable to bonds issued after the effective date, to conform to the structure of tax credit bonds described below.

Rules applicable to tax credit bonds generally.

The holder of a tax credit bond would accrue Federal income tax credits on a quarterly basis equal to one-quarter of the annual credit rate multiplied by the amount held. Because the credits compensate the holder for lending money, they would be treated as payments of interest for Federal income tax purposes and, accordingly, would be included in the holder's gross income. The credits would be allowable against Alternative Minimum Tax as well as regular tax liabilities. Credit rates would be set on a daily basis equal to a measure of the yield on outstanding corporate bonds, following the existing rules for qualified zone academy bonds. The credit rate for a particular issue would be the announced rate for the date on which the sale of the issue occurs. The maximum term of the bonds would be 15 years. Any taxpayer would be able to hold a tax credit bond and thereby claim the tax credit. Treasury would provide regulations regarding the treatment of credits that flow through from a mutual fund to the holder of mutual fund shares. Ownership of the bonds and credits could be separated, or "stripped"; that is, rights to future credits could be sold separately from rights to repayment of principal. In addition, the credits could be transferred through sale and repurchase agreements. Unused credits could not be carried backward but would be carried forward. The proposal would require information returns to be provided with respect to holders (including corporations) that are entitled to credits.

Under the proposal, at least 95 percent of the tax credit bond proceeds must be used for qualifying purposes for the entire term of the bond. Any investment earnings (and earnings on those earnings) associated with unexpended proceeds during the three-year period following the date of issuance would be treated as proceeds. As of the date of issue, issuers must reasonably expect that at least 95 percent of bond proceeds would be expended for qualifying purposes within three years and that at least 95 percent of any property financed with bond proceeds will be used for a qualified purpose for at least the entire term of the bond. During the three-year period, unexpended proceeds may be invested only in bank accounts or U.S. Treasury securities maturing in three years or less. As of the date of issue, issuers must reasonably expect to incur a binding obligation with a third party to expend at least 10 percent of the proceeds of the issue within six months of the issue date and to allocate the bond sale proceeds to expenditures with due diligence. To the extent 95 percent of the proceeds is not expended by the end of the three-year period for qualifying purposes, unexpended proceeds must be used to retire bonds within 90 days. Tax credit bond proceeds could be allocated to reimburse qualifying expenditures paid prior to the issuance of the bonds under rules similar to those currently applicable to qualified

zone academy bonds. If the issuer establishes a sinking fund to repay principal, sinking fund amounts may be invested only in State and Local Government Securities (SLGS) issued by the Treasury. Both school modernization bonds and qualified zone academy bonds could be issued using a pooled financing structure so long as each loan satisfied the applicable requirements described above. Property financed with the proceeds of both types of bonds must be owned by a State or local governmental unit, or an agency thereof.

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

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

## EXPAND EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE TO INCLUDE GRADUATE EDUCATION

### Current Law

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

The exclusion applies with respect to undergraduate courses beginning before January 1, 2002. The exclusion does not apply to graduate level courses beginning after June 30, 1996.

### Reasons for Change

Well-educated workers are essential to an economy experiencing technological change and facing global competition. Reinstating the exclusion for graduate courses will expand educational opportunity and increase productivity. In addition, expanding the exclusion to apply to graduate courses will encourage retraining of current and former employees to reflect the changing needs of the workplace, and will simplify the rules for employers and workers by eliminating the need to distinguish between job-related graduate training and other employer-provided educational assistance.

## Proposal

The current-law exclusion would be expanded to apply to graduate courses beginning after July 1, 2000 and before January 1, 2002.

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

## Current Law

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

## Reasons for Change

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

## Proposal

The proposal would eliminate the limit on the number of months during which interest paid on a qualified education loan is tax-deductible. The proposal generally would be effective for interest paid on qualified education loans after December 31, 2000.

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

**Current Law**

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

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

**Reasons for Change**

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

**Proposal**

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

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

## TAX TREATMENT OF EDUCATION AWARDS UNDER CERTAIN FEDERAL PROGRAMS

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

**Current Law**

Section 117 provides tax-free treatment for certain scholarship and fellowship grants used to pay qualified tuition and related expenses, but not to the extent that any grant represents

compensation for services. The National Health Service Corps (NHSC) Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program provide certain education awards to participants on condition that the participants provide certain services. These education awards generally involve the payment of higher education expenses (under the NHSC program, the awards may be also used for the repayment or cancellation of existing or future student loans). Because the recipients are required to perform services in exchange for the education awards, the awards used to pay higher education expenses are taxable income to the recipient.

**Reasons for Change**

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

**Proposal**

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

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

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

**Current Law**

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

**Reasons for Change**

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

**Proposal**

The proposal would provide that any repayment or cancellation of a student loan under the NHSC Scholarship Program, the Americorps Education Award Program, or the Armed Forces Health Professions Loan Repayment Program is excludable from income. The tax-free treatment would apply only to the extent that the student incurred qualified tuition and related expenses in excess of creditable expenses -- that is, those expenses taken into account in determining the amount of any education credit claimed during academic periods when the student loans were incurred. If the otherwise allowable credit was reduced due to the taxpayer's AGI, creditable expenses should be reduced by the same proportion.

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

**Provide Poverty Relief and Revitalize Communities**

## EXPAND AND SIMPLIFY THE EITC

**Current Law**

Low and moderate-income workers may be eligible for the refundable earned income tax credit (EITC). For every dollar a low-income worker earns up to a limit, between 7.65 and 40 cents are provided as a tax credit. The applicable credit rate depends on the presence and number of children in the worker's family. For example, taxpayers with two or more qualifying children will receive 40 cents in tax credits for each dollar of earnings up to $9,720 in 2000. Thus, their maximum credit is $3,888.

Above a given income threshold, the size of the tax credit is gradually phased-out at a rate between 7.65 and 21.06 percent. The applicable phase-out rate also depends on the presence and number of children in the worker's family. For a worker with two or more qualifying children, the credit is reduced by 21.06 percent for each dollar of modified adjusted gross income (or earned income, if greater) above $12,690. The dollar thresholds are adjusted annually for inflation.

Generally, married couples are eligible for the EITC only if they file joint returns. The amount of the credit is based on a couple's combined income. Eligibility for the EITC and the amount of the credit otherwise do not depend on filing status.

For purposes of calculating the EITC, earned income includes wages, salaries, tips and other employee compensation, and net self-employment earnings. Employee compensation includes anything of value received by the taxpayer from the employer in return for services rendered, including nontaxable earned income. Examples of nontaxable earned income include 401(k) contributions, voluntary salary reductions, excludable dependent care benefits, military employee basic housing and subsistence, and parsonage allowances.

In order to claim the EITC, a social security number must be provided for the taxpayer and their spouse (if filing a joint return) and for each qualifying child. The social security number must be one that allows the taxpayer to work in the United States.

If one or more taxpayer may claim the EITC with respect to the same qualifying child, only the taxpayer with the highest modified adjusted gross income may claim the credit. This test is known as the AGI tiebreaker. The IRS Restructuring and Reform Act of 1998 clarified that a child who meets the EITC age, relationship, and residency tests is a taxpayer's qualifying child even if the taxpayer does not claim the child as an EITC qualifying child on the tax return. If two or more taxpayers could claim the same qualifying child under these tests, the lower income taxpayer may not claim any EITC (including the small EITC for taxpayers without qualifying children), even if the higher-income taxpayer does not (or may not) claim the credit.

**Reasons for Change**

The EITC was expanded in 1993 to help reduce poverty, particularly among four-person families headed by full-time minimum wage workers. The minimum wage increase in 1996 further advanced this goal. These policies, along with economic growth, have contributed to a significant decline in poverty. Between 1993 and 1998, the poverty rate has fallen from 15.1 percent to 12.7 percent. In 1998, the EITC directly lifted 4.3 million persons out of poverty – more than twice the number in 1993.

However, many children remain in poverty, especially in large families. In 1998, 18.9 percent of children lived in poverty. The child poverty rate in families with three or more related children was 28.5 percent – more than twice the 11.9 percent rate for children in smaller families. Roughly 60 percent of all poor children are in families with three or more children.

Because the credit initially increases as income rises, the EITC rewards marriage for very low-income workers. But the EITC also causes marriage penalties among two-earner couples whose income falls in or above the credit's phase-out range. Further, while the EITC has been shown, on net, to increase work effort, phasing out the credit results in high marginal tax rates for recipients in the phase-out range. High marginal tax rates may discourage work effort, particularly by non-working spouses.

Taxpayers must add nontaxable earned income to taxable earned income in order to compute their eligibility for the EITC. This provision is confusing to taxpayers and difficult for the IRS to administer. While some nontaxable forms of earned income are reported on Form W-2, many others are not. As a result, taxpayers may not even know the correct amount of nontaxable earned income received during the year. Further, the IRS cannot easily determine that the individual has received nontaxable earned income unless the income is reported on a W-2. Because 401(k) contributions constitute much of reported nontaxable earned income, eliminating nontaxable earned income from the EITC definition of earned income would reward retirement savings for many taxpayers.

The 1998 Act clarified that the AGI tiebreaker applies to all households where more than one taxpayer could potentially claim the same child, even if the higher-income taxpayer in the household did not claim the child on the tax return by providing the child's name and social security number. However, the 1998 Act inadvertently affected taxpayers' eligibility for the EITC in cases where the AGI tiebreaker is not applicable. Thus, under the Act, taxpayers who live alone with their children do not qualify for any EITC, including the small credit for workers without qualifying children, if their children do not have valid social security numbers.

**Proposal**

For taxpayers with three or more children, the credit rate would increase from 40 percent to 45 percent. In 2000, the maximum credit would rise from $3,888 to $4,374, an increase of $486.

For married couples, the beginning point of the EITC phase-out range would be increased by $1,450 in 2000 and 2001. Thus, the EITC would begin to phase out at $14,140 in 2000 ($7,220

if the couple has no children). To qualify, each spouse must have earned income of at least $725. All of these dollar amounts would be indexed in subsequent years.

The EITC phase-out rate would be reduced from 21.06 percent to 19.06 percent for taxpayers with two or more children. Nontaxable earned income would no longer be included in earned income.

A proposed technical correction would clarify that taxpayers would be eligible to receive the small credit for workers without qualifying children if they cannot claim the credit for workers with children because their child does not have a social security number. The proposed change also would clarify that taxpayers may not receive any credit (even the small credit for workers without qualifying children) if their child is not taken into account because another taxpayer who may claim the child has higher modified AGI.

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

## INCREASE AND INDEX THE LOW-INCOME HOUSING TAX CREDIT PER CAPITA CAP

### Current Law

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

### Reasons for Change

Inflation has eroded the value of the cap on low-income housing credit allocations by 45 percent since 1986, but the need for decent affordable low-income rental housing remains acute. Most State agencies receive qualified proposals for far more low-income rental housing than they can support with available credits. Without the tax credits, these projects will not be undertaken. A modest increase in the per capita amount will allow additional low-income housing to be provided but still require that State agencies choose projects that best meet their housing needs. Indexing the per capita amount for inflation will ensure that the real value of the credit is maintained.

**Proposal**

Under the proposal, the annual State low-income housing credit allocations to each State would be increased to $1.75 per capita for calendar year 2001 and indexed for inflation each year thereafter.

## PROVIDE NEW MARKETS TAX CREDIT

**Current Law**

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

**Reasons for Change**

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

**Proposal**

In general.--Taxpayers would be allowed a credit against Federal income taxes for qualified equity investments made to acquire stock or other equity interests in a selected community development entity. The credits would be allocated to selected community development entities by the Department of Treasury, pursuant to regulations to be issued by that Department. For each year during the period 2001-2005, the Department of the Treasury would be permitted to authorize selected community development entities to issue an aggregate of $3 billion of equity interests with respect to which credits could be claimed under the proposal (a total of $15 billion of new equity investment). If the selected community development entity fails to sell qualified equity investments up to the amount authorized within five years of the authorization, then the remaining authorization would be canceled, and the Department of the Treasury could authorize another community development entity to issue qualified equity investments for the unused portion.[1]

The credit allowed to the investor (either the original purchaser or a subsequent holder) would be a six-percent credit (i.e., six percent of the amount paid to the issuing community development

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

entity) for each of five years after the equity interest is purchased from the community development entity. A taxpayer holding a qualified equity investment would be entitled to a credit on each credit allowance date (meaning the original date the equity interest was purchased from the community development entity and each of the four one-year anniversary dates after such date). The taxpayer's basis in the investment would be reduced by the amount of the credit. The credit would be subject to the general business credit rules.

Qualified equity investments.--"Qualified equity investments" which entitle the investor to a credit must be common stock or other similar equity interest acquired from a selected community development entity in exchange for cash.[2] The stock or other equity interest must not be redeemed (or otherwise cashed out) by the selected community development entity for at least five years. Substantially all of the proceeds of the investment must be used by the community development entity to make "qualified low-income community investments," meaning equity investments in, or loans to, qualified active businesses located in low-income communities, and certain financial counseling and other services provided to businesses and residents in low-income communities.[3] Qualified low-income community investments could be made directly by a selected community development entity, or could be made indirectly through another community development entity.[4]

Community development entities.--"Community development entities" that could apply for credit allocations would include (but would not be limited to) Community Development Financial Institutions, Community Development Corporations, Small Business Investment Corporations-LMIs, New Market Venture Capital Firms, America's Private Investment Corporations, or other investment funds (including for-profit subsidiaries of nonprofit organizations). To be selected for a credit allocation, the community development entity's primary mission must be serving or providing investment capital for low-income communities or

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[2] To ensure that credits are available only for new equity investments in selected community development entities, the term "qualified equity investment" would not include any stock or other equity interest acquired from a community development entity which made a substantial stock redemption or distribution (determined under rules similar to current-law section 1202(c)(3)). As with the low-income housing tax credit, section 183 would not bar a taxpayer from claiming a loss with respect to a qualified equity investment.

[3] If at least 85 percent of the aggregate gross assets of the community development entity are invested in qualified low-income community investments, 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.

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

low-income persons, and the entity must maintain accountability to residents of low-income communities (through representation on governing or advisory boards, or otherwise).

As part of the credit allocation process, the Department of the Treasury would certify entities as eligible "community development entities." Certified entities would be required to file annual reports demonstrating that they continue to meet all the requirements for initial certification, and would be required to identify the amount (and purchasers) of equity interests with respect to which allocated credits may be claimed by the purchaser and to demonstrate that the entity monitors its investments to ensure that capital is used in low-income communities.

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

Low-income communities.--For purpose of the credit, "low-income communities" would be defined as census tracts with either (1) poverty rates of at least 20 percent (based on the most recent census data), or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (or, for a non-metropolitan census tract, which does not exceed 80 percent of non-metropolitan statewide median family income). In addition, any area that is part of an "empowerment zone" or "enterprise community" designated under section 1391 would be treated as a low-income community for purposes of the proposal.

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

For purposes of the credit, there would be no requirement that employees of a "qualified active business" be residents of the low-income community. Rental of improved commercial real estate located in a low-income community (e.g., an office building or shopping mall) would be a qualified active business, regardless of the characteristics of the commercial tenants of the property. In addition, a qualified active business that receives a loan from a community

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[5] 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.

development entity could include an organization that is organized and operated on a non-profit basis. The purchase and holding of unimproved real estate would not be a qualified active business. In addition, a qualified active business would not include (a) any business consisting predominantly of the development or holding of intangibles for sale or license; (b) operation of any facility described in sec. 144(c)(6)(B) (e.g., commercial golf course, country club, massage parlor, hot tub facility, suntan facility, liquor store); or (c) any business if a significant equity interest in such business is held by a person who also holds a significant equity interest in the community development entity.

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

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

## EXTEND AND EXPAND EMPOWERMENT ZONE INCENTIVES

### Current Law

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

Among other benefits, certain businesses located in the nine original empowerment zones are eligible for four Federal tax incentives: (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; (3) a new category of tax-exempt private activity bonds to finance certain zone facilities; and (4) so-called "brownfields" expensing for certain environmental remediation expenditures. The designations of the nine original empowerment zones became effective on January 1, 1995, and are scheduled to expire after 2004.

Businesses located in the designated enterprise communities are eligible for the new category of tax-exempt private activity bonds, but not the other special tax incentives available to businesses in empowerment zones. OBRA93 also provided that Federal grants would be made to designated empowerment zones and enterprise communities.

The Taxpayer Relief Act of 1997 (TRA97) authorized the designation of two additional empowerment zones located in urban areas (referred to as the "additional empowerment zones") which generally are eligible for the same tax incentives as are available within the nine empowerment zones authorized by OBRA93. The tax incentives for these two additional empowerment zones became effective on January 1, 2000, and generally will remain in effect through 2009. However, the wage credit available in the two additional empowerment zones is scheduled to phase down beginning in 2005 and to expire after 2007.

TRA97 also authorized the designation of another 20 empowerment zones, which are commonly referred to as "Round II empowerment zones." With respect to these 20 empowerment zones, the eligibility criteria for designating the geographic areas were expanded slightly in comparison to the eligibility criteria for the 11 other empowerment zones. The designation of the 20 Round II empowerment zones -- 15 of which are located in urban areas and five of which are located in rural areas -- became effective on January 1, 1999, and are scheduled to expire after 2008. Businesses located in these 20 Round II empowerment zones are eligible for the additional $20,000 of section 179 expensing, special tax-exempt financing benefits[6], and "brownfields" expensing. However, businesses located in the Round II empowerment zones are not eligible for the special wage credit that is available in the 11 other empowerment zones.

## Reasons for Change

To date, the empowerment zone program has promoted significant economic development, but these communities still do not fully share in the nation's general prosperity. Therefore, the Administration proposes that the empowerment zone program should be extended beyond the scheduled expiration dates that apply to the various zones. Moreover, the program should be strengthened by providing for enhanced tax incentives and the designation of additional empowerment zones. These changes will provide businesses located (or considering locating) in any empowerment zone with certainty that significant tax incentives will be available through 2009 in these economically distressed areas.

## Proposal

The proposal would extend and expand the current-law empowerment zone program in the following manner:

First, the designation of empowerment zone status for the existing 31 empowerment zones would be extended through December 31, 2009.

Second, the 20-percent wage credit would be made available in all 31 designated empowerment zones (i.e., the nine original empowerment zones, the two additional empowerment zones, and

[6] A special rule enacted as part of TRA '97 provides that certain "new empowerment zone facility bonds" issued for qualified businesses in the 20 Round II empowerment zones are not subject to the State volume caps or the special limits on issue size generally applicable to tax-exempt private activity bonds available in the 11 other empowerment zones.

the 20 Round II empowerment zones). The credit rate would remain at 20 percent (rather than being phased down) through December 31, 2009, in all empowerment zones.

Third, an additional $35,000 (rather than $20,000) of section 179 expensing would be available for qualified zone property placed in service after December 31, 2000, and prior to December 31, 2009, by a qualified business in any of the empowerment zones.[7]

Fourth, the Secretaries of Housing and Urban Development (HUD) and Agriculture would be authorized to designate 10 additional empowerment zones (to be referred to as "Round III empowerment zones"). Eight of these Round III empowerment zones would be located in urban areas, and two would be located in rural areas. The eligibility and selection criteria for the 10 Round III empowerment zones would be the same as the criteria that applied to the Round II empowerment zones authorized by TRA '97. During the period 2002 through 2009, businesses located in the 10 Round III empowerment zones would be eligible for the 20-percent wage credit, an additional $35,000 of section 179 expensing, special tax-exempt financing benefits[8], and brownfields expensing.

The proposal would be effective after December 31, 2000.

## BRIDGE THE DIGITAL DIVIDE

### *TAX CREDITS FOR SPONSORSHIP OF QUALIFIED ZONE ACADEMIES AND TECHNOLOGY CENTERS*

#### Current Law

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

Under Section 1397E, State and local governments can issue qualified zone academy bonds to fund improvements in certain "qualified zone academies" which provide elementary or secondary education. Qualified zone academies must be located in either a designated

[7] The additional $35,000 of section 179 expensing would be available throughout all areas that are part of a designated empowerment zone, including the non-contiguous "developable sites" that were allowed to be part of the designated Round II empowerment zones under TRA '97.

[8] The Round III empowerment zones would be eligible for the same tax-exempt financing benefits that are available in the nine original empowerment zones designated under OBRA '93 and the two additional empowerment zones designated under TRA '97.

empowerment zone or enterprise community, or, if not, there must be a reasonable expectation that at least 35 percent of the students attending the academy will be eligible for free or reduced-cost lunches under the National School Lunch Act. No tax credits are currently available for corporate sponsorship payments to such academies, public libraries or community technology centers. Corporations may be able to deduct contributions to qualified zone academies, public libraries or community technology centers as charitable contributions.

**Reasons for Change**

To encourage private-sector support of, and participation in, educational programs conducted at qualified zone academies and to help bridge the digital divide, a tax credit should be provided for certain corporate sponsorship payments made to qualified zone academies, public libraries, and community technology centers located in empowerment zones or enterprise communities.

**Proposal**

This proposal would provide a tax credit equal to 50 percent of the amount of corporate sponsorship payments made to a qualified zone academy, or public library or community technology center, located in a designated empowerment zone or enterprise community. For purposes of the credit, a qualified zone academy would be treated as located in a designated empowerment zone or enterprise community if a significant percentage of its students reside in the zone or community. A public library or community technology center would be treated as located in a designated empowerment zone or enterprise community if it is adjacent to such a zone or community.

The credit would be available for corporate cash contributions, but only if a credit allocation has been made with respect to the contribution by the local governmental agency with responsibility for implementing the strategic plan of the empowerment zone or enterprise community under section 1391(f)(2). The local government agency for each of the existing 31 empowerment zones (and each of the 10 additional empowerment zones proposed under the Administration's budget) could designate up to $16 million of corporate sponsorship payments as eligible for the 50-percent credit (that is, up to $8 million of tax credits). In addition, up to $4 million of sponsorship payments would be eligible for the 50-percent credit (that is, up to $2 million of tax credits) for each of the enterprise communities. The deduction otherwise allowed for a corporate sponsorship payment would be reduced by the amount of the credit claimed for that payment. The proposed tax credit would be subject to the current-law general business credit rules, and would be effective for sponsorship payments made after December 31, 2000.

## *ENHANCED DEDUCTION FOR CORPORATE DONATIONS OF COMPUTERS*

**Current Law**

The deduction for charitable contributions of ordinary income property is generally limited to the lesser of the taxpayer's cost basis in the property or fair market value. The Taxpayer Relief Act of 1997 provided an enhanced deduction for a three-year period for charitable contributions of

computer technology or equipment to eligible donees to be used for educational purposes for elementary or secondary school children within the United States. Under this provision, the amount of the deduction is equal to the taxpayer's 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. The enhanced deduction is limited to twice the taxpayer's basis in the donated property. To qualify for the enhanced deduction, the contribution must satisfy various requirements. This enhanced deduction provision is scheduled to expire for taxable years beginning after December 31, 2000.

**Reasons for Change**

This provision was enacted to provide an incentive for businesses to contribute computer equipment and software for the benefit of elementary and secondary school children by providing schools with needed technological resources. Given the growing importance of computers and the Internet, widespread access to technology is more important than ever. Therefore, the Administration believes the provision should be extended and expanded.

**Proposal**

The Administration proposes extending the current-law enhanced deduction for donations of computer technology and equipment through June 30, 2004. In addition, to promote access of all persons to computer technology and training, the enhanced deduction would be expanded to apply to contributions of computer equipment to a public library or community technology center located in a designated empowerment zone or enterprise community, or in a census tract with a poverty rate of 20 percent or more. The proposed modifications would be effective for contributions made after December 31, 2000 and before July 1, 2004.

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

**Current Law**

Workplace literacy and basic education expenses, including for basic computer skills, are deductible to employers, either as ordinary and necessary business expenses to the extent they are job-related or as employee compensation. If they are deemed to be compensation, the expenses are includible in the worker's gross income unless provided under a section 127 educational assistance plan or treated as a working condition fringe benefit. Under a section 127 plan, educational expenses other than for graduate education are excluded from an employee's gross income for income and employment tax purposes, up to $5,250 per year. (Section 127 expires with respect to courses beginning after December 31, 2001.) Educational expenses paid by an employer outside of a section 127 plan that are related to the employee's current job may be excludable from the employee's gross income as a working condition fringe benefit, but not if the education relates to certain minimum educational requirements or enables the employee to begin working in a new trade or business.

No credits generally are allowed to employers for workplace literacy, basic computer skills or other types of employee education expenses.

**Reasons for Change**

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

**Proposal**

Employers who provide certain workplace literacy, English literacy, basic education, and basic computer training programs for their eligible employees would be allowed to claim a credit against the employer's Federal income taxes. The amount of the credit would equal 20 percent of the employer's eligible expenses incurred with respect to qualified education programs, with a maximum credit of $1,050 in a taxable year per participating employee. The credit would be treated as a component of the general business credit, and would be subject to the limitations of that credit.

Qualified education would be limited to (1) basic skills instruction at or below the level of a high school degree; (2) basic, entry-level computer skills instruction of broad applicability; and (3) English literacy instruction. Eligible employees -- employees with respect to whom the employer could claim a credit -- would generally not have received a high school degree or its equivalent, or, for English literacy programs, would have limited English proficiency. The employer could claim a credit with respect to employees with high school degrees but who lack sufficient mastery of basic educational skills to function effectively in the workplace only if an eligible provider both assesses the educational level of the employees and provides the instructional program for the employer. Eligible employees must be citizens or resident aliens aged 18 or older who are employed by the taxpayer in the United States for at least six months. Terms such as qualified education and eligible employees will be further defined in Treasury regulations.

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

Expenses eligible for the credit would include payments to third parties and payments made directly to cover instructional costs, including but not limited to salaries of instructors,

curriculum development, textbooks, and instructional technology used exclusively to support basic skills instruction. Wages paid to workers while they participate as students in the education programs would not be eligible for the credit. The amount of the credit claimed reduces, dollar for dollar, the amount of education expenses that the employer may otherwise deduct in computing its taxable income.

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

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

## PROVIDE TAX CREDITS FOR HOLDERS OF BETTER AMERICA BONDS

### Current Law

State and local governments may issue tax-exempt bonds without limit for environmental purposes so long as: 1) no more than 10 percent of the bond proceeds is used by private entities in a trade or business if payments or security associated with that use are available to pay interest and principal on the bonds; and 2) no more than 5 percent of the bond proceeds is lent to private businesses or individuals. If these private activity requirements are not met, tax-exempt private activity bonds may nonetheless be issued, subject to State-by-State volume caps, for the following environmental purposes: water, sewage, solid waste disposal, and hazardous waste facilities; environmental enhancements of hydro-electric generating facilities; and redevelopment infrastructure in blighted areas if the bonds are supported by incremental property taxes. The Federal subsidy indirectly provided by tax-exempt bonds is limited by market forces to the differential in interest rates between tax-exempt bonds and taxable bonds of similar risk and maturity. Deeper subsidies are provided by tax credit bonds, such as Qualified Zone Academy Bonds, the entire interest on which is paid in the form of tax credits.

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

### Reasons for Change

Significant public benefits are provided by protecting open spaces; creating forest preserves near urban areas; protecting water quality; rehabilitating land that has been degraded by toxic or other wastes or destruction of its ground cover; and improving parks and reestablishing wet lands. These benefits include creating more livable urban, suburban, and rural environments, protecting

public health, repairing environmental damage and, in the case of reforestation, absorbing greenhouse gases. Local governments are typically unwilling to assume the major financial burdens required to take the actions necessary to secure these benefits because the benefits are so widely diffused. Tax-exempt bond financing may not provide a deep enough subsidy to induce State and local governments to undertake beneficial environmental infrastructure projects. Moreover, the brownfields expensing provision does not provide an incentive for environmental remediation of property owned by governments and intended for future public use or for use by a tax-exempt entity.

**Proposal**

State and local governments (including Indian tribal governments and U.S. possessions) would be able to issue Better America Bonds (BABs). A total of $2.1 billion of BABs would be authorized for each of the five years beginning in 2001 and would be allocated by the Administrator of the Environmental Protection Agency (EPA) based on competitive applications. To the extent EPA does not allocate all of its available authority for a particular year, it could allocate the remainder in the following year. Amounts that are allocated but not issued in the year of allocation could be issued up until the end of the third following year. To the extent any allocated amounts remain unissued after the third year following the allocation year, they would become available for re-allocation by EPA.

As part of an annual competition, States (including Indian tribal governments and U.S. possessions) and local governments could apply to EPA for authority to issue BABs. Applications would be submitted following guidelines that EPA would publish prior to January 1, 2001. Those guidelines would indicate the criteria to be used for approving applications. EPA, in consultation with other Federal agencies, would review applications and award bond allocations in conjunction with the Community Empowerment Board. A government could issue BABs under an agreement with the sponsor of an approved application. Issuers would be responsible for repayment of principal to the holders of BABs upon their maturity.

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

The structure of BABs as tax credit bonds would be identical to that proposed for Qualified School Modernization Bonds and Qualified Zone Academy Bonds. See the description for "Provide tax credits for holders of qualified school modernization bonds and qualified zone academy bonds."

Except as described below, acquisition, construction, remediation or use of land and facilities is a qualifying purpose only if the property is available for use by the public. Any agreement, other than a management contract that would be a qualified management contract if the land or facilities had been financed with tax-exempt bonds, conveying priority rights or other preferential benefits to a private person violates the general public use provision and would not constitute a qualified purpose. Furthermore, except as noted below, repayment of principal may

not be secured or paid with monies derived from private persons in any capacity other than that of the general public.

Bonds would cease to be qualified bonds and would accrue no further tax credits in the event that any of the tax-related requirements is not met (for example, if there were a change to a nonqualified use). The issuer would be obligated to reimburse the Federal government (with interest) for any credits accruing prior to the date of non-compliance. If this obligation is not timely paid by the issuer, the Federal government would have the right to recover the credit amount from the current holders of the bonds.

The qualifying purposes for BABs would be:

a. Acquisition of land for open space, wetlands, public parks or greenways to be owned by an eligible issuer or by a 501(c)(3) entity whose exempt purpose includes environmental preservation.

b. Construction of visitor facilities, such as campgrounds and hiking or biking trails, in connection with such acquired land or other open space, wetlands, or parks that are owned by an eligible issuer or by a 501(c)(3) entity whose exempt purpose includes environmental preservation.

c. Remediation of land acquired under (a) above, or of publicly-owned open space, wetlands or parks (for example, for enhancing water quality), by planting trees or other vegetation, creating settling ponds to control runoff, undertaking reasonable measures to control erosion or protect endangered species, and remediating conditions caused by the prior disposal of toxic or other waste.

d. Acquisition of easements on privately-owned open land that prevent commercial development and any substantial change in the use or character of the land. Such easements must be in a form which, if contributed by the owner of the open land, would qualify under section 170(h).

e. Environmental assessment and remediation of contaminated property -- brownfields -- owned by a State or local government if the property was acquired by a State or local government (1) before January 1, 2000 or (2) by reason of foreclosure or abandonment by the prior owner, e.g., for non-payment of taxes. The property would have to be an area at or on which there has been a release (or threat of release) or disposal of any hazardous substance within the meaning of section 198. For this use, private use (by an entity which is not a 501(c)(3) entity) of proceeds as well as private payment of bond principal is permitted. For example, the cost of environmental remediation of such property could be financed with BABs and the land subsequently sold to a private entity with the proceeds of the sale used to repay principal through the use of a sinking fund. The Federal government would not be a qualifying private entity.

f. Environmental assessment and remediation of certain property damaged by anthracite coal mining if the property is owned by a State or local government or 501(c)(3) entity. For this use, as is the case with the use described in (e) above, private use (by an entity which is not a 501(c)(3) entity) of proceeds as well as private payment of bond principal is permitted. Thus, for example, the cost of environmental remediation of such property could be financed with BABs and the land subsequently sold to a private entity (but not the Federal government) with the proceeds of the sale used to repay principal through the use of a sinking fund. Furthermore, certain special rules would apply to BABs issued for the purposes described in this paragraph (f).

In the case of property acquired, constructed or remediated with BAB proceeds in the manner described in paragraph (a), (b) or (c) above, the eligible owner would be required to record under State law a restrictive covenant with respect to the financed property. Such a covenant would prohibit the owner from selling or permitting a nonqualified use of the property after the bonds are retired unless, prior to such a sale or conversion to a nonqualified use, a reasonable period is allowed for a qualifying 501(c)(3) organization to purchase the property at a price that does not exceed the value of the property at the time of the expenditure of bond proceeds. For these purposes, a qualifying 501(c)(3) organization is a 501(c)(3) entity (1) that has an exempt purpose which includes environmental protection and (2) that covenants to retain the property in a qualifying use in perpetuity.

Issuance of BABs would be subject to the public approval rules of section 147(f). BABs could be issued using a pooled financing structure so long as each loan satisfied the applicable requirements described above.

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

## MAKE PERMANENT THE EXPENSING OF BROWNFIELDS REMEDIATION COSTS

### Current Law

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

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

A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas are defined as: (1) empowerment zones and enterprise communities; (2) sites that were announced before February 1997 as being subject to one of the Environmental Protection Agency Brownfields Pilots; (3) any population census tract with a poverty rate of 20 percent or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above.

As part of the Tax Relief Extension Act of 1999, this provision was extended for one year. As extended, this special treatment applies to expenditures paid or incurred on or before December 31, 2001.

**Reasons for Change**

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

**Proposal**

The proposal would eliminate the restriction requiring that expenditures must be paid or incurred on or before December 31, 2001 in order to be deductible as environmental remediation expenditures.

## SPECIALIZED SMALL BUSINESS INVESTMENT COMPANY TAX INCENTIVES

**Current Law**

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

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

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

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

**Reasons for Change**

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

**Proposal**

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

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

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

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

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

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

**Make Health Care More Affordable**

## ASSISTING TAXPAYERS WITH LONG-TERM CARE NEEDS

### Current Law

Several provisions in the tax code provide assistance to taxpayers with a disabled family member or with long-term care expenses. A taxpayer can receive a child and dependent care tax credit for expenses incurred to care for a disabled spouse or dependent so the taxpayer can work. A low-income working taxpayer can qualify for the earned income tax credit if he or she resides with a disabled adult son or daughter or certain other specified individuals. A taxpayer who itemizes can deduct expenses for qualified long-term care services if he or she is chronically ill or such expenses were incurred on behalf of a chronically ill spouse or dependent. However, taxpayers can only deduct medical expenses, including expenses for qualified long-term care services, which exceed 7.5 percent of adjusted gross income.

### Reasons for Change

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

### Proposal

A taxpayer would be allowed to claim a $3,000 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.[9] The credit (aggregated with the child credit and the

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[9] To qualify as a dependent, an individual must (1) be a specified relative or member of the taxpayer's household; (2) be a citizen or resident of the U.S. or resident of Canada or Mexico; (3) not be required to file a joint tax return with his or her spouse; and (4) receive over half of his or her support from the taxpayer. For purposes of the personal exemption, the dependent must have gross income below the dependent exemption amount ($2,800 in 2000) if not the taxpayer's child. The taxpayer may be deemed as providing over half the cost of supporting the individual if (a) no one person contributes over half the support of such individual; (b) over half the support is received from persons each of whom, but for the fact that he or she did not provide over half such support, could claim the individual as a dependent; (c) the taxpayer contributes over 10 percent of such support; and (d) the other caregivers, who provide over 10 percent of the support, file written declarations stating that they will not claim the individual as a dependent.

In the FY 2001 budget, the Administration is proposing that the dependency test be simplified. Under the proposal, the support test would be waived if taxpayers meet a residency test. This modification would apply only to child dependents.

proposed disabled worker credit) would be phased-out for certain high-income taxpayers--that is, the aggregate credit amount would be phased out by $50 for each $1,000 (or fraction thereof) by which the taxpayer's modified AGI exceeds $110,000 (in the case of a joint return), $75,000 (in the case of a taxpayer who is not married), or $55,000 (in the case of a married individual filing a separate return).

For purposes of the proposed tax credit only, the dependency tests 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). Thus, in 2001, a single individual could not be claimed as a dependent if his or her gross income exceeds approximately $7,400 ($8,500 if age 65 or over).

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

An individual age six or older would be considered to have long-term care needs if he or she were certified by a licensed physician (prior to the filing of a return claiming the credit) as being unable for at least six months to perform at least three activities of daily living (ADLs) without substantial assistance from another individual, due to a loss of functional capacity (including individuals born with a condition that is comparable to a loss of functional capacity).[10] As under section 7702B(c)(2)(B), ADLs would be eating, toileting, transferring, bathing, dressing, and continence. Substantial assistance would include both hands-on assistance (that is, the physical assistance of another person without which the individual would be unable to perform the ADL) and stand-by assistance (that is, the presence of another person within arm's reach of the individual that is necessary to prevent, by physical intervention, injury to the individual when performing the ADL).

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

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

prescribed by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services.

A child between the ages of two and six would be considered to have long-term care needs if he or she were certified by a licensed physician as requiring substantial assistance for at least six months with two of the following activities: eating, transferring, and mobility. A child under the age of two would qualify if he or she were certified by a licensed doctor as requiring for at least six months specific durable medical equipment (for example, a respirator) by reason of a severe health condition or requiring a skilled practitioner trained to address the child s condition when the parents are absent. Within five years of enactment, the Department of the Treasury and the Department of Health and Human Services would report to Congress on the effectiveness of the definition of disability for children and recommend, if necessary, modifications to the definition. The taxpayer would be required to provide a correct taxpayer identification number for the individual with long-term care needs, as well as a correct physician identification number (e.g., the Unique Physician Identification Number that is currently required for Medicare billing) for the certifying physician. The IRS would be authorized to use mathematical error procedures to deny credit claims during returns processing if taxpayers do not provide valid taxpayer and physician identification numbers. Further, the taxpayer could be required to provide other proof of the existence of long-term care needs in such form and manner, and at such times, as the Secretary requires.

The credit would be coordinated with the current law child credit and the proposed disabled workers credit to allow these credits to be refundable for a taxpayer claiming three or more credit amounts.[11] As under the current-law child credit, the amount of refundable credit would be the amount that the nonrefundable personal credits would increase if the tax liability limitation of section 26(a) were increased by the excess of the taxpayer's social security taxes over the taxpayer's earned income credit (if any).

The proposal would be effective for taxable years beginning after December 31, 2000. The credit would be phased in at $1,000 in 2001, $1,500 in 2002, $2,000 in 2003, $2,500 in 2004, and $3,000 in 2005 and thereafter.

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

## ENCOURAGE COBRA CONTINUATION COVERAGE

### Current Law

Under present law, the tax treatment of health insurance expenses depends on whether a taxpayer is covered under a health plan paid for by an employer, whether an individual has self-employment income, or whether an individual has medical expenses that exceed a certain threshold. An employer's contribution to a plan providing health benefits coverage for an employee, and his or her spouse and dependents, is excludable from the employee's income for both income and payroll tax purposes. In addition, active employees participating in a cafeteria plan may pay their employee share of premiums on the same tax-preferred basis. A self-employed individual, who is not eligible for subsidized coverage under his or her employer plan or a spouse's employer plan, currently may deduct 60 percent of health insurance premiums, providing the deduction does not exceed self-employed income. Self-employed individuals will be able to deduct 70 percent of health insurance premiums starting in 2002 and 100 percent in 2003, and thereafter. Other individuals who pay for their own health insurance may claim an itemized deduction for their health insurance premiums only to the extent that premiums, when combined with other unreimbursed medical expenses, exceed 7.5 percent of adjusted gross income.

Under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), qualified individuals, primarily separating employees, covered by employer insurance in firms with more than 20 employees are eligible to purchase continuation coverage from their employers. Other covered individuals include spouses and dependent children who would lose coverage as a result of a covered employee's death, divorce or legal separation. The firm may charge a separating employee up to 102 percent of the average cost of the employer's health plan. Depending on the circumstances, former employees and their dependents can elect to continue COBRA coverage for up to 18 to 36 months.

### Reasons for Change

There are several reasons to provide a tax preference for employer-provided health insurance. First, depending on the response of employers and employees to tax preferences, the cost of the tax preference may be more than offset by a reduction in the reliance of individuals on publicly funded programs and on cross subsidies from other consumers. Second, because an employer's decision to hire a worker is generally based on productivity factors rather than on health factors, the current tax preference for employer-provided health insurance acts as an inducement for the pooling of risks across a broad range of individuals.

However, when employees separate from a firm, their tax preferences for health insurance decrease in two ways. First, employer contributions for health insurance tend to decline substantially at termination. Second, employee contributions towards COBRA coverage are made on an after-tax basis. The lack of tax preference for contributions by former employees to COBRA coverage may be one of several reasons why participation in COBRA is so low. Some studies suggest that only 20 to 25 percent of individuals eligible for COBRA actually purchase it.

Under a separate proposal, retired employees whose employers eliminate retiree health benefits after their retirement would be eligible to buy into COBRA until they are sixty-five years of age. Unless retired employees are otherwise eligible for COBRA, employers would be permitted to charge up to 125 percent of the average cost of the employer's group health benefits plan. Because retirees are generally much more expensive to insure than active workers, the 125 percent premium would be expected generally to cost less than a policy purchased in the individual insurance market. Nevertheless, many retirees would find the 125 percent premium to be unaffordable.

**Proposal**

Individuals who participate in an employer-provided health benefit plan through COBRA would be eligible for a 25% nonrefundable tax credit for their COBRA continuation premiums. For individuals qualifying under the new proposal as retirees whose employers drop coverage, eligibility for the tax credit would continue until they reach age sixty-five. For all others, eligibility for the credit would be limited to the current law COBRA eligibility period (18 to 36 months). To be eligible for the COBRA credit, taxpayers must be under age sixty-five. The Secretary of the Treasury would issue regulations on reporting requirements for employers.

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

## PROVIDE TAX CREDIT FOR MEDICARE BUY-IN PROGRAM

**Current Law**

See the description of current law under "Encourage COBRA Continuation Coverage".

**Reasons for Change**

Individuals age 55 through 64 are too young for the current Medicare program (unless disabled), yet often are not covered by employer-provided health insurance. Recently there has been growing concern for this age cohort as some employers eliminate retiree health insurance. Because these individuals are older and are more likely to have health problems, individually purchased health insurance is very expensive. Individuals who are not covered by the protections of the Health Insurance Portability and Accountability Act of 1996 (HIPAA) may have difficulty obtaining coverage for pre-existing conditions. Some who are not covered by HIPAA may be denied coverage altogether.

To address these concerns, a separate Administration proposal would extend eligibility to buy into Medicare to older workers, retirees and displaced workers. Premiums plus a surcharge to the Medicare part B premium would be set to make the buy-in self-financing. As with employment based health insurance, a tax incentive is warranted to encourage healthy as well as wealthy individuals to participate, creating a broad risk pool with more affordable premiums.

## Proposal

Taxpayers would be allowed to claim a nonrefundable tax credit for health insurance purchased through the new Medicare buy-in program. The credit would equal 25 percent of Medicare buy-in premiums paid by a taxpayer prior to reaching age 65.

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

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

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

# PROVIDE TAX RELIEF FOR WORKERS WITH DISABILITIES

## Current Law

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

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

Impairment-related work expenses are defined as expenses for attendant care services at the individual's place of employment and other expenses in connection with such place of

employment which are necessary for the individual to be able to work. Impairment-related work expenses must be ordinary and necessary.

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

**Reasons for Change**

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

**Proposal**

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

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

The taxpayer would be required to provide a correct physician identification number (e.g., the Unique Physician Identification Number that is currently required for Medicare billing) for the certifying doctor. The IRS would be authorized to use mathematical error procedures to deny

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

credit claims during returns processing if taxpayers do not provide valid taxpayer and physician identification numbers. Further, the taxpayer could be required to provide other proof of the existence of disability in such form and manner, and at such times, as the Secretary requires.

The credit would be coordinated with the current law child credit and the proposed long-term care credit to allow these credits to be refundable for a taxpayer claiming three or more credit amounts.[13] As under the current-law child credit, the amount of refundable credit would be the amount that the nonrefundable personal credits would increase if the tax liability limitation of section 26(a) were increased by the excess of the taxpayer's social security taxes over the taxpayer's earned income credit (if any).

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

## PROVIDE TAX RELIEF TO ENCOURAGE SMALL BUSINESS HEALTH PLANS

### Current Law

Employer contributions toward employee accident or health insurance costs are generally deductible by employers and excluded from gross income by employees. For participants in cafeteria plans, the employee's premium share may similarly be excluded from gross income. Otherwise, an employee's share of health insurance premiums is an itemized medical expense deduction, but only to the extent that unreimbursed medical or long-term care expenses (including health insurance costs) exceed 7.5 percent of the employee's adjusted gross income.

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

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

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[13] 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 disabled worker with a child under age 17 a child credit and a disabled worker credit.

Employee Retirement Income Security Act (ERISA) with respect to reporting, disclosure, fiduciary, and claims procedures.

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

**Reasons for Change**

Over a quarter of private-sector workers in firms with 50 or fewer employees lack health insurance -- significantly more than the national average. This deficiency in insurance coverage occurs, in part, because the costs of setting up and operating health plans in the current small business insurance market are higher than those for larger employers. Consequently, small employers tend to pay more for similar employee health insurance benefits than do larger employers. In addition, insurance companies may need a minimum number of covered employees in order to be able to provide insurance to a group. This makes it difficult for small employers to offer multiple health plans to their employees. Only a fraction of the small businesses that offer health insurance benefits provide their workers with a choice of health plans.

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

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

**Proposal**

The proposal has two parts. First, it would establish a special rule to facilitate private foundation grants and loans to qualified health benefit purchasing coalitions. Second, it would create a new income tax credit designed to encourage use of these purchasing coalitions by small businesses

that currently do not provide health insurance to their workforces. Both provisions would be temporary, expiring after a set period of time.

Foundation Grants to Qualified Health Benefit Purchasing Coalitions

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

Initial operating expenditures 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 expenditures would include the cost of tangible personal property purchased by the qualified coalition for its own use. Initial operating expenditures would not include (1) the purchase of real property, (2) any payment made to, or for the benefit of, members (or employees or affiliates of members) of the qualified coalition, such as any payment of insurance premiums on policies insuring members (or their employees or affiliates), or (3) any expense incurred more than 24 months after the date of formation of the coalition.

Requirements Imposed on Qualified Health Benefit Purchasing Coalitions

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

Qualified coalitions would be subject to HIPAA and subsequent Federal health laws, including participant nondiscrimination rules and provisions applicable to MEWAs under ERISA and the

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

Small Business Health Plan Tax Credit

The second part of the proposal would create a temporary tax credit for small businesses to encourage the purchase of employee health insurance through qualified health benefit purchasing coalitions. The credit would be available to employers with at least two, but not more than 50, employees, counting only employees with annual compensation (including 401(k) and SIMPLE employer contributions) of at least $10,000 in the prior calendar year. Eligible employers could not have had an employee health plan during any part of 1998 or 1999, and they would be required to purchase employee health insurance through a qualified coalition. The credit would equal 20 percent of employer contributions to the cost of such insurance. The maximum credit amount per policy would be $400 per year for individual coverage and $1,000 per year for family coverage (to be ratably reduced if coverage is provided for less than 12 months during the employer's taxable year). The credit would be allowed to a qualifying small employer only with respect to contributions made during the first 24 months that the employer purchases health insurance through a qualified coalition. This 24-month limit would not include months beginning before January 1, 2001. As a condition of qualifying for the credit, employers would need to cover at least 70 percent of those workers who have compensation (including 401(k) and SIMPLE employer contributions) of at least $10,000 and who are not covered by another health plan. A self-employed individual who is eligible to take a business deduction for his or her family's health insurance premiums would not be allowed to include any of those insurance premiums in the calculation of the credit amount. The small business health plan credit would be treated as a component of the general business credit, and would be subject to the limitations of that credit.

Effective Dates

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

## ENCOURAGE THE DEVELOPMENT OF VACCINES FOR TARGETED DISEASES

### Current Law

No special deductions or credits are provided for the sale or purchase of vaccines. However, under present law an enhanced charitable contribution deduction applies to certain contributions of business inventory to charitable organizations for the care of infants, the ill, or the needy. Corporate donors of vaccines and medicines can claim a deduction for their basis plus one-half of the difference between basis and market value, but not more than twice the firm's basis. (Absent this enhanced deduction, deductions for charitable contributions of business inventory are generally limited to the firm's cost basis.) Corporate deductions for charitable contributions generally are limited to 10 percent of the corporation's taxable income.

Under present law, the Federal Government supports research (including research on vaccines) through the research and experimentation (R&E) tax credit and the orphan drug tax credit. The R&E credit is 20 percent of qualified research expenses above a base amount that reflects the firm's historical research experience. A taxpayer may also elect an alternative credit with a lower credit rate and base amount. The orphan drug credit is 50 percent of the expenses incurred for human clinical testing of drugs for certain rare diseases or conditions.

### Reasons for Change

Highly effective vaccines do not yet exist for malaria, TB and AIDS, which take over 5 million lives each year, most in developing countries. The present research and orphan drug tax credits provide incentives for research on vaccines and medicines, foster the development of drug candidates, and subsidize certain clinical trials. Nonetheless, pharmaceutical companies may be reluctant to invest in the development of vaccines for diseases that primarily afflict people in poor countries because no paying market exists in those countries. The proposed tax credit would augment the efforts of qualifying nonprofit organizations (such as UNICEF) to provide a market for new vaccines for diseases that occur primarily in developing countries. Thus, the proposal would encourage the development of vaccines for diseases that occur primarily in poor countries.

### Proposal

A credit against Federal income taxes would be allowed for sales of a qualifying vaccine to a qualifying nonprofit organization. The seller would be allowed to claim a credit equal to 100 percent of the amount paid by the qualifying organization. In effect, every dollar paid by the qualifying organization would be matched dollar for dollar, thereby doubling the organization's purchasing power.

A qualifying vaccine would be a vaccine for a targeted disease that receives FDA approval as a new drug after the date of enactment. The targeted diseases would include malaria, tuberculosis, HIV/AIDS, and any infectious disease (of a single etiology) that is determined by the Secretary of the Treasury (after consultation with the Center for Disease Control and the U.S. Agency for International Development (AID)) to cause the deaths of over 1,000,000 people annually

worldwide. A qualifying organization would be a nonprofit organization that purchases and distributes vaccines for developing countries.

The credit would be available only if a credit allocation has been made with respect to the sale of a qualifying vaccine to a qualifying organization by AID. AID would issue regulations specifying procedures for nonprofit organizations to apply for a credit allocation with respect to specific purchases to be made by the nonprofit organization of qualifying vaccines for distribution in developing countries. For the period 2002 – 2010, AID would be allowed to designate up to $1 billion of sales as eligible for the credit. The maximum amount of sales that would be eligible for a credit allocation by AID would be $100 million per year for 2002 through 2006 and $125 million per year for 2007 through 2010. Unallocated amounts for any year would be carried over and available for allocation in the ten following years and would increase the amount of sales otherwise available for a credit allocation in those years. Amounts attributable to a given year that are unallocated after the ten-year carryover period would be cancelled. The credit would be subject to the general business credit rules.

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

## Strengthen Families and Improve Work Incentives

### PROVIDE MARRIAGE PENALTY RELIEF AND INCREASE THE STANDARD DEDUCTION

#### Current Law

The standard deduction amounts in 2000 are $4,400 for single taxpayers, $6,450 for heads of household, and $7,350 for married taxpayers filing joint returns. These amounts are indexed annually for inflation. Taxpayers over age 65 and blind taxpayers are entitled to additional amounts. Taxpayers who may be claimed as dependents by another taxpayer may have a lower standard deduction.

#### Reasons for Change

Together with personal exemptions, the standard deduction sets the levels of income below which taxpayers do not have any income tax liability. A majority of taxpayers take the standard deduction rather than itemizing deductions. Use of the standard deduction greatly simplifies record keeping and tax filing for taxpayers because they are not required to maintain records and determine specific amounts of deductible expenditures.

The standard deduction for joint filers is less than the combined amount for two single individuals. As a result, a couple's combined tax liability may increase when they marry.

The "marriage penalty" almost exclusively affects two-earner couples. Thus, the tax system discourages paid work by second earners, especially in combination with the indirect costs of working such as childcare and commuting.

#### Proposal

The standard deduction for two-earner couples would be increased to double the amount of the standard deduction for single filers or, if less, the sum of the standard deduction for one-earner couples and the smaller of the two spouses' earned incomes. When fully phased in, the proposal would effectively exempt from tax the first $1,450 (in 2001 dollars) of the earnings of the lower paid spouse.

Earned income is defined as the sum of wages, salaries, and net income from self-employment less certain deductions for IRA, Keogh, SEP, and SIMPLE plan contributions, self-employed health insurance, and one-half of self-employment taxes.

The increase would be phased in over five years beginning in 2001. In each year, the maximum increase would equal the following percentage of the difference between the standard deduction for joint filers and two standard deductions for single filers:

| | |
|---|---|
| 2001: | 20 percent |
| 2002: | 40 percent |
| 2003: | 60 percent |
| 2004: | 80 percent |
| 2005 and thereafter: | 100 percent |

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

In 2005, the proposal would further increase the standard deduction amounts by $250 for single filers, $350 for heads of household, and $500 for married taxpayers filing a joint return. The increases would be indexed for inflation after 2005.

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

### Current Law

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

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

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

**Reasons for Change**

Many working parents cannot find affordable and safe child care. Working mothers with income below the poverty level who paid for child care expenses spent 21 percent of their monthly income in 1993 on child care. In contrast, higher income working mothers who paid for child care spent, on average, 7 percent of their monthly income on these expenses. While low-income working families may be eligible for child care subsidies under the child care and development fund (CCDF), large numbers of children remain unserved. HHS reports that between 10 and 15 percent of low and moderate-income children eligible for CCDF assistance actually received help through the program in a typical month in 1998.

The Federal government also provides assistance to working families with child care costs through the child and dependent care tax credit. However, because they have little, if any, income tax liabilities, many low-income families do not receive any of the nonrefundable child and dependent care tax credit. Moreover, the real value of the child and dependent care tax credit has declined over time because the credit has not been increased since 1982.

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

**Proposal**

Make the child and dependent care tax credit refundable

For tax years beginning after December 31, 2002, the basic child and dependent care tax credit would be made refundable.

Expand basic child and dependent care credit

The maximum credit rate would be increased from 30 percent to 50 percent. Taxpayers would be eligible for the maximum credit rate if their adjusted gross income is $30,000 or less. For taxpayers with adjusted gross incomes above $30,000, the credit rate would be reduced by one percentage point for each additional $1,000, or fraction thereof, of adjusted gross income in excess of $30,000. However, the credit rate would never fall below 20 percent.

The maximum amounts of employment-related expenses for which the credit can be claimed ($2,400 for one qualifying individual and $4,800 for two or more qualifying individuals) would be retained, but would be indexed for inflation after 2001. Thus, when fully phased-in, the maximum credit would range from $480 to $1,200 (in 2001 dollars) for a taxpayer with one qualifying individual and $960 to $2,400 for a taxpayer with two or more qualifying individuals.

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

The provision would be effective for tax years beginning after December 31, 2000. The credit rate would be increased from 30 percent to 40 percent for tax years beginning after December 31, 2002 and to 50 percent for tax years beginning after December 31, 2004. For tax years beginning after December 31, 2001, certain parameters would be adjusted for inflation. These include the $30,000 starting point for the phase-down range, as well as the maximum amounts of qualifying child and dependent care expenses that could be claimed for the credit.

Additional credit for taxpayers with infants

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

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

Taxpayers with infants who do not incur any out-of-pocket child care expenses would also be eligible for the additional credit for infants. For example, a taxpayer with a stay-at-home spouse who cares for their infant would qualify for a maximum credit of up to $250 (50 percent x $500) ($500 if they have two or more infants). Similarly, a two-earner couple with an infant could qualify for a credit of up to $250 even if they rely on unpaid relatives or friends to help care for their infant while they are at work.

The provision would be effective for taxable years beginning after December 31, 2000. The additional credit for taxpayers with infants would be adjusted for inflation for tax years beginning after December 31, 2001.

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

### Current Law

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

### Reasons for Change

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

### Proposal

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

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

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

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

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

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

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

## Promote Savings, Retirement Security, and Portability

### RETIREMENT SAVINGS ACCOUNTS (RSAs)

#### Current Law

Various tax preferences exist for retirement savings, including the exclusion from income tax for contributions to employer-sponsored retirement plans and individual retirement arrangements (IRAs).

Tax-preferred employer-sponsored retirement plans comprise a number of different arrangements, such as section 401(a) qualified plans (including plans with a section 401(k) qualified cash-or-deferred arrangement), section 403(a) qualified annuity plans, section 403(b) annuities, section 408(k) simplified employee pensions (SEPs), section 408(p) SIMPLE retirement accounts, and section 457(b) eligible deferred compensation plans. In general, an employer and, in certain cases, employees contribute to the employer plan, and taxation of the contributions and their investment earnings is generally deferred until benefits are distributed from the plan to the employees or their beneficiaries. Contributions and benefits under employer-sponsored retirement plans are subject to specific limitations. For example, in 2000 total pre-tax salary-reduction contributions made on behalf of an employee under a section 401(k) qualified cash-or-deferred arrangement cannot exceed $10,500.

Employer-sponsored retirement plans are generally subject to coverage and nondiscrimination rules. These rules are designed to ensure that employer plans do not disproportionately cover higher-paid employees and that benefits provided to moderate- and lower-paid employees are generally proportional to those provided to higher-paid employees.

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

Most taxable distributions made from employer retirement plans and IRAs before the employee or individual has reached age 59-1/2 are subject to a 10-percent additional tax.

#### Reasons for Change

The favorable tax treatment accorded contributions to employer-sponsored retirement plans and IRAs has played an important role in expanding retirement-savings opportunities for many

individuals, but tens of millions of lower-and moderate-income workers still are not benefiting from these opportunities.

Only half of workers are covered by an employer-sponsored retirement plan, and workers with lower earnings are much less likely to be covered than workers with higher earnings. Moreover, lower-income workers are less likely to contribute to a 401(k)-type plan even when such an option is offered, and lower-income individuals are even less likely to contribute to an IRA.

A key reason for these low levels of participation by lower income workers is that these families, compared to higher-income workers and families, tend to have less access to credit and financial markets. These families must devote a high proportion of their disposable income to necessities such as food, clothing, housing, and medical care, leaving little or no income for retirement saving. An additional reason is that lower-income families are less likely to have experience with financial institutions and their investment products or the benefits of long-term saving on a tax-preferred basis. Finally, the value of the existing tax incentives for saving is significantly lower for lower-income families. The three-quarters of households in the 15% bracket or below receive little or no tax subsidy on their IRA or pension contributions. The combined effect is that lower-income families are less likely to accumulate assets that will generate retirement income.

The retirement savings options available under current law should be supplemented by an option that addresses these impediments to savings by lower- and middle-income families. Providing a substantial government matching contribution would highlight for people the benefit of saving. And most importantly, unlike the existing savings incentives provided in the form of deductions and exclusions, the tax benefits offered by the new savings option would be greatest for those workers with the most modest incomes.

**Proposal**

The Administration's proposal would create Retirement Savings Accounts (RSAs), which provide progressive matches to individual contributions made by eligible taxpayers to a 401(k)-type retirement plan or an account held by a financial institution. This RSA match would supplement any employer matching contributions, and would be provided whether or not the employer offers matching contributions under its 401(k)-type plan.

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

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

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

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

Eligible taxpayers would be those age 25 to 60 with at least $5,000 in earnings (which could be joint earnings for married taxpayers filing a joint return), who are not claimed as a dependent by another taxpayer. An otherwise-eligible individual without earnings could establish an RSA if his or her spouse earns at least $5,000. The earnings requirement would target the RSA matches to working families. For joint filers who both meet the age requirement, each spouse could establish a separate RSA and receive up to the maximum match.

Eligible taxpayers and spouses could make voluntary salary reduction contributions to a 401(k)-type employer plan in which they participate, or cash contributions to an RSA held in a qualifying financial institution that chooses to offer RSAs. The employer or financial institution would provide the RSA matching contribution upon verification of the individual's eligibility.

Salary-reduction contributions to employer plans that receive RSA matching contributions would continue to be subject to current-law requirements. Thus, these contributions would be excluded from income when made, taken into account in nondiscrimination testing, and subject to the general salary reduction contribution limits. The RSA matching contributions would also be excluded from income when deposited, but would not be taken into account in nondiscrimination testing (e.g., the nondiscrimination testing applicable to the employer's regular matching contributions) or for any other limits.

Individual contributions to RSAs at qualifying financial institutions that are matched would be deductible. The RSA matching contributions would also be excluded from income when deposited. The individual contributions and the RSA matching contributions would offset the individual's $2,000 IRA contribution limit. Like excess IRA contributions, individual RSA contributions in excess of $1,000 ($500 from 2002 to 2004) would be subject to an annual excise tax.

As is the case with IRAs and employer plans, earnings would accumulate on a tax-deferred basis and distributions would be taxable.

Preretirement withdrawals of limited amounts for certain special purposes (i.e., purchase of a first home, a medical emergency or paying for a college education) would be permitted after 5 years. Except in the case of death or disability, all other amounts could not be distributed before the account holder reaches retirement age.

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

To allow efficient administration of the RSA program, participation by financial institutions would be limited to Federally insured depository institutions and certain other financial institutions as specified by Treasury regulations. To assist with account administration requirements, an on-line database of eligible taxpayers and spouses and available government matching contributions would be maintained. It is anticipated that employers and financial institutions could access this database to determine if plan participants and accountholders requesting a government matching contribution are eligible.

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

## SMALL BUSINESS TAX CREDIT FOR QUALIFIED RETIREMENT PLAN CONTRIBUTIONS

### Current Law

A qualified retirement plan is accorded special tax treatment under current law. Employees do not include qualified plan benefits in income until the benefits are distributed. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though the contributions are not currently included in an employee's income. Contributions to a qualified plan are held in a tax-exempt trust.

The qualification standards and related rules governing qualified plans are designed to ensure that qualified plans benefit an employer's rank-and-file employees as well as highly compensated employees. Certain rules are designed to ensure that amounts contributed to qualified plans are used for retirement purposes.

Small employers that wish to sponsor a tax-favored retirement savings plan, yet seek to avoid the administrative cost and complexity associated with traditional qualified retirement plans, may establish a simplified defined contribution retirement plan called a savings incentive match plan

for employees (SIMPLE) retirement plan. SIMPLE plans must provide for certain specified employer contributions. An employer is eligible to adopt a SIMPLE plan if the employer has no more than 100 employees who received at least $5,000 of earnings in the preceding year and does not maintain another retirement plan.

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

**Reasons for Change**

Many small employers are reluctant to establish a qualified retirement plan for employees that provides nonelective or matching contributions to all employees. Plans that offer only salary reduction contributions often do not benefit many lower- and moderate-income employees and, thus, do not provide these workers with the advantage of tax-deferred savings through the employer-sponsored qualified plan. By encouraging employers to provide nonelective contributions and matching contributions for non-highly compensated employees, retirement savings for those workers will increase.

**Proposal**

The Administration proposes that small employers would be entitled to claim a nonrefundable income tax credit equal to 50 percent of certain qualifying employer contributions made to a qualified retirement plan on behalf of a nonhighly compensated employee (defined as such without taking into account the top paid group election). For this purpose, a small employer is one that has no more than 100 employees who received at least $5,000 of earnings in the preceding year.

To be eligible for the credit, a small employer must make nonelective contributions equal to at least one percent of compensation. The credit would apply to both qualifying nonelective employer contributions or qualifying employer matching contributions, but only up to a total of three percent of the nonhighly compensated employee's pay.

Plan sponsors would likewise be able to claim the credit for 50 percent of qualifying benefit accruals under a nonintegrated defined benefit plan if the benefits are equivalent, as defined in regulations, to a three-percent nonelective contribution to a defined contribution plan.

To qualify for the credit, the nonelective and matching contributions to a defined contribution plan and the benefit accruals under a defined benefit plan must vest at least as rapidly as under a three-year cliff vesting schedule or under a five-year 20-percent-a-year graded vesting schedule. Amounts contributed to qualified plans other than pension plans would be withdrawable only in accordance with the withdrawal rules for section 401(k) qualified nonelective employer contributions (for example, upon separation from service, attainment of age 59½ , death, or

disability). Qualifying contributions to a pension plan would be eligible to be withdrawn only subject to the withdrawal restrictions generally applicable to those plans (upon severance from employment, death or disability). However, in the case of both pension and non-pension plans, contributions generally could not be withdrawn upon separation from service or severance from employment within 5 years after the first contribution is made to the plan, unless directly transferred to an account with the same withdrawal restrictions.

The plan to which the qualifying contributions are made (and any plan aggregated with that plan for nondiscrimination testing purposes) must provide for any nonelective employer contributions to be allocated proportionally to participants' compensation from the employer (or on a flat-dollar basis) and, accordingly, cannot use permitted disparity or cross-testing.

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

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

The credit would be effective for taxable years beginning after December 31, 2001. An employer could only claim the credit for three taxable years. The credit would generally not be effective for taxable years beginning after December 31, 2009, but an employer that claims the credit for the first time in 2008 or 2009 may claim the credit for the remaining one or two taxable years.

## SMALL BUSINESS TAX CREDIT FOR EXPENSES OF STARTING NEW RETIREMENT PLANS

### Current Law

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

### Reasons for Change

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

## Proposal

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

The credit generally would be available to an employer that has no more than 100 employees who received at least $5,000 of earnings in the preceding year, but only if the employer did not have a plan or payroll deduction IRA arrangement during any part of 1998. An employer could not claim the credit unless the plan covered at least one nonhighly compensated employee. In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement would have to be made available to all employees of the employer who have worked with the employer for at least three months.

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

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

# PROMOTE INDIVIDUAL RETIREMENT ACCOUNT CONTRIBUTIONS THROUGH PAYROLL DEDUCTION

## Current Law

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

## Reasons for Change

Payroll deduction contributions to IRAs could be an important means of increasing retirement savings among employees. The advantages of saving through payroll deduction -- the

convenience of automatic periodic contributions, reinforcement of the value of saving by peer groups in the workplace, and the incentive of tax-favored treatment of contributions -- encourage employees to save more for retirement. One way to encourage employers to offer, and employees to make, payroll deduction contributions to IRAs would be to provide employees with a convenient way to receive an immediate tax benefit for these contributions and simplify tax reporting by eliminating the need for most employees to report the contributions on their tax returns (and enables some employees to use simpler tax forms).

**Proposal**

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

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

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

**Current Law**

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

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

**Reasons for Change**

There is no alternative, similar to SIMPLE plans or SEPs, that is available for small business employers seeking to provide their employees with a simplified, tax-favored defined benefit

pension plan. The need for complex actuarial calculations, administrative costs, and the unpredictability of funding requirements may inhibit these employers from adopting such plans.

## Proposal

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

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

### Employer Eligibility

An employer generally would be eligible to maintain a SMART Plan if the employer had no more than 100 employees who received at least $5,000 of earnings in the prior year and did not maintain a defined benefit pension plan or a money purchase pension plan within the preceding five years.

### Employee Eligibility and Vesting

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

### Benefits and Funding

#### *Minimum Defined Benefit*

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

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

benefit for a year would be $100,000 (indexed for inflation in $5,000 increments using the year of enactment as the base year).

*Funding and Investment Returns*

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

In the case of a SMART Trust, each employee would have an account to which actual investment returns would be credited. If a participant's account balance were less than the total of past employer contributions credited with 5 percent interest per year, the employer would be required to contribute an additional amount for the year to make up for any shortfall. Moreover, the employer would be required to contribute an additional amount for the year to make up for any shortfall between the balance in the employee's account and the purchase price of an annuity paying the minimum guaranteed benefit when an employee retires and takes a life annuity. On the other hand, if the investment returns exceeded the 5 percent assumption, the employee would be entitled to the larger account balance. If the employee elected to receive an annuity, the larger account balance would translate to a larger annuity.

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

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

Distributions

*Timing*

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

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

*Form*

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

*Taxation*

Distributions from SMART Plans would be subject to tax under current rules applicable to the taxation of annuities under section 72. A 20 percent additional tax would be imposed for violating the pre-age 65 distribution restrictions under a SMART Annuity or SMART Account.

PBGC Guarantee and Premiums

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

Reporting and Disclosure

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

Nondiscrimination Requirements and Benefit Limitations

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

Miscellaneous

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

*Employee contributions*. The SMART Plan would not accept employee contributions.

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

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

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

These provisions would be effective for calendar years beginning after 2000.

## ENHANCEMENTS TO SIMPLE 401(k) PLAN NONELECTIVE CONTRIBUTION ALTERNATIVE

### Current Law

Under current law, small business employers that wish to sponsor a tax-favored retirement savings plan, yet seek to avoid the administrative cost and complexity associated with traditional qualified retirement plans, may instead establish a SIMPLE IRA (a SIMPLE plan funded through an IRA) or a SIMPLE 401(k) plan (a SIMPLE plan funded through a 401(k) plan). SIMPLE IRA and SIMPLE 401(k) plans are defined contribution plans that are not subject to many of the rules applicable to qualified retirement plans (e.g., nondiscrimination and top-heavy rules). In addition, SIMPLE IRA plans are subject to only minimal reporting and disclosure requirements. SIMPLE plans allow employees to make salary reduction contributions up to $6,000 a year. SIMPLE plans generally must provide for either a 100 percent matching contribution on employee elective contributions up to 3 percent of pay, or a nonelective contribution on behalf of all employees equal to 2 percent of pay. Other than the prescribed levels of matching or nonelective contributions, no other employer contributions may be made to SIMPLE plans. An employer sponsoring a SIMPLE plan must decide on the contribution formula for a year prior to the beginning of the year.

Although the contribution requirements under SIMPLE IRA plans and SIMPLE 401(k) plans generally are the same, there are several differences between these types of plans under current law. For example, employees generally become eligible to participate after one year under SIMPLE 401(k) plans, instead of after up to two years under SIMPLE IRA plans. In addition, unlike employee elective contributions to SIMPLE 401(k) plans, which are subject to the normal 401(k) plan withdrawal restrictions, employee elective contributions to SIMPLE IRAs may be withdrawn at any time, subject to an increased early withdrawal tax under Section 72(t) (at a rate of 25 percent instead of 10 percent) during an employee's first two years of participation in the SIMPLE IRA plan. While employee and employer contributions to SIMPLE 401(k) plans are subject to the percentage-of-pay contribution limits of section 415, contributions under SIMPLE IRA plans are not.

**Reasons for Change**

Surveys indicate that one of the main reasons many small businesses do not sponsor plans is that the financial situation of the small business often is too uncertain to enable the business to commit to maintaining a plan. Given this uncertainty, some small businesses are especially hesitant about committing themselves, before the beginning of a year or early in the year, to make even modest levels of employer contributions for the year. On the other hand, some small businesses that are attracted to the SIMPLE plan as a simplified means of providing 401(k)-type plan coverage may also wish to have the option of making nonelective contributions in excess of 2 percent of compensation in more profitable years.

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

**Proposal**

The Administration's proposal would enhance the SIMPLE 401(k) plan nonelective contribution alternative in a number of ways.

First, an employer would have the flexibility to make a nonelective contribution equal to 1 percent, 2 percent, or 3 percent (or more, up to 15 percent) of compensation for all eligible employees. As under current law, the nonelective contribution rate would be uniform for all employees and contributions would be fully vested when made. In addition, these contributions would be subject to the withdrawal restrictions applicable to employer contributions under the 401(k) safe harbor rules.

Second, in order to provide an employer with an adequate opportunity to assess its financial situation each year, the employer would be permitted to wait until as late as December 1 of the year for which a contribution is made to determine the level of nonelective contributions for the year. The level of nonelective contributions would be disclosed in the annual notice provided to employees at the end of the year.

Third, in order to provide nonhighly compensated employees with an adequate opportunity to make the maximum permissible elective contributions available to highly compensated employees under the plan -- particularly when an employer decides late in the year to make a nonelective contribution of 3 percent or more -- the elective contribution limit for nonhighly compensated employees under the 3 percent SIMPLE 401(k) nonelective contribution alternative (or, for that matter, the 1 percent or 2 percent alternative) would be conformed to the limit that generally applies to 401(k) plans ($10,500 for 2000) even when employers make no contributions. Thus, this limit would apply for non-highly compensated employees regardless of the level of employer nonelective contributions made to the plan.

The elective contribution limit for highly compensated employees under the SIMPLE 401(k) nonelective contribution alternative would depend on the level of nonelective contributions made on behalf of all eligible employees. This in essence would provide a "reverse matching" incentive for small business owners and executives. If an employer chose (by December 1) to make a nonelective contribution equal to 2 percent of compensation on behalf of all eligible employees, then, as under current law, highly compensated employees would be permitted to contribute up to $6,000 (indexed for inflation) in elective contributions to the SIMPLE 401(k) plan. Alternatively, if an employer chose (by December 1) to make a nonelective contribution equal to 1 percent of compensation, highly compensated employees would be permitted to contribute up to $3,000 (indexed for inflation) in elective contributions to the plan. As a further alternative, if an employer chose (by December 1) to make a nonelective contribution equal to 3 percent of compensation (or more), highly compensated employees would be permitted to contribute up to the maximum 401(k) elective contribution limit ($10,500 for 2000). An employer maintaining a SIMPLE 401(k) plan using the nonelective contribution alternative for a year also would have the option to make no nonelective contributions to the plan for a year, in which case highly compensated employees would not be permitted to make elective contributions to the plan for the year.

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

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

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

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

## ELIMINATE IRS USER FEES FOR INITIAL DETERMINATION LETTERS FOR SMALL BUSINESSES ADOPTING A QUALIFIED RETIREMENT PLAN FOR THE FIRST TIME

### Current Law

An employer that maintains a retirement plan for the benefit of its employees may request from the IRS a determination as to whether the form of the plan satisfies the requirements applicable

to tax-qualified plans. While sponsors are not required to obtain a determination letter, most sponsors apply for such letters. To obtain a determination letter from the IRS the sponsor must pay a user fee. For 2000, the user fee ranges from $125 to $1,250, depending upon the scope of the request and the type of format of the plan. (The IRS sets the dollar amount of the fee applicable to any particular type of request, provided that the average fee must not be less than $250 for an employee plan ruling or $300 for an employee plan determination letter request.) For 2000, the IRS user fee is $125 in the case of a plan for which the IRS has given form pre-approval (e.g., prototype plans offered to customers of financial institutions) and $1,250 for individually designed plans.

User fees were first statutorily authorized in 1987 for a limited period that has since been extended. The most recent extension authorizes user fees through September 30, 2003.

**Reasons for Change**

Plan start-up costs may pose a barrier to the establishment of new retirement plans, especially for smaller employers. Elimination of user fees for small employers starting new plans could promote the adoption of new retirement plans, especially in conjunction with the small employer retirement plan start-up tax credit.

**Proposal**

Under the proposal, the IRS user fee would be eliminated for the initial determination letter of a qualified retirement plan maintained by a small business. Specifically, the user fee would be eliminated for the initial determination letter of a plan established by an employer if (1) the employer did not maintain a qualified plan in 1998, (2) the employer had no more than 100 employees who received at least $5,000 of earnings in the preceding year, and (3) the qualified retirement plan covers at least one non-highly compensated individual. The elimination of the user fee would be available with respect to one plan of each eligible employer. In addition, there would be no adjustment to any other user fee.

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

## SIMPLIFY PROHIBITED TRANSACTION PROVISIONS FOR LOANS TO INDIVIDUALS WHO ARE S CORPORATION OWNERS OR SELF-EMPLOYED

**Current Law**

A qualified retirement plan is permitted to make loans to participants. While section 4975 and parallel ERISA rules prohibit any loan from a retirement plan to a person who is a disqualified person with respect to the plan, there is a general statutory exemption for participant loans. This exemption does not apply to participants who are either sole proprietors, 5 percent owners of a corporation that has made an election to be taxed under the provisions of Subchapter S, or self-employed individuals who are 10 percent owners. The prohibited transaction exemption for

participant loans does not extend to these owners because of historical abuses associated with the use of plan assets by business owners.

**Reasons for Change**

The historical abuses associated with the use of plan assets by business owners generally involve individuals who are sole owners or who have very substantial ownership control over the business. The limit on loans to small business owners should be more consistent among the various forms of business and should permit individuals without meaningful control of the business to borrow under the same rules as other employees. In addition, a loan made to a participant who is an owner of a business when that business is taxable as a C corporation should not become immediately prohibited merely because the business elects to be taxed under the provisions of Subchapter S.

**Proposal**

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

The changes would take effect for loans first made by the qualified retirement plan after December 31, 2000.

## PROVIDE FASTER VESTING FOR EMPLOYER CONTRIBUTIONS TO QUALIFIED RETIREMENT PLANS

**Current Law**

Generally, employer contributions on behalf of an employee under a qualified plan either must be fully vested after the employee has completed five years of service, or must become vested in increments of 20 percent for each year of service the employee completes beginning with the third year of service, with full vesting after the employee has completed seven years of service. Employee contributions must be fully vested immediately.

**Reasons for Change**

The relative importance of vesting for retirement savings has grown substantially in recent years. Given the increasingly mobile nature of today's workforce, there is more risk than existed in past years that many participants will leave employment before fully vesting in benefits. Faster vesting for employer contributions increases benefits for workers who change jobs frequently

and move in and out of the workforce, such as workers who leave employment to raise a child or to care for seriously ill family members.

**Proposal**

Under the proposal, minimum vesting requirements would be changed to require that an employee vest in employer contributions after completing three years of service, or become vested in increments of 20 percent for each year of service the employee completes, with full vesting after the employee has completed five years of service. This would apply to both defined contribution and defined benefit plans. Conforming changes would be made to the top heavy rules and Title I of ERISA.

The proposal would be effective for plan years beginning after December 31, 2000, with extended effective dates for plans maintained pursuant to a collective bargaining agreement. The proposal would not apply to any employee until the employee has an hour of service after the effective date. In applying the new vesting schedule, service before the effective date would be taken into account.

## COUNT FMLA TIME TOWARD RETIREMENT VESTING AND PARTICIPATION REQUIREMENTS

**Current Law**

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

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

**Reasons for Change**

The loss of a year of vesting can be critical for many workers who may have to leave the workforce to care for a seriously ill family member or to raise a child.

**Proposal**

Under the proposal, workers who take time off under the Family and Medical Leave Act (FMLA) could count that time toward retirement plan vesting and eligibility to participate.

The proposal would ensure that workers do not lose the retirement benefits they have earned when they take time off under FMLA. The proposal would be effective for plan years beginning after December 31, 2000.

## INCREASE DEFINED CONTRIBUTION PLAN PERCENTAGE OF PAY LIMITATION

### Current Law

Section 415 provides overall limits on contributions and benefits under qualified pension, profit sharing, and stock bonus plans, qualified annuity plans, tax-sheltered annuities, and simplified employee pensions (SEPs). The overall limits apply to all such contributions and benefits provided to an individual by any private or public employer or by certain related employers.

Under a defined contribution plan, the qualification rules limit the annual additions with respect to each plan participant to the lesser of (1) 25 percent of compensation or (2) $30,000 (adjusted for cost of living increases in $5,000 increments). Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. For purposes of applying the limit, all defined contribution plans of an employer and certain related employers are treated as a single defined contribution plan. Increased limits are provided for certain employees who participate in a tax-sheltered annuity program maintained by specified employers.

### Reasons for Change

The 25 percent of compensation limit may be overly restrictive for some lower- and moderate-income workers who wish to increase their retirement savings. This is especially true for workers moving in and out of the workforce and second earners in a family. The Administration proposal is designed to increase the retirement savings opportunities for these lower- and moderate-income workers who are most in need of additional retirement savings and have the ability to increase their retirement savings, while continuing to maintain appropriate limits on the percentage of compensation that an employee is permitted to defer on a tax-favored basis.

### Proposal

The Administration proposes to increase the maximum allowable annual addition for defined contribution plans from 25 percent to 35 percent of compensation. The $30,000 annual limit would not be changed.

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

## CERTAIN ELECTIVE CONTRIBUTIONS NOT TAKEN INTO ACCOUNT FOR PURPOSES OF DEDUCTION LIMITS

### Current Law

Under present law, employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, nondeductible contributions are subject to a 10-percent excise tax.

In the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15 percent of the aggregate compensation of the employees covered by the plan for the year. For purposes of the deduction limits, employee elective deferral contributions to a section 401(k) plan are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.

In the case of a money purchase pension plan, the employer may generally deduct the minimum funding requirement for the plan. Money purchase pension plans are pension plans that provide fixed, automatic employer contributions, are generally subject to stricter withdrawal restrictions than profit sharing or stock bonus contributions and must comply with other pension rules. Because the allocations for an individual are limited by section 415 to no more than 25 percent of an individual's compensation, the deductible limit for the plan is also no more than 25 percent of the aggregate compensation of the employees covered by the plan for the year.

If an employer sponsors both a pension plan (defined benefit or money purchase) and a defined contribution plan that is not a pension plan, the total deduction for all plans for a plan year generally is limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan’s unfunded current liabilities, in the case of a plan with more than 100 participants).

For purposes of the deduction rules, compensation generally includes only taxable compensation, and thus does not include salary reduction amounts (e.g., elective deferrals under a section 401(k) plan or salary reduction contributions under a section 125 cafeteria plan). For purposes of the contribution limits under section 415, compensation includes such salary reduction amounts.

### Reasons for Change

The deduction limits for defined contribution plans result in an additional incentive for employers to sponsor pensions plans by prescribing greater limits for money purchase and defined benefit pension plans than for profit-sharing or stock bonus plans. On the other hand, subjecting elective deferrals to the normally applicable deduction limits for profit-sharing plans may cause employers to restrict the amount of elective contributions an employee may make (e.g., limiting each employee's elective deferrals to 15 percent of compensation) or to restrict employer contributions to the plan to ensure that the deduction limits are satisfied. These

restrictions primarily affect nonhighly compensated participants and may reduce their ability to save for retirement.

**Proposal**

The Administration's proposal would modify the deduction limitation rules so that nonhighly compensated employees' retirement savings would not be constrained by reason of the deduction limits on elective contributions, while retaining the deduction-related incentive for employers to sponsor money purchase or defined benefit pension plans.

Specifically, the Administration proposes to increase the 15 percent deduction limit under section 404(a)(3)(A)(i)(I) by the amount of contributions on behalf of nonhighly compensated employees participating in the profit-sharing or stock bonus plan that exceed, in the aggregate, 15 percent of compensation otherwise paid or accrued on behalf of those nonhighly compensated employees. The relief would be available only if the contributions under the plan, other than elective contributions for those nonhighly compensated employees, would be deductible under 404(a)(3)(A)(i)(I) without regard to this provision.

Elective contributions that are deductible only as a result of this special rule would be disregarded for purposes of determining the amount deductible under section 404(a)(7)(A)(i) (the 25 percent limit applicable when an employee participates in both a defined contribution plan and a defined benefit plan).

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

## CONFORM DEFINITION OF COMPENSATION FOR PURPOSES OF DEDUCTION LIMITS

**Current Law**

See description of current law under "Certain Elective Contributions Not Taken into Account for Purposes of Deduction Limits."

**Reasons for Change**

Inconsistent definitions of compensation for purposes of the deduction limits under section 404 and the contribution limits under section 415 may unnecessarily complicate plan administration.

**Proposal**

Under the Administration's proposal, salary reduction amounts that are treated as compensation for purposes of section 415 would be treated as compensation for purposes of applying the limitations of section 404. Thus, for example, salary reduction amounts contributed to a section 401(k) cash or deferred arrangement or a section 125 cafeteria plan would be included in

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

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

### Current Law

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

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

Under Revenue Ruling 2000-8, elective contributions under a section 401(k) plan include contributions made pursuant to an arrangement under which, in any case in which an employee does not affirmatively elect to receive cash, the employee's compensation is reduced by a fixed percentage and that amount is contributed on the employee's behalf to the plan. Under the holding of this "automatic enrollment" ruling, the employee must have an effective opportunity to elect to receive cash.

### Reasons for Change

Under the section 401(k) safe harbor plan design, employers need not perform nondiscrimination tests. Especially under the matching contribution safe harbor, employers may not have adequate incentives to encourage nonhighly compensated employees to contribute or to educate them about the value of tax-deferred savings for retirement.

Plan sponsors could be allowed more flexibility in choosing between the 401(k) nonelective contribution safe harbor and the 401(k) matching formula safe harbor by permitting them to replace an appropriate portion of their safe harbor matching contributions with safe harbor nonelective contributions.

**Proposal**

The proposal would modify the section 401(k) matching formula safe harbor by requiring that, in addition to the matching contribution, employers either (1) make a contribution of one percent of compensation for each eligible nonhighly compensated employee, regardless of whether the employee makes elective contributions, or (2) automatically enroll eligible employees in the 401(k) plan at a 3 percent of compensation contribution rate, while giving them the opportunity to opt out or change their contribution rate pursuant to Revenue Ruling 2000-8.

In addition, in order to permit more flexibility in satisfying the 401(k) safe harbors and to further encourage safe harbor nonelective contributions under 401(k) safe harbor plans, the level of matching contributions required under the 401(k) matching formula safe harbor could be reduced, beginning with matching contributions provided at the highest rate of elective contributions, by the amount of safe harbor nonelective contributions under the plan. If the employer chooses not to provide for automatic enrollment, and accordingly must provide the 1 percent nonelective contribution described above, that 1 percent nonelective contribution would not reduce the matching contribution requirement.

For example, a plan sponsor that would otherwise satisfy the 401(k) matching formula safe harbor by automatically enrolling eligible employees and providing for a 100 percent matching contribution on elective contributions up to 3 percent of compensation and a 50 percent matching contribution on elective contributions up to the next 2 percent of compensation, could instead satisfy the 401(k) matching formula safe harbor by automatically enrolling eligible employees, providing eligible employees with a 100 percent matching contribution on elective contributions up to 3 percent of compensation and providing a 1 percent of compensation nonelective contribution (in lieu of a 50 percent matching contribution on elective contributions that exceed 3 percent of compensation). Similarly, a plan sponsor could satisfy the 401(k) matching formula safe harbor by automatically enrolling eligible employees, providing a 100 percent matching contribution on elective contributions up to 2 percent of compensation, and providing a 2 percent of compensation nonelective contribution.

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

## SIMPLIFY DEFINITION OF HIGHLY COMPENSATED EMPLOYEE

**Current Law**

A qualified retirement plan must satisfy various nondiscrimination tests to ensure that it does not discriminate in favor of highly compensated employees. To apply these tests, the employer must identify highly compensated employees. Under current law, effective for plan years beginning

after December 31, 1996, an employee is treated as a highly compensated employee if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) for the preceding year, had compensation in excess of $80,000 (indexed for inflation), and, if the employer elects, was in the top-paid group of employees for the preceding year. For this purpose, an employee is in the top-paid group if the employee was among the top 20 percent of employees of the employer when ranked on the basis of compensation paid to the employees during the preceding year.

**Reasons for Change**

The definition of highly compensated employee could be simplified by elimination of the top-paid group election. Permitting elections that may vary from year to year has increased the complexity of the rules.

In addition, under the current definition, it is possible for employees earning very high compensation (of several hundred thousand dollars or more) to be treated as nonhighly compensated for testing purposes if the employer has a sufficient percentage of high-paid employees in its workforce. This would allow some employers to effectively eliminate benefits for low- and moderate-wage workers without violating the nondiscrimination rules. The simplified definition of highly compensated employee should better reflect the purpose of promoting meaningful benefits for low- and moderate-wage workers, not only the high-paid.

**Proposal**

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

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

## TAX TREATMENT OF THE DIVISION OF SECTION 457 PLAN BENEFITS UPON DIVORCE

**Current Law**

Section 457(b) provides rules for deferral of compensation by an individual participating in an eligible deferred compensation plan of a tax exempt or State or local government employer. Under an eligible deferred compensation plan, distributions cannot commence prior to the earlier of (1) attainment of age 70-1/2, (2) the date a participant is separated from service with the employer, or (3) upon an unforeseeable emergency.

Benefits provided under a qualified retirement plan for a participant may not be assigned or alienated to creditors of the participant, except in limited circumstances. One exception to the

prohibition on assignment is a qualified domestic relations order (QDRO). A QDRO is a domestic relations order meeting certain requirements that creates or recognizes a right of an alternate payee to a plan benefit payable with respect to a participant. A distribution from a governmental or church plan qualified under section 401(a) is treated as made pursuant to a QDRO if it is made pursuant to a domestic relations order that creates or recognizes a right of an alternate payee. Such distributions are not required to meet the other procedural requirements that apply with respect to the determination of whether an order is a QDRO. The QDRO rules do not apply to section 457(b) plans.

Amounts distributed from a qualified plan generally are taxable to the participant in the year of distribution. However, if such amounts are distributed to the spouse or former spouse of the participant pursuant to a QDRO, the benefits are taxable to the spouse and not the participant.

**Reasons for Change**

The treatment of retirement plan payments made pursuant to divorce should be consistent among the various types of retirement plans.

**Proposal**

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

The current law rules exempting governmental plans from certain QDRO requirements for purposes of determining whether a distribution from a governmental section 457(b) plan is pursuant to a QDRO are not changed. It is not intended, however, that a governmental section 457(b) plan be precluded from applying the requirements of section 414(p)(1)(B) or (C) prior to honoring a QDRO, if the plan document provides that the order must satisfy those requirements.

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

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

**Current Law**

Traditional pension plans are currently required to offer to pay pension benefits in the form of a joint and survivor annuity option. This protects a surviving spouse of a plan participant by providing the spouse with regular annuity payments for life. Under these rules, an annuity payment is made as long as either spouse is alive. This amount is usually less than the amount that would have been payable if the participant had elected a single life annuity (one that pays benefits only for the lifetime of the plan participant). However, if the participant dies first, the surviving spouse continues to receive benefit payments for life (although usually in an amount

less than the amount paid while both spouses were alive). Plans can meet the joint and survivor annuity requirement by offering only a joint and 50 percent survivor annuity. Under this option, the monthly pension payments to the surviving spouse are reduced to 50 percent of the monthly payments that were made while both spouses were alive.

## Reasons for Change

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

## Proposal

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

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

# ENCOURAGE PENSION ASSET PRESERVATION BY DEFAULT ROLLOVER TO IRAS OF INVOLUNTARY DISTRIBUTIONS

## Current Law

Under current law, a qualified plan participant with a nonforfeitable accrued benefit of more than $5,000 generally has the right to defer receipt of payments that otherwise would be immediately distributable. Plans can immediately distribute nonforfeitable accrued benefits of $5,000 or less and can immediately distribute benefits to participants who have attained age 62 or normal age under the plan.

A qualified retirement plan must give a distributee of an eligible rollover distribution the option to have the eligible rollover distribution paid directly to an eligible retirement plan specified by the distributee in the form of a direct rollover from trustee to trustee. In a direct rollover, funds are not distributed to the plan participant, but are transferred directly by the trustee to another plan trustee, account trustee or custodian, or section 403(a) annuity contract holder. By contrast, when a distributee receives funds from a qualified retirement plan, amounts can be retained or be rolled over to a qualified retirement plan, an IRA or section 403(a) annuity within 60 days.

Eligible rollover distributions not directly rolled over are subject to income tax withholding at a rate of 20 percent.

Generally, an eligible rollover distribution is any distribution to an employee of all or a portion of the balance to the credit of the employee in a qualified retirement plan, except that the term does not include (1) a distribution which is part of a series of substantially equal periodic payments over 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 for a specified period of 10 years or more, (2) a required minimum distribution under section 401(a)(9), or (3) a hardship distribution described in section 401(k)(2)(B)(i)(IV).

Similar rules apply to section 403(b) tax-sheltered annuities.

**Reasons for Change**

One important means of increasing retirement savings is to encourage preservation of plan assets for use in retirement. Although many participants retain distributable amounts in their employer's plan, amounts that are distributed, particularly involuntary cashouts, often are not rolled over. This can significantly reduce the retirement income that would otherwise be accumulated by workers who change jobs frequently. In many cases, distributions are not rolled over because employees lack experience with financial institutions and are not familiar with the process of opening an IRA.

**Proposal**

Under the Administration's proposal, the direct rollover rules would be modified to encourage preservation of retirement assets by making a direct rollover the default option for involuntary cashouts that are eligible rollover distributions from qualified retirement plans, tax-sheltered section 403(b) annuities, or governmental section 457 plans. The modification to the direct rollover rules would apply if the eligible rollover distribution is greater than $1,000 and the distribution is subject to involuntary cashout under the plan (i.e., the distribution does not exceed $5,000 or is made after the later of age 62 or normal retirement age). In these circumstances, the distribution would be directly rolled over to an eligible retirement plan (including an IRA) unless the participant affirmatively elects to receive the distribution in cash (or, if applicable, property). The rollover IRA could be designated when the employee is enrolled as a participant in the plan; alternatively, the rollover IRA could be designated at termination of employment.

At the election of the plan sponsor, if participants fail to designate a rollover plan or IRA and do not affirmatively elect to receive the distribution in cash, then involuntary cashout amounts could be retained in the plan or the plan sponsor may designate an institution that will serve as the IRA trustee on behalf of the participant. In either case, the plan administrator would disclose to distributees the plan's choice of a default arrangement for cashout amounts (i.e., retention in the plan or direct rollover to a specified IRA in the participant's name).

Because the assets that are rolled over constitute plan assets, the plan sponsor's designation would be subject to ERISA's general fiduciary responsibility provisions (e.g., the requirements

that the selection be prudent and solely in the interest of the participant) and the prohibited transaction provisions of ERISA and the Code. A plan sponsor may choose an IRA provider that imposes annual maintenance fees and charges which are reasonable. The Department of Labor would be directed to issue safe harbors under which the designation of an institution and investment of the funds would be deemed to be prudent.

Once assets are rolled over to an IRA, they no longer would be assets of the plan from which they originated, and the plan fiduciary would not have any further responsibility under ERISA with respect to the IRA. Benefits directly rolled over to an IRA designated by the payor would be treated in the same way as any other benefits rolled over to an IRA. For example, the IRA owner could withdraw funds from the IRA at any time, subject to the normal income tax rules, including the additional 10 percent tax on early withdrawals where applicable.

The proposal would apply to distributions made after December 31, 2001, except that the proposal would not apply prior to January 1, 2003 to distributions from plans sponsored by small employers (i.e., those having no more than 100 employees). In addition, any plan sponsor could amend its plan and voluntarily comply with the proposal at an earlier date.

## ROLLOVERS ALLOWED AMONG VARIOUS TYPES OF PLANS

### Current Law

An eligible rollover distribution from a qualified retirement plan (i.e., a plan qualified under section 401(a) or 403(a)) may be either (1) rolled over by the distributee to an eligible retirement plan if the rollover occurs within 60 days of the distribution, or (2) directly rolled over by the distributing plan to an eligible retirement plan. If a qualified plan participant or a section 403(b) annuity holder does not elect the direct rollover option, then withholding is required on the distribution at a 20-percent rate.

Generally, an eligible rollover distribution is any distribution to an employee of all or a portion of the balance to the credit of the employee in a qualified retirement plan, except that the term does not include (1) a distribution which is part of a series of substantially equal periodic payments over 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 for a specified period of 10 years or more, (2) a required minimum distribution under section 401(a)(9), or (3) a hardship distribution described in section 401(k)(2)(B)(i)(IV).

An eligible retirement plan is a section 401 plan, a section 403(a) plan or an IRA. In the case of section 403(b) tax-sheltered annuities, distributions which would be eligible rollover distributions except for the fact that they are distributed from a section 403(b) tax-sheltered annuity may be rolled over to another section 403(b) tax-sheltered annuity or a traditional IRA.

Under these rules, for example, an eligible rollover distribution from a section 401(k) plan may not be rolled over to a section 403(b) tax-sheltered annuity or to an eligible nonqualified deferred compensation plan of a State and local government under section 457(b) (also known as a

governmental section 457 plan), and an eligible rollover distribution from a section 403(b) tax-sheltered annuity may not be rolled over to a section 401(k) plan or to a governmental section 457 plan.

Separate rules permit participants in governmental section 457 plans to transfer benefits in these plans to other governmental section 457 plans. Participants may not roll over distributions from these plans to qualified retirement plans, section 403(b) tax-sheltered annuities, or IRAs.

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

A surviving spouse who receives an eligible rollover distribution from a qualified plan or a section 403(b) tax-sheltered annuity may roll over the distribution to an IRA, but not to a qualified plan, a 403(b) tax-sheltered annuity or a governmental section 457 plan.

**Reasons for Change**

Given the increasing mobility of the American workforce, some individuals could accumulate a number of small retirement savings accounts and small amounts in various qualified retirement plans, section 403(b) tax-sheltered annuities, or governmental section 457 plans. Expansion of the current law rules to permit rollovers between qualified retirement plans, section 403(b) tax-sheltered annuities, and governmental section 457 plans would allow participants in these plans to combine their retirement plan savings in one vehicle if they change jobs. Permitting the consolidation of a participant's or a surviving spouse's retirement savings in a single retirement vehicle simplifies retirement planning and promotes preservation of retirement savings.

**Proposal**

An eligible rollover distribution made to a participant or a surviving spouse from a qualified retirement plan could be rolled over to a qualified retirement plan, a section 403(b) tax-sheltered annuity, a governmental section 457 plan, or a traditional IRA. Likewise, an eligible rollover distribution made to a participant or a surviving spouse from a section 403(b) tax-sheltered annuity could be rolled over to another section 403(b) tax-sheltered annuity, a qualified retirement plan, a governmental section 457 plan, or a traditional IRA. In addition, an eligible rollover distribution to a participant or a surviving spouse from a governmental section 457 plan could be rolled over to another governmental section 457 plan, a qualified retirement plan, a section 403(b) tax-sheltered annuity, or a traditional IRA. The conduit IRA rules would be modified in the same manner.

A special rule would prevent application of special capital gains and income averaging treatment available to distributions from qualified retirement plans if there was a rollover to the plan that was not permitted under present law. In addition, amounts held in a governmental section 457

plan attributable to rollovers from another type of plan would not be taxed until distributed. A distribution from a governmental section 457 plan of amounts rolled over from another type of plan would be subject to the early withdrawal tax. Governmental section 457 plans would be required to separately account for rollover amounts.

In addition, the direct rollover and withholding rules would be extended to distributions from a governmental section 457 plan. Governmental section 457 plans also would be required to provide written notification regarding eligible rollover distributions similar to that provided by qualified plans and section 403(b) tax-sheltered annuities. However, plans would not be required to accept rollovers.

The proposals would be effective for distributions made after December 31, 2000.

## ROLLOVERS OF AFTER-TAX CONTRIBUTIONS

### Current Law

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

### Reasons for Change

After-tax savings in qualified retirement plans enhance retirement security. Allowing such distributions to be rolled over to a traditional IRA or another qualified retirement plan would enable these amounts to benefit from the compounding of tax-deferred earnings and would increase the chances that they will be retained until needed for retirement.

### Proposal

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

The proposal would be effective for distributions made after December 31, 2000.

## ROLLOVERS OF REGULAR IRAS INTO WORKPLACE RETIREMENT PLANS

### Current Law

Regular contributions to a traditional IRA (i.e., contributions subject to the deduction limitations of section 219, as opposed to rollover contributions from a qualified retirement plan or a section

403(b) tax-sheltered annuity) cannot be directly or indirectly rolled over to a qualified retirement plan, section 403(b) tax-sheltered annuity or governmental section 457 plan.

**Reasons for Change**

Expansion of the current law rules permitting rollovers will allow a participant in a qualified retirement plan, a section 403(b) tax-sheltered annuity or a governmental section 457 plan, who also has made regular contributions to a traditional IRA, more opportunities to consolidate retirement savings.

**Proposal**

Under this proposal, an individual who has a traditional IRA and whose IRA contributions have all been tax deductible would be offered the opportunity to transfer funds from the traditional IRA into a qualified defined contribution retirement plan, section 403(b) tax-sheltered annuity or governmental section 457 plan -- provided that the retirement plan trustee meets the same standards as an IRA trustee. In addition, amounts distributed from a governmental section 457 plan would be subject to the early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from a traditional IRA. Governmental section 457 plans would be required to separately account for such amounts.

The proposal would be effective for distributions made after December 31, 2000.

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

**Current Law**

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

**Reasons for Change**

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

**Proposal**

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

The proposal would be effective after December 31, 2000.

## THRIFT SAVINGS PLAN PORTABILITY PROPOSALS

**Current Law**

The Thrift Savings Plan (TSP) is a retirement savings and investment plan for Federal and Postal employees. It offers employees the same type of before-tax savings and tax-deferred investment earnings that many private corporations offer their employees under section 401(k) plans.

A newly-hired Federal employee is first allowed to contribute to the FERS Thrift Savings Plan (TSP) in the second semi-annual election period -- six to twelve months after being hired. Rehired employees become eligible in the first election period following their rehire and thus wait up to six months. When an employee becomes eligible to participate in the TSP, the employing agency will automatically contribute 1 percent of pay to the employee's account. If the employee contributes, the agency makes certain matching contributions. Employee contributions to the TSP are limited to salary reduction amounts, precluding rollover contributions from a qualified trust.

**Reasons for Change**

New and rehired Federal employees should be provided the same retirement savings opportunities as current employees. Eliminating waiting periods for employee contributions would reduce gaps in savings opportunities for new and rehired Federal employees. Eliminating waiting periods for agency matching and automatic contributions would increase retirement savings and enhance employees' incentives to contribute.

Allowing tax-free rollovers to the TSP from qualified trusts sponsored by previous employers would make it easier for TSP participants to consolidate their retirement savings. Changing these rules would conform TSP practices to those followed by many private employer plans.

**Proposal**

All waiting periods for employee elective contributions and agency contributions to the TSP would be eliminated for new hires and rehires. In addition, an employee would be allowed to roll over an "eligible rollover distribution" from a qualified trust sponsored by a previous employer to the employee's TSP account. The proposal would be effective after December 31, 2000.

## PERMIT ACCELERATED FUNDING OF DEFINED BENEFIT PLANS

### Current Law

An employer's annual deduction for contributions to a defined benefit plan may not exceed the plan's full funding limitation. The full funding limitation is generally defined as the excess of the plan's accrued liability (or, if less, a specified percentage of the plan's current liability) over the value of the plan's assets. The specified percentage was initially 150 percent, but the Taxpayer Relief Act of 1997 provided for a gradual increase in the percentage over an 8-year period. The specified percentage is 155 percent for plan years beginning before January 1, 2000 and it increases by 5 percent in alternate years beginning in 2001, until it reaches 170 percent for plan years beginning on or after January 1, 2005. Whenever the specified percentage of current liability is less than the plan's accrued liability, the full funding limitation restricts the extent to which an employer can deduct contributions for benefits that have not yet accrued.

Special rules allow additional deductions in limited situations. For example, in the case of any defined benefit plan (other than a multiemployer plan) that has more than 100 participants, the employer may generally deduct any contribution necessary to increase plan assets to 100 percent of the plan's current liability. In addition, in the case of a single employer plan terminating under a standard termination, contributions are currently deductible up to the level of the benefits guaranteed by the PBGC under Title IV of ERISA.

A 10 percent excise tax is generally imposed on employers making nondeductible contributions to qualified plans.

### Reasons for Change

Benefit security for employees would be enhanced if the extended phase-in of the increase in the specified percentage from 150 percent to 170 percent were accelerated.

In addition, while the current liability full funding limit serves as a useful check on the ability of employers to systematically accelerate deductible contributions, in certain circumstances plan assets may be insufficient to properly fund the plan upon termination. In these situations, the contributions needed to terminate the plan should be deductible.

Some employers are concerned that the current liability full funding limit can put their employees at risk by forcing funding to be deferred into the future. Permitting an employer to contribute amounts which are currently nondeductible as a result of the current liability full funding limit, without applying the excise tax on nondeductible contributions, provides more security for employees while restricting employers' ability to use excessive pension funding as a tax shelter.

## Proposal

Under the Administration's proposal, the full funding limitation based on current liability would be phased up more quickly, so that it would be 170 percent of current liability for years beginning after December 31, 2002. In addition, the 10 percent excise tax on nondeductible contributions would not apply to the extent a contribution is nondeductible solely as a result of the current liability full funding limit.

Finally, the special deduction rule for terminating plans under section 404(g) would be modified so that all contributions needed to satisfy the plan's liabilities upon plan termination would be immediately deductible. In the case of a plan with fewer than 100 participants, liabilities attributable to recent benefit increases for highly compensated employees would be disregarded for this purpose.

Conforming changes would be made to Title I of ERISA.

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

# SIMPLIFY BENEFIT LIMITS FOR MULTIEMPLOYER PLANS UNDER SECTION 415

## Current Law

Annual benefits payable under a defined benefit plan are limited to the lesser of $135,000 (for 2000) or 100 percent of average compensation for a participant's three highest consecutive years. Reductions in both of these limits apply when the employee has fewer than ten years of plan participation or service. In addition, if an employee starts to receive benefits before the Social Security normal retirement age, the dollar limit must be actuarially reduced to compensate for the earlier commencement.

The Code contains a special rule for defined benefit plans sponsored by governmental or tax-exempt employers and qualified merchant marine plans. For these plans, the $135,000 section 415 limit applies to pensions payable beginning at age 62 (instead of Social Security normal retirement age) and the actuarial reductions for earlier commencements are based on this age 62 limit. In addition, the 100 percent of pay limit does not apply to governmental plans.

For purposes of section 415, all plans maintained by an employer and related entities are combined, except that the regulations permit a multiemployer plan to disregard benefits provided by the same employer through other multiemployer plans. Thus, aggregation of benefits within a multiemployer plan that are attributable to service with a specific employer and a single-employer plan maintained by the same (or a related) employer is required.

**Reasons for Change**

The qualified plan limitations present significant administrative problems for many multiemployer plans. These plans typically base benefits on years of credited service, not on a participant's compensation. In addition, the 100 percent-of-compensation limit is based on an employee's average compensation for the three highest consecutive years. This rule often produces an artificially low limit for employees in certain industries, such as building and construction, where wages vary significantly from year to year. In addition, the aggregation requirements for applying section 415 to employees who are in both a multiemployer plan and a single employer plan involves complex calculations and the sharing of potentially confidential data between the plan administrators of the multiemployer plan and the single employer plan.

Multiemployer plans should be permitted to provide for higher early retirement benefits because the participants in these plans often have a special need to retire early: in the absence of long-term employer-employee relationships, employers are less likely to hire or retain workers for jobs involving hard physical labor when the workers have reached an age at which they are less capable of bearing the physical stresses of the work.

**Proposal**

The section 415 limits applicable to multiemployer defined benefit pension plans would be modified to eliminate the 100 percent-of-compensation limit (but not the $135,000 limit) for such plans. In addition, the rule requiring aggregation of benefits provided from a single employer for purposes of section 415 would be modified to eliminate aggregation between a multiemployer defined benefit plan and a single employer defined benefit plan for purposes of the 100 percent-of-compensation limit. Finally, the special early retirement provisions for determining the section 415 limit that currently apply to defined benefit plans sponsored by governmental or tax-exempt employers and qualified merchant marine plans would be expanded to include multiemployer plans.

The proposals would be effective for limitation years beginning after December 31, 2000.

## SIMPLIFY FULL FUNDING LIMITATION FOR MULTIEMPLOYER PLANS

**Current Law**

See description of current law under "Permit Accelerated Funding of Defined Benefit Plans."

**Reasons for Change**

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

**Proposal**

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

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

## INCREASE DISCLOSURE FOR PENSION AMENDMENTS THAT REDUCE THE FUTURE RATE OF BENEFIT ACCRUAL

**Current Law**

Under section 204(h) of ERISA, a pension plan amendment that significantly reduces the rate of future benefit accrual cannot become effective unless notice is provided to participants at least 15 days before the effective date. However, the notice does not have to describe the amendment or the reduction, nor does it have to indicate that a reduction will in fact occur.

**Reasons for Change**

The limited notice requirement under current law does not provide pension plan participants with clear and adequate information about pension plan benefit reductions. If a pension plan is amended to significantly reduce the rate of future benefit accrual, participants should receive a description of the amendment and a statement that the amendment significantly reduces the rate of future benefit accrual. This additional information should be provided earlier than the 15 days currently imposed. If, for example, the amendment is a conversion from a traditional final pay pension plan to a cash balance plan, the change can be understood by participants only if the notice includes examples showing how the change affects future benefits for illustrative participants. Participants should have the ability to obtain plan documents in order to do their own calculations regarding future pension benefits, and should also be able to obtain projections of the effect of the change on their own future pensions. This personalized analysis will allow participants to better understand their potential retirement income and will afford them the opportunity to plan for their retirement accordingly.

**Proposal**

The Administration's proposal would require that the notice of a significant reduction of the rate of future benefit accrual summarize the important terms of the plan amendment, including identification of the effective date, a statement that the amendment is expected to significantly reduce the rate of future benefit accrual, a general description of how the amendment significantly reduces the rate of future benefit accrual, and a description of the class or classes of

participants to whom the amendment applies.   Participants would receive the notice at least 45 days before the effective date of the plan amendment.

If a plan has 100 or more active participants, the plan administrator would also be required to provide affected participants an enhanced advance notice of the amendment that describes, and illustrates using specific examples, the impact of the amendment on representative affected participants, to make available the formulas and factors used in those examples in order to permit similar calculations to be made, and to make available a follow-up individualized benefit statement estimating the participant's projected retirement benefits.  Certain amendments would be exempted, such as amendments that do not make a fundamental change in a plan's formula.

In the case of an egregious failure to comply with the notice requirements (for example, a failure to provide the required information to most affected participants or an intentional failure to provide notice to any affected participant), the amendment would be prohibited from going into effect for all affected participants, and the employer would be subject to excise taxes.  In the case of a failure that is not an egregious failure, the employer would be subject to excise taxes (which could be waived in certain cases), but the amendment would be permitted to take effect, provided the notice is promptly furnished to the affected participants who did not previously receive it.

The proposal would be effective for plan amendments taking effect after the date of enactment, with special transition rules in certain circumstances.

**Provide AMT Relief for Families and Simplify the Tax Laws**

## ALTERNATIVE MINIMUM TAX (AMT) RELIEF FOR INDIVIDUALS

### Current Law

Taxpayers are subject to an alternative minimum tax (AMT) if their tentative minimum tax is greater than their regular tax liability. Taxable income for AMT purposes is calculated differently than for regular tax purposes. Among the differences are the treatment of personal exemptions and the standard deduction. Under the AMT, there is an AMT exclusion which differs by filing status, but not by the number of persons in the tax-filing unit. For AMT purposes, taxpayers may not deduct the personal exemptions they are allowed under the regular income tax. Also, for AMT purposes, taxpayers may not deduct the standard deduction they are allowed under the regular tax, even though they may deduct certain itemized deductions that are permitted under the regular tax.

### Reasons for Change

The original individual AMT was enacted in the 1960's as a separate tax system within the income tax to ensure that high-income taxpayers could not eliminate their income tax liability through extensive use of special provisions considered "tax preferences." The Administration is concerned that, because of design flaws, the AMT increasingly imposes significant financial and compliance burdens on taxpayers who have few, if any, tax preference items and who are not the intended targets of the AMT.

In particular, the Administration is concerned that, because the AMT does not permit deductions for personal exemptions for dependents, large families with modest incomes can incur AMT liability because their regular income tax is reduced by these exemptions.

The AMT also creates complexity for taxpayers who would otherwise use the standard deduction, but because of the AMT may find it advantageous to itemize their deductions.

### Proposal

The tax deduction for dependent personal exemptions that is allowed for regular tax purposes would be allowed in computing the AMT on a phased in basis, beginning in 2000. For tax years 2000 through 2007, all but two dependent personal exemptions would be allowed for AMT purposes. For tax years 2008 and 2009, all but one dependent personal exemption would be allowed for AMT purposes. For tax year 2010 and later, all dependent personal exemptions would be allowed for AMT purposes.

For tax years 2000 and 2001, taxpayers who use the standard deduction for ordinary income tax purposes would be able to claim the same standard deduction for AMT purposes.

## SIMPLIFY AND INCREASE THE STANDARD DEDUCTION FOR DEPENDENTS

### Current Law

The standard deduction for tax filers who can be claimed as dependents by another taxpayer is the smaller of the standard deduction for single taxpayers ($4,400 for 2000), or the special standard deduction for dependent filers. The special standard deduction is the larger of $700 (for 2000) or the individual's earned income plus $250 (for 2000). Thus, under current law, dependents who have over $250 of income from savings and whose earnings plus income from savings is greater than $700 must file a tax return.

### Reasons for Change

These rules are complex and require hundreds of thousands of dependents to file tax returns even though they owe little tax. The Administration believes that teenagers and other dependents who have income from savings should be allowed to earn a greater amount of income without having to file a tax return or incurring tax liability, thereby encouraging them to work and save for their education or other needs.

### Proposal

Under the proposal, beginning in 2000, the standard deduction for dependent filers would be the individual's earned income plus $700 (indexed after 2000), but not more than the regular standard deduction.

## SIMPLIFICATION OF DEFINITION OF CHILD DEPENDENT

### Current Law

To qualify as a dependent, an individual must (1) be a specified relative or member of the taxpayer's household for a full year; (2) receive over half of his or her support from the taxpayer; (3) be a citizen or resident of the U.S. or resident of Canada or Mexico; and (4) not be required to file a joint tax return with his or her spouse.

For purposes of claiming the dependent exemption, a fifth test also applies. A taxpayer cannot claim an exemption for a dependent if the dependent's gross income exceeds the exemption amount ($2,800 in 2000). This test does not apply if the dependent is the taxpayer's child (son, daughter, stepson, or stepdaughter or foster child) and is under the age of 19 at the close of the calendar year (24 if a full-time student).

Specified relatives include the taxpayer's sons, daughters, grandchildren, siblings, parents, aunts, uncles, nieces and nephews. A foster child is defined to mean an individual for whom the

taxpayer "cares for as the taxpayer's own child." A foster child must reside with the taxpayer for the full tax year.

For purposes of determining whether a taxpayer provides over half of an individual's support, public assistance payments are taken into account as support payments made by a governmental authority. In the event of divorce or separation, the custodial parent is generally entitled to the dependent exemption if the parents, in combination, provide over half the support of the child. To qualify as the custodial parent, the taxpayer must reside with his or her child for over half the year. The custodial parent may waive the exemption to the noncustodial parent by providing the noncustodial parent with a written waiver.

For purposes of the earned income tax credit (EITC), a child is a qualifying child if the following three requirements are met: (1) the child must be the son, daughter, grandchild, or foster child of the taxpayer; (2) the child must generally reside with the taxpayer in the U.S. for over half the year (or a full year in the case of a foster child); and (3) the child must be under the age of 19 (or 24 if a full-time student). For EITC purposes, a foster child must meet the same tests that apply to the dependency exemption, and must also be either the taxpayer's sibling (or descendant of a sibling) or placed in the taxpayer's home by an agency of a State or one of its political subdivisions or a tax-exempt child placement agency. If more than one taxpayer satisfies the age, relationship, and residence tests with respect to the same child, only the taxpayer with the highest adjusted gross income can claim the child.

**Reasons for Change**

The proposal would simplify tax filing requirements for many taxpayers who reside with either their children or grandchildren. Many taxpayers would no longer be required to maintain extensive records (other than proof of residency) to prove that they support their own children.

The proposal would also more closely conform the rules for dependent children to those used for EITC qualifying children and may, as a consequence, further reduce taxpayer confusion. Under current law, a child may qualify a custodial parent for the EITC but not the dependent exemption. Under the proposal, taxpayers would be able to claim the same child as a dependent and as an EITC qualifying child.

The proposal would also clarify the definition of foster children. Current law does not provide the taxpayer or the IRS with sufficient guidance as to the application of the rule that the taxpayer must care for the child as if the child were his or her own. By specifying that a foster child must meet either a relationship or legal status test, the proposal would eliminate much of the ambiguity in current law.

**Proposal**

Taxpayers would no longer have to meet the support test in order to claim a child as a dependent if the child meets the following three requirements: (1) the child is the son, daughter, stepchild, grandchild or foster child of the taxpayer; (2) the child is under the age of 19 at the end of the taxable year (24 in the case of a full-time student); and (3) the child lives with the taxpayer for

over half the year (a full year in the case of foster children). If more than one taxpayer resides with the child and would be eligible to claim the child as a dependent under the proposed residency test, only the taxpayer with the highest adjusted gross income would be entitled to claim the child as a dependent.

The proposal would eliminate the current law requirement that a custodial parent is entitled to the dependent exemption only if both parents, in combination, provide over half the support of the child. Thus, under the proposal, a custodial parent would be entitled to the dependent exemption if the residency test is met. The custodial parent's right to waive the exemption to the noncustodial parent by providing the noncustodial parent with a written waiver would not be changed.

The proposal would also provide that a taxpayer who meets the proposed residency test (and the AGI tiebreaker, if applicable) may waive the exemption to a taxpayer who provides over half of the dependent's total support and meets the other current law rules for dependency (e.g., the relationship or residency tests under the broader dependency tests).

Also, for purposes of the dependent exemption residency and gross income tests, a foster child would be defined as a child who (1) is under the age of 19 (24 if a full-time student), (2) is cared for by the taxpayer as if he or she were the taxpayer's own child, and (3) is either the taxpayer's sibling (or descendant of a sibling) or has been placed in the taxpayer's home by an agency of a State or one of its political subdivisions or a tax-exempt child placement agency licensed by a State. In addition, under the proposal, grandchildren would be exempted from the gross income test if they are under the age of 19 (or 24 if a full time student).

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

## INDEX MAXIMUM EXCLUSION FOR CAPITAL GAINS ON SALE OF PRINCIPAL RESIDENCE

### Current Law

Taxpayers can generally exclude up to $250,000 ($500,000 for married taxpayers filing joint returns) of gain on the sale of a principal residence. The maximum exclusion amounts are not indexed for inflation. To be eligible for the full exclusion, the taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years preceding the sale. A taxpayer may claim the deduction only once in any two-year period.

### Reasons for Change

Since the maximum exclusion amounts are not indexed for inflation, increases in house prices due to inflation would mean that more and more taxpayers would be subject to tax over time. As a result, a much larger number of taxpayers would have to maintain detailed records for purposes of computing an inflated capital gain potentially subject to tax. Many taxpayers may not maintain such records, believing that their residence would be unlikely to be subject to tax due to

the exclusion. Thus, over time, inflation could undermine the simplification benefits of this provision by increasing many house prices above the exclusion limits. Indexation of the maximum exclusion amounts would prevent inflation from subjecting more homeowners to tax when they sell their homes, and thus reduce their recordkeeping requirements.

**Proposal**

The proposal would index the maximum exclusion amounts for gains from the sale of a principal residence for inflation after 2000.

## TAX CREDIT TO ENCOURAGE ELECTRONIC FILING OF INDIVIDUAL INCOME TAX RETURNS

**Current Law**

Tax return preparation costs of individuals, including any costs of electronic filing, may be deducted only by taxpayers who itemize deductions and then only to the extent that such costs, in combination with other miscellaneous itemized deductions, exceed two percent of AGI.

**Reasons for Change**

A tax credit for electronic filing would encourage taxpayers to try electronic return submission, moving the IRS closer to the goal set in the 1998 IRS Restructuring and Reform Act of having 80 percent of tax year 2006 returns filed electronically. Higher levels of electronic filing will reduce costs and burdens for both taxpayers and the IRS. Electronic filing reduces taxpayer errors and the need for subsequent contacts between the taxpayer and the IRS. Electronic filing permits taxpayers to receive their tax refunds faster. Form 1040EZ taxpayers may file electronically by telephone under the TeleFile program (where returns are filed by entering information through the keypads of telephones).

To achieve higher levels of electronic filing, more taxpayers whose returns are prepared by computer will have to switch to electronic filing an will require more taxpayers to use computerized tax-preparation methods. The switch to computerized tax preparation may cause an actual or perceived transitional increase in burden and/or costs, even if in the longer run burdens are reduced. A tax credit would help compensate taxpayers for such transitional burdens.

**Proposal**

The proposal would provide a temporary, refundable tax credit for the electronic filing of individual income tax returns. The credit would be for tax years 2002 through 2006 and would be $10 for each electronically filed return other than TeleFile returns for which the credit would be $5.

The proposal also would provide that, no later than tax year 2002, the IRS would be required to offer one or more options to the public for preparing and filing individual income tax returns over the Internet at no cost to the taxpayer. If the IRS offered such options through contract arrangements with Authorized IRS E-file Providers, it would be with the assurance that the taxpayer's tax return information would not be used by the Provider without the taxpayer's permission for any purpose other than submission to the IRS.

## CLARIFICATION OF EMPLOYMENT TAX TREATMENT OF INDIVIDUALS IN SHELTERED WORKSHOPS

### Current Law

Sheltered workshop programs provide training, job placement and on-site employment for individuals with disabilities. During an initial training and evaluation period, participants learn skills for employment outside the sheltered workshop. Typically the amount of remuneration paid by the workshop is below minimum wage under a special waiver granted by the Department of Labor. For purposes of the personal exemption rules, income attributable to services performed by disabled individuals in certain sheltered workshops is not taken into account in determining whether the dependent has gross income less than the exemption amount.

Under Revenue Ruling 65-165, 1965-1 C.B. 446, during a limited initial training period, individuals performing services under a sheltered workshop training program are not employees (and thus the service is excluded from employment taxes). In addition, the ruling holds that the individuals are employees if, after training, they continue to perform services on the workshop's premises under working conditions, pay scales, and benefits comparable to private industry.

### Reasons for Change

The use of sheltered workshops has expanded significantly since 1965. Sheltered workshops now provide a variety of services to clients in addition to job training. As a result, it is often not clear when the job training period ends and employment begins. Clarification will eliminate the current ambiguity in the existing administrative guidance which results in a number of individual cases being addressed by the Internal Revenue Service. By eliminating the ambiguity, sheltered workshops and the Internal Revenue Service can more effectively use resources.

### Proposal

The proposal would clarify the exclusion from employment taxes for service provided in a sheltered workshop. Under the proposal, the definition of "employment" under section 3121(b) would be amended to exclude certain services rendered by disabled individuals in a sheltered workshop program. The exclusion would be limited to service that is both (1) performed for a period of no more than 18 months under a minimum wage exemption certificate issued by the Department of Labor and (2) provided in a sheltered workshop operated by a section 501(c)(3) organization or a State or local government. However, organizations could voluntarily agree to

provide coverage, pursuant to an agreement with the Social Security Administration. Corresponding changes would be made to the Social Security Act.

The proposal would be effective for service after December 31, 2000.

## ENHANCE SECTION 179 EXPENSING FOR SMALL BUSINESSES

### Current Law

In place of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect under Section 179 to deduct up to $20,000 (Tax year (TY) 2000) of the cost of qualifying property placed in service for the taxable year. The deductible amount rises to $24,000 for TY 2001 and 2002, and to $25,000 for TY 2003 and thereafter. In general qualifying property is defined as depreciable tangible property that is purchased for use in the active conduct of a trade or business. Qualifying property does not include Section 197(e)(3) off-the-shelf computer software, which is depreciable over 3 years.

The $20,000 limit on the amount of property that may be expensed is reduced (but not below zero) by the amount by which the cost of all qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed taxable income that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). In the case of a partnership or S corporation, the limits on the amount that can be expensed and on business income are applied first to the business and then to the owners separately, aggregating each owner's potential Section 179 deductions from all sources.

### Reasons for Change

The Administration wants to encourage more investment by small business. Increasing the limit on Section 179 expensing is an effective way to accomplish this. The rules of Section 179 are too complex. For example, the expensing limit and business income test are complicated for both flow-through businesses and their owners. The treatment of computer software is confusing to many taxpayers. Because off-the-shelf software is intangible property, it is not eligible for expensing under Section 179 like most other 3-year property. If a taxpayer determines that a previous election under Section 179 is in fact not to its advantage, it cannot revoke the election without incurring the expense and uncertainty of requesting the consent of the Secretary of the Treasury. (A Section 179 election may not be to a taxpayer's advantage if, for example, it limits his or her income and makes various tax credits unusable.) Section 179 is also not well targeted to small business. Some of the biggest firms are able to use Section 179 deductions because they have few investments. In 1996, 32% of all corporations with gross receipts over $10 million (the largest 5 percent of all businesses) claimed Section 179 deductions, compared to only 23% of corporations with less than $5 million in receipts.

**Proposal**

The proposal contains five parts. First, it would increase the amount of investment that can be expensed to $25,000 in TY 2001 and index that amount for inflation, rounding down to increments of $1000.

Second, the proposal would allow the Section 179 deduction to be claimed at the entity level for flow-through businesses, with no additional limits based on the returns of partners or S corporation shareholders.

Third, it would clarify and simplify the deduction for business software by including off-the-shelf computer software under Section 167(f) as property eligible for expensing under Section 179.

Fourth, it would limit the eligibility of Section 179 to small businesses, defined as those averaging no more than $10 million in gross receipts over the three preceding taxable years. A single business would include its predecessors and related businesses (if any), as in applying the expensing limit under current law. If a taxpayer had not been in existence for three years, the gross receipts test would be applied over the period of its existence. The gross receipts test would replace the phase-out of the expensing limit which starts at $200,000 in investment in qualifying property.

And fifth, it would allow a Section 179 election to be revoked on an amended return.

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

# OPTIONAL SELF-EMPLOYMENT CONTRIBUTIONS ACT (SECA) COMPUTATIONS

## Current Law

The Self-Employment Contributions Act (SECA) imposes taxes on net earnings from self-employment to provide social security coverage to self-employed workers. The maximum amount of earnings subject to the self-employment (or SECA) tax is coordinated with, and is set at the same level as, the maximum level of wages and salaries subject to FICA taxes ($76,200 for OASDI taxes in 2000 and indexed annually, and without limit for the Hospital Insurance tax).

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

## Reasons for Change

Combining the two different optional methods of computing self-employment income for self-employment tax purposes into a single combined optional method would simplify the self-employment tax for the approximately 30,000 taxpayers (in 1997) who use one of these methods. Forms and instructions would also be simplified for the millions of self-employed workers who do not use the optional methods.

By permitting non-farm self-employed workers to use the more favorable requirements that currently apply to the farm optional method, more non-farm self-employed persons would be expected to use the combined optional method and, thereby, to obtain additional social security and Medicare coverage and, eventually, to receive higher social security benefits.

## Proposal

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

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

## CLARIFY RULES RELATING TO CERTAIN DISCLAIMERS

### Current Law

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

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

### Reasons for Change

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

### Proposal

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

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

### Current Law

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

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

### Reasons for Change

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

### Proposal

The proposal would simplify the application of the foreign tax credit limitation by applying the look-through approach immediately to dividends paid by a 10/50 company, regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated. The proposal would grant regulatory authority to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of the stock, including rules that disregard preacquisition earnings and profits, and foreign taxes, in appropriate circumstances. The proposal would be effective for dividends paid in taxable years beginning after December 31, 1999.

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

### Current Law

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

### Reasons for Change

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

### Proposal

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

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

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

### Current Law

In contrast to the rules governing charities, non-charities (i.e., organizations not described in section 501(c)(3)) generally are not required to file an application with the IRS to obtain a determination of their tax-exempt status. In practice, however, some organizations voluntarily do so by filing a Form 1024. If an organization that voluntarily files Form 1024 later receives a favorable determination from the IRS, the determination of tax-exempt status is usually effective

as of the date of formation of the organization if its purposes and activities during the period prior to the date of the determination letter were consistent with the requirements for exemption. However, if the organization later receives an adverse determination from the IRS, the IRS may assert that the organization is subject to tax on some or all of its income for open taxable years. The IRS position could be challenged in court only in the context of a deficiency or refund proceeding.

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

**Reasons for Change**

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

**Proposal**

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

The proposal would be effective for applications for recognition of exemption filed after December 31, 2000.

## TRANSLATION OF FOREIGN WITHHOLDING TAXES BY ACCRUAL BASIS TAXPAYERS

**Current Law**

Taxpayers who take foreign income taxes into account when accrued generally are required to translate such taxes into dollars by using the average exchange rate for the taxable year to which such taxes relate. This rule applies to both foreign income taxes imposed on a net basis and to foreign withholding taxes, but does not apply to taxes paid more than two years after the close of the taxable year to which such taxes relate and in certain other circumstances.

## Reasons for Change

Current law was enacted as a simplification measure that would reduce the need for accrual basis taxpayers to redetermine the amount of foreign tax credits claimed with respect to foreign taxes accrued prior to the date of payment. Although current law does simplify tax accounting for many accrual basis taxpayers that conduct foreign operations through a foreign branch or foreign subsidiary, the rule may not clearly reflect income in the case of foreign withholding taxes because such taxes are never accrued prior to the date the tax is paid (regardless of the taxpayer's method of accounting). Further, the income associated with such taxes is either taken into account at an appropriate spot rate (in the case of dividend payments), or, if accrued by the taxpayer, is adjusted as of the date the income is received to account for variations between the rate used to accrue the payment and the spot rate on the date the income is received. Accordingly, the rule results in a mismatch between the exchange rate used to translate foreign withholding taxes and the exchange rate used to translate the associated income. Moreover, certain taxpayers that receive income subject to withholding taxes (such as regulated investment companies with a taxable year that differs from the calendar year) may find it impossible to comply with current law.

## Proposal

The proposal would modify current law so that foreign withholding taxes would be translated at the spot rate on the date of payment, regardless of the method of accounting of the taxpayer. Treasury would have the authority to modify this rule in certain cases, such as in the case of foreign withholding taxes paid by a foreign branch of a U.S. taxpayer (because such taxes are translated into dollars at the average exchange rate for the taxable year).

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

# SIMPLIFY PENALTIES FOR FAILURE TO FILE FORM 5500

## Current Law

ERISA requires that an annual report (Form 5500) be filed with the Department of Labor for retirement plans that are subject to ERISA and with the Pension Benefit Guaranty Corporation (PBGC) for ERISA pension plans that are guaranteed by the PBGC. The ERISA penalty for failure to file the report with the Department of Labor is a civil penalty of up to $1,000 per day and the ERISA penalty for failure to file the report with the PBGC is a civil penalty of up to $1,000 per day. The Code imposes the same filing requirement (Form 5500) on tax-qualified retirement plans. The Code imposes a penalty tax of up to $25 per day up to a maximum of $15,000 for failure to file this report.

The Code also requires that the sponsor of a plan that is subject to ERISA file a statement of vested benefits (SSA) for each participant who separated from employment in the prior year and a statement of certain plan changes. The SSAs are forwarded to the Social Security Administration which uses this information to notify the participant of their entitlement at

normal retirement age. The SSAs and the statement of plan changes are required to be attached to Form 5500. The penalty for failure to file an SSA or the statement of plan changes is $1 per day up to $5,000.

The Code and ERISA require that the sponsor of a defined benefit plan that is subject to the minimum funding requirements of section 412 file an annual actuarial report (Schedule B). The report is required to be attached to Form 5500. The penalty for failure to file a report is $1,000.

The Department of Labor has instituted the Delinquent Filer Voluntary Correction (DFVC) Program to encourage entities to correct delinquent filings of Form 5500 in exchange for reduced penalties. An entity using the program cannot obtain the same relief from penalties imposed by other agencies.

**Reasons for Change**

There is no need for multiple penalties by multiple agencies to apply to a failure to file the required annual report, including associated attachments. A single coordinated penalty structure should apply.

**Proposal**

The tax penalty and the PBGC penalty for failure to file an annual report, SSA, statement of plan changes and a Schedule B would be repealed for a retirement plan subject to penalties for failure to report under ERISA. The ERISA requirement to file annual reports would be modified to make appropriate adjustments.

The proposal would be effective for plan years beginning after December 31, 2001.

## CLARIFY THE FOREIGN TAX CREDIT TO PROVIDE THE CIRCUMSTANCES UNDER WHICH A DOMESTIC CORPORATION THAT OWNS A FOREIGN CORPORATION THROUGH A PARTNERSHIP WILL BE ELIGIBLE FOR THE DEEMED PAID CREDIT

### Current Law

Section 902(a) provides that a domestic corporation which owns 10 percent or more of the voting stock of a foreign corporation may claim a deemed paid credit for foreign income taxes paid by the foreign corporation. Foreign income taxes paid by a lower-tier foreign corporation are also eligible for the deemed paid credit if the foreign corporation is within a "qualified group" as defined in section 902(b)(2). A foreign corporation that is within a qualified group must be within the first six tiers of a chain of foreign corporations. The tier limitation exists in order to ensure that the deemed paid credit is administrable. Section 1113(c)(2) in the Taxpayer Relief Act of 1997, P.L. No. 105-34 (1997 Act) provides that, in the case of a chain of corporations described in section 902(b)(2), no liquidation, reorganization or similar transaction in a taxable year beginning after the date of enactment of the 1997 Act can permit taxes to be taken into account under section 902 that could not have been taken into account but for that transaction.

Section 960 allows a domestic corporation that has a subpart F inclusion from a controlled foreign corporation ("CFC") to claim foreign tax credits with respect to foreign taxes paid by the CFC on the subpart F income to the same extent that it would be so allowed under section 902 if the subpart F inclusion were an actual dividend distribution.

Current law is unclear about the circumstances under which a partner can claim a foreign tax credit under section 902 or 960 when the partner indirectly owns its interest in a foreign corporation through a partnership.

In the case of the direct foreign tax credit, section 901(b)(5) allows an individual who is a member of a partnership, or a beneficiary of an estate or trust, to claim a credit for his proportionate share of taxes of the partnership, or estate or trust, paid to a foreign country. Section 901(b)(5), however, does not refer to corporations that are members of a partnership or beneficiaries of an estate or trust. But see section 702(a)(6) (providing that a partner shall take into account his distributive share of the partnership's foreign taxes described in section 901).

### Reasons for Change

Unnecessary confusion has resulted from the lack of clarity with regard to (1) the application of sections 902 and 960 when a partner indirectly owns an interest in a foreign corporation through a partnership, and (2) the application of section 901(b)(5) to a corporation with an interest in a partnership, estate or trust. The proposal would clarify the appropriate circumstances in which foreign income taxes paid are eligible for credit in these cases. Defining the appropriate circumstances includes a consideration of the administrative and audit concerns that underlie the tier limitation rule.

## Proposal

Under the proposal, section 902(a) would be amended to make the deemed-paid credit available to a domestic corporation that, through a partnership, owns 10% or more of the voting stock of a foreign corporation from which it receives its proportionate share of dividend income. This rule would apply whether the partnership is foreign or domestic. For purposes of the tier limitation rule of section 902(b), a qualified business unit, as defined in section 989(a), (including a partnership and a disregarded entity) would be treated as a separate tier. In addition, the special rule contained in section 1113(c)(2) in the Taxpayer Relief Act of 1997, P.L. No. 105-34 (1997 Act) would be incorporated into the Code.

Section 901(b)(5) also would be amended to clarify that corporations as well as individuals can claim a direct credit for their proportionate share of taxes of the partnership, estate or trust.

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

# TREAT CORPORATIONS IN AN AFFILIATED GROUP AS A SINGLE CORPORATION

## Current Law

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

## Reasons for Change

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

## Proposal

The Administration proposes to simplify the active trade or business requirement by removing the substantially all test and generally allowing an affiliated group to satisfy this requirement as

long as the relevant affiliated group, taken as a whole, is considered active. The relevant affiliated group would be determined immediately after the distribution. With respect to the distributing corporation, the relevant affiliated group would consist of the distributing corporation as the common parent and all corporations (regardless of whether such corporations are includable corporations under section 1504(b)) connected with the distributing corporation through stock ownership described in section 1504(a)(1)(B). The relevant affiliated group for the controlled corporation would be determined in the same manner, treating the controlled corporation as the common parent of such group.

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

## Encourage Philanthropy

### ALLOW DEDUCTION FOR CHARITABLE CONTRIBUTIONS FOR NON-ITEMIZING TAXPAYERS

### Current Law

Individual taxpayers who itemize their deductions generally may claim a deduction (subject to certain percentage limitations) for charitable contributions made to qualified charitable organizations. In general, total deductible charitable contributions may not exceed 50% of the taxpayer's adjusted gross income (AGI), although certain lower deductibility limits apply in the case of contributions of appreciated property and contributions to certain private foundations. Under section 170(f)(8), no charitable contribution deduction is allowed for any contribution of $250 or more unless the taxpayer receives a contemporaneous written acknowledgment of the contribution from the donee charity that includes, among other required information, a description and good faith estimate of the value of any goods or services provided in return for the taxpayer's contribution.

By contrast, individual taxpayers who elect the standard deduction (so called "nonitemizers") may not claim a deduction for charitable contributions, although the standard deduction theoretically includes an allowance for moderate amounts of charitable contributions.

### Reasons for Change

Under current law, taxpayers who claim the standard deduction and who make charitable contributions have no tax incentive to increase their charitable contributions. Providing a deduction for significant charitable contributions would create an incentive for nonitemizers to increase their charitable contributions.

### Proposal

The proposal would provide a deduction for substantial charitable contributions made by taxpayers who do not itemize their deductions. The proposal would allow nonitemizers to deduct 50 percent of their charitable contributions in excess of $1,000 ($2,000 for married taxpayers filing jointly) for taxable years beginning after December 31, 2000 and before January 1, 2006. For taxable years beginning after December 31, 2005, nonitemizers would be allowed to deduct 50 percent of their charitable contributions in excess of $500 ($1,000 for married taxpayers filing jointly). As under current law, the charitable contribution deduction would be subject to certain percentage limitations. In addition, the section 170(f)(8) substantiation requirements would apply to all charitable contributions in excess of $250, including contributions below and above the applicable floor. The deduction would not affect the calculation of AGI, and would be allowed for purposes of the Alternative Minimum Tax.

## SIMPLIFY AND REDUCE THE EXCISE TAX ON PRIVATE FOUNDATIONS

### Current Law

Private foundations generally are subject to a two percent excise tax on their net investment income. The excise tax rate is reduced to one percent in any year in which the foundation's distributions for charitable purposes exceed the average level of the foundation's charitable distributions over the five preceding taxable years (with certain adjustments). The "two tier" structure of the excise tax was intended to encourage private foundations to increase their current rates of distribution. Under current law, private nonoperating foundations generally are required to make annual distributions for charitable purposes equal to at least five percent of the fair market value of the foundation's noncharitable use assets (with certain adjustments). The amount that a foundation is required to distribute annually for charitable purposes is reduced by the amount of the excise tax paid by the foundation.

### Reasons for Change

In certain cases, the current "two-tier" structure of the excise tax on private foundation net investment income creates a perverse incentive for foundations not to significantly increase their distributions for charitable purposes in any particular year. Under the current formula, any increase in the foundation's percentage payout in a given year would make it more difficult for the foundation to qualify for the reduced one percent excise tax rate in subsequent years. Eliminating the "two-tier" structure of this excise tax would ensure that private foundations do not suffer adverse excise tax consequences if they respond to charitable needs by significantly increasing their grantmaking in a particular year. Such a change would also simplify tax planning and the calculation of the excise tax for private foundations. In addition, lowering the excise tax rate for all foundations would make additional funds available for charitable purposes.

### Proposal

This proposal would reduce and simplify the excise tax on private foundation net investment income by reducing the general two percent excise tax rate to a flat rate of 1.25 percent. The formula for determining whether a foundation is maintaining its historic level of charitable distributions and the special reduced excise tax rate available to only some foundations would be repealed. The proposal would be effective for taxable years beginning after December 31, 2000.

## INCREASE LIMIT ON CHARITABLE DONATIONS OF APPRECIATED PROPERTY

### Current Law

Under current law, charitable contributions made by individuals who do not claim the standard deduction are deductible for income tax purposes, up to certain limits depending on the type of property donated and the type of organization to which the property is contributed. Total deductible contributions to public charities (and private operating foundations and certain private nonoperating foundations) generally may not exceed 50 percent of the taxpayer's adjusted gross

income (AGI).  Total deductible contributions to private foundations generally may not exceed the lesser of (i) 30 percent of the taxpayer's AGI or (ii) the "unused" portion of the 50 percent deductibility limit for gifts to public charities.  However, in the case of contributions of certain capital gain property, the limits are lowered to 30 percent of AGI for gifts to public charities, and 20 percent of AGI for gifts to private foundations.

**Reasons for Change**

The special, lower contribution limits that apply to contributions of capital gain property create added complexity and could discourage gifts of valuable or unique property to charitable organizations.

**Proposal**

This proposal would repeal the special, lower contribution limits for gifts to charity of capital gain property.  Instead, both cash and non-cash contributions would be subject to the general 50 percent deductibility limit for gifts to public charities and the 30 percent deductibility limit for gifts to private foundations.  The proposal would be effective for charitable contributions made after December 31, 2000.

## CLARIFY PUBLIC CHARITY STATUS OF DONOR ADVISED FUNDS

**Current Law**

Charitable organizations described in section 501(c)(3) are classified under section 509 as either public charities or private foundations, depending on their exempt purposes (e.g., a church, a hospital, or a school), the sources of their financial support (e.g., the amount of contributions received from members of the general public), or their manner of operation (e.g., a supporting organization of a public charity).   Private foundations are more highly regulated than public charities.  In addition, contributions to private foundations are subject to lower deductibility limits than are contributions to public charities.   Section 170 generally allows taxpayers who itemize to deduct charitable contributions made to qualified charitable organizations or governmental entities, subject to certain percentage limitations.  However, if the taxpayer retains control over the assets transferred to charity, the transfer is not a completed gift for purposes of section 170.

Section 4958 imposes penalty excise taxes on certain excess benefit transactions between a public charity (or a section 501(c)(4) social welfare organization) and any "disqualified person" with respect to the organization.   Section 4958 defines the term "disqualified person" to include any person who is in a position to exercise substantial influence over the affairs of the organization, as well as certain family members and entities controlled by such person.

Section 4941 generally prohibits transactions between a private foundation and its "disqualified persons."   Disqualified persons are defined in section 4946 to include foundation managers

(directors, trustees, and officers of the foundation), substantial contributors to the foundation, and certain family members and entities controlled by such persons.

**Reasons for Change**

In recent years, the use of so-called "donor advised funds" maintained by charitable organizations has grown dramatically. These funds generally permit a donor to claim a current charitable contribution deduction for amounts contributed to the charity and to provide ongoing advice regarding the investment or distribution of such amounts, which are maintained by the charity in a separate fund or account. Several financial institutions have formed charitable corporations for the purpose of offering such donor advised funds, and other existing charities have begun operating donor advised funds. Although these donor advised funds resemble the separate funds maintained by community trusts, the rules governing their operation are unclear.

Some, but not all, charities that maintain donor advised funds have voluntarily adopted minimum annual payout requirements. As a result, there is concern that amounts maintained in donor advised funds are not being distributed currently for charitable purposes. The lack of uniform guidelines governing the operation of donor advised funds also raises concerns that such funds may be used to provide donors with the benefits normally associated with private foundations (such as control over grantmaking), without the regulatory safeguards that apply to private foundations. Accordingly, legislation is needed to encourage the continued growth of donor advised funds by providing clear rules that are easy to administer, while minimizing the potential for misuse of donor advised funds to benefit donors and advisors.

**Proposal**

The proposal would provide that a charitable organization which has, as its primary activity[14], the operation of one or more donor advised funds may qualify as a public charity only if: (1) there is no material restriction or condition that prevents the organization from freely and effectively employing the assets in such donor advised funds, or the income therefrom, in furtherance of its exempt purposes; (2) distributions are made from such donor advised funds only as contributions to public charities (or private operating foundations) or governmental entities; and (3) annual distributions from donor advised funds equal at least five percent of the net fair market value of the organization's aggregate assets held in donor advised funds (with a carry forward of excess distributions for up to five years). It is intended that the definition of "material restriction" generally will be based on current-law regulations under section 507, but that the existence of a material restriction will not be presumed from fact that a charity regularly follows a donor's advice. Failure to comply with any of these requirements with respect to any donor advised fund would result in the organization's being classified as a private foundation and, therefore, being subject to the current-law private foundation rules and excise taxes. In addition, the proposal would require any other charitable organization that operates one or more donor advised funds, but not as its primary activity, to comply with the above three requirements.

[14] Any charity that maintains more than 50% of its assets in donor advised funds would be deemed to meet this primary activity test.

If such an organization (e.g., a school that operates donor advised funds) fails to satisfy these requirements with respect to its donor advised funds, the organization's public charity status would not be affected, but all assets maintained by the organization in donor advised funds would be subject to the current-law private foundation rules and excise taxes.

Under the proposal, a "donor advised fund" would be defined as any segregated fund (or account) maintained by a charity for contributions received from a particular donor (or donors) as to which there is an understanding that the donor or the donor's designee may advise the charity regarding the investment or distribution of any amounts held in the fund.[15] However, the term "donor advised fund" does not include any fund (or account) as to which such advice is limited to the use to be made by the charity for its own operations (rather than grants to be made by the charity to third parties) of amounts held in the fund.

The proposal would also amend the definition of disqualified person under section 4958 to clarify that a person who is a donor or a designated advisor to a particular donor advised fund maintained by any public charity (and such person's family members and controlled entities) will be treated as having substantial influence with respect to any transactions involving that particular fund. In addition, the proposal would amend the definition of disqualified person under section 4946 to include any person who is a donor or a designated advisor to a particular donor advised fund maintained by a private foundation (and such person's family members and controlled entities) for purposes of applying section 4941 (self-dealing rules) to transactions involving that particular fund.

No inference is intended regarding the tax treatment of transfers to donor advised funds or the application of current-law rules, including section 4958, to transactions involving donor advised funds.

The Department of the Treasury would be granted authority to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the proposal, including regulations interpreting the "no material restriction" requirement, and regulations describing procedures sufficient to ensure that distributions from donor advised funds are made only as contributions to eligible entities.

The proposal relating to the public charity status of certain charitable corporations operating donor advised funds would be effective for taxable years beginning after the Department of the Treasury issues final regulations interpreting the "no material restriction" requirement with respect to donor advised funds. The proposed amendments to sections 4946 and 4958 would be effective for excess benefit transactions occurring on or after the date of enactment.

[15] A donor advised fund would not include a contribution to charity where the donor, at the time of making the contribution, specifies a charitable recipient, but retains no advisory rights (such as in the case of certain contributions to the United Way).

**Promote Energy Efficiency and Improve the Environment**

## PROVIDE TAX CREDIT FOR ENERGY-EFFICIENT BUILDING EQUIPMENT

### Current Law

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

### Reasons for Change

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

### Proposal

A credit of 20 percent of the purchase price would be allowed for the purchase after December 31, 2000 and before January 1, 2005 of the following building equipment:

> Fuel cells (equipment using an electrochemical process to generate electricity and heat) with an electricity-only generation efficiency of at least 35 percent and a minimum generating capacity of 5 kilowatts. The maximum credit would be $500 per kilowatt of capacity.
>
> Electric heat pump hot water heaters (equipment using electrically powered vapor compression cycles to extract heat from air and deliver it to a hot water storage tank) with an Energy Factor of at least 1.7 in the standard DOE test procedure. The maximum credit would be $500 per unit.
>
> Natural gas heat pumps (equipment using either a gas-absorption cycle or a gas-driven engine to power the vapor compression cycle to extract heat from one source and deliver it to another) with a coefficient of performance for heating of at least 1.25 and for cooling of at least 0.70. The maximum credit would be $1,000 per unit.

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

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

### Current Law

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

### Reasons for Change

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

### Proposal

A tax credit of up to $2,000 would be available to purchasers of highly energy-efficient new homes that meet energy-efficiency standards for heating, cooling and hot water that significantly exceed those of the IECC. A taxpayer may claim the credit only if the new home is the taxpayer's principal residence and reduces energy use by prescribed amounts as compared to the IECC for single family residences. The tax credit would be $1,000 for new homes that reduce energy use by at least 30 percent compared with the IECC standard, and that are purchased in the three-year period beginning January 1, 2001 and ending December 31, 2003. The tax credit would be $2,000 for new homes that reduce energy use by at least 50 percent compared with the IECC standard, and are purchased in the five-year period beginning January 1, 2001 and ending December 31, 2005.

## EXTEND TAX CREDIT FOR ELECTRIC VEHICLES AND PROVIDE TAX CREDIT FOR CERTAIN HYBRID VEHICLES

### Current Law

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

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

**Reasons for Change**

The transportation sector now accounts for one-third of greenhouse gas emissions in the United States. Cars, sport utility vehicles, light trucks and minivans alone account for 20 percent of our greenhouse gas emissions. These vehicles also account for about 20 to 40 percent of all urban smog-forming emissions and 40 percent of U.S. oil consumption. Almost all of these vehicles use a single gasoline-fueled engine.

Hybrid vehicles, which have more than one source of power on-board the vehicle, and electric vehicles have the potential to reduce greenhouse gas emissions, air pollution, and petroleum consumption. The proposed credits will encourage the purchase of vehicles that incorporate advanced automotive technologies and will help to move hybrid vehicles from the laboratory to the highway. These vehicles can significantly reduce emissions of carbon dioxide, the most prevalent greenhouse gas.

**Proposal**

The proposal would extend the present credit for qualified electric vehicles and provide temporary tax credits for certain 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 qualified hybrid vehicles. A credit, of up to $3,000, would be available for purchases of qualified hybrid vehicles after December 31, 2002, and before January 1, 2007. The credit would be:

(a) $500 if the rechargeable energy storage system provides at least 5 percent but less than 10 percent of the maximum available power;
(b) $1,000 if the rechargeable energy storage system provides at least 10 percent and less than 20 percent of the maximum available power;
(c) $1,500 if the rechargeable energy storage system provides at least 20 percent and less than 30 percent of the maximum available power; and
(d) $2,000 if the rechargeable energy storage system provides 30 percent or more of the maximum available power.

If the vehicle actively employs a regenerative braking system, the amount of the credit shown in (a) through (d) above would be increased by the following amounts:

(i) $250 if the regenerative braking system supplies at least 20 percent but less than 40 percent of the energy available from braking in a typical 60 miles per hour (mph) to 0 mph braking event to the rechargeable energy storage system;
(ii) $500 if the regenerative braking system supplies at least 40 percent but less than 60 percent of such energy; and
(iii) $1,000 if the regenerative braking system supplies 60 percent or more of such energy.

A qualifying hybrid vehicle is a road vehicle that can draw propulsion energy from both of the following on-board sources of stored energy: (1) a consumable fuel, and (2) a rechargeable energy storage system. A qualifying vehicle must meet all applicable regulatory requirements.

Maximum available power means the maximum value of the sum of the heat engine and electric drive system power or other non-heat energy conversion devices available for a driver's command for maximum acceleration at vehicle speeds under 75 mph.

These credits would be available for all qualifying light vehicles including cars, minivans, sport utility vehicles, and light trucks. Taxpayers who claim one of the qualified hybrid vehicle credits would not be able to claim the qualified electric vehicle credit or the deduction for clean-fuel vehicle property for the same vehicle. Business taxpayers claiming the qualified hybrid vehicle credit would be subject to the limitations on the general business credit and would be required to reduce the basis of the vehicle by the amount of the credit.

## EXTEND AND MODIFY THE TAX CREDIT FOR PRODUCING ELECTRICITY FROM CERTAIN SOURCES

### Current Law

Current law provides taxpayers a 1.5-cent-per-kilowatt-hour tax credit for electricity produced from wind, "closed-loop" biomass (organic material from a plant that is planted exclusively for purposes of being used at a qualified facility to produce electricity), and poultry waste. The electricity must be sold to an unrelated third party and the credit is limited to the first 10 years of production. The credit applies only to facilities placed in service before January 1, 2002. The credit amount is indexed for inflation after 1992.

### Reasons for Change

The tax credit helps make electricity produced from wind and biomass price competitive with other forms of electricity. These renewable energy sources produce virtually no greenhouse gas emissions. Expanding eligible biomass sources would increase the use of this renewable energy source.

Allowing a tax credit for electricity produced from methane from landfills would reduce greenhouse gas emissions. Methane gas, which has approximately 21 times the greenhouse gas effect as carbon dioxide, accounts for about 10 percent of the warming caused by U.S. emissions.

Methane from landfills, the single largest source of methane emissions, accounted for 37 percent of total U.S. methane emissions in 1997.

**Proposal**

The proposal would extend the present credit for wind and closed-loop biomass, expand eligible biomass sources, and provide a credit for electricity produced from methane from landfills:

Wind and biomass. The present credit for wind and closed-loop biomass would be extended for two and one-half years to facilities placed in service before July 1, 2004 and eligible biomass sources would be expanded for facilities placed in service after December 31, 2000 and before January 1, 2006. Biomass facilities that were placed in service before January 1, 2001 would be eligible for a credit of 1.0 cent per kilowatt hour for electricity produced from the newly eligible sources from January 1, 2001 through December 31, 2003. Biomass that is co-fired in coal plants to produce electricity would be eligible for the credit at a reduced rate (0.5 cent per kilowatt hour adjusted for inflation after 2000) from January 1, 2001 through December 31, 2005.

Biomass qualifying for the credit would include (i) closed-loop biomass and (ii) any solid, nonhazardous, cellulosic waste material, which is segregated from other waste materials, and which is derived from: (a) any of the following forest-related resources: mill residues, pre-commercial thinnings, slash and brush, but not including old growth timber or wood waste incidental to pulp and paper production, (b) waste pallets, crates, and dunnage, and landscape or right-of-way tree trimmings, but not including unsegregated municipal solid waste (garbage) and post-consumer waste paper, or (c) agricultural sources, including orchard tree crops, vineyard grain, legumes, sugar, and other crop-by-products or residues.

A facility that produces electricity from wind or biomass (other than a facility that cofires biomass with coal) would be treated as being placed in service before July 1, 2004 if it is placed in service before July 1, 2005 and (1) the facility is constructed, reconstructed, or acquired by the taxpayer pursuant to a written contract binding on June 30, 2004; or (2) the facility is constructed or reconstructed by the taxpayer and (i) the lesser of (a) $1 million, or (b) 5 percent of the cost of such facility has been incurred or committed by June 30, 2004, and (ii) the construction or reconstruction of such facility began by such date.

Methane from landfills. Facilities that produce electricity from landfill methane would be eligible for a credit for the first ten years of production if the facility is placed in service after December 31, 2000 and before January 1, 2006. The credit for electricity produced from methane from qualified facilities would equal 1.5 cent per kilowatt hour for facilities at landfills that are not subject to EPA's 1996 New Source Performance Standards/Emissions Guidelines (NSPS/EG) and 1.0 cent per kilowatt hour for facilities at landfills that are subject to NSPS/EG. These credits would be adjusted for inflation after 2000. A qualified facility would include equipment and housing required to generate electricity (but not wells and related systems required to collect and transmit gas to the production facility).

A facility that produces electricity from methane from landfills would be treated as being placed in service before January 1, 2006 if it is placed in service before January 1, 2007 and (1) the facility is constructed, reconstructed, or acquired by the taxpayer pursuant to a written contract binding on December 31, 2005; or (2) the facility is constructed or reconstructed by the taxpayer and (i) the lesser of (a) $1 million, or (b) 5 percent of the cost of such facility has been incurred or committed by December 31, 2005, and (ii) the construction or reconstruction of such facility began by such date.

## PROVIDE TAX CREDIT FOR SOLAR ENERGY SYSTEMS

### Current Law

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

### Reasons for Change

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

### Proposal

Under this proposal, a tax credit would be available for purchasers of rooftop photovoltaic systems and solar water heating systems that are located on or adjacent to a building and are used exclusively for purposes other than heating swimming pools. The credit would be equal to 15 percent of qualified investment up to a maximum of $1,000 for solar water heating systems and $2,000 for rooftop photovoltaic systems. This credit would be nonrefundable. For businesses, this credit would be subject to the limitations of the general business credit and the basis of the qualified property would be reduced by the amount of the credit claimed. The credit would apply only to equipment placed in service during the five-year period after December 31, 2000 and before January 1, 2006 for solar water heating systems and during the seven-year period after December 31, 2000 and before January 1, 2008 for rooftop photovoltaic systems. Taxpayers must choose between the proposed credit and the present tax credit for each investment.

## PROVIDE A 15-YEAR DEPRECIABLE LIFE FOR DISTRIBUTED POWER PROPERTY

### Current Law

Distributed power property used to produce electricity and/or steam for use in a taxpayer's industrial manufacturing process or plant activity, and not ordinarily available for sale to others,

is generally depreciated using the 150 percent declining balance method over 15 years. Distributed power property with a rated total capacity of 500 kilowatts or less of electricity (or 12,500 pounds per hour or less of steam) is depreciated in accordance with the class life assigned to the taxpayer's applicable manufacturing equipment class.

Building structural components include all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts, and all other components relating to the operation or maintenance of a building. Distributed power property used to produce electricity and/or heat for use in a commercial or residential building is likely to classified as a building structural component and depreciated using the straight-line method over 39 years.

**Reasons for Change**

Distributed power technologies have made it possible to place electrical generation assets in or adjacent to commercial establishments and residential rental properties, as well as in industrial establishments. These technologies can be more energy efficient and generate fewer greenhouse gases than conventional electrical generation methods. Under current law, distributed power assets used in a commercial or residential building are likely to be depreciated over much longer lives than are similar assets used to produce process energy in an industrial setting. Also, because the current asset classification system predates the development of these technologies and the era of electricity deregulation, there are ambiguities regarding the proper classification of distributed power property. The proposed change would simplify current law by clarifying and rationalizing the assignment of recovery periods to distributed power property, including property used to produce both electricity and useful heat and mechanical power. It would therefore reduce taxpayer uncertainty and controversy in this area, and would promote the use of these more efficient technologies.

**Proposal**

Distributed power property placed in service after the date of enactment would be assigned a 15-year depreciation recovery period and a 22-year class life. For this purpose, distributed power property would include only (1) property used in the generation of electricity for primary use in nonresidential real property or residential rental property used in the taxpayer's trade or business, and (2) property with a rated total capacity in excess of 500 kilowatts that is used in the generation of electricity for primary use in a taxpayer's industrial manufacturing process or plant activity. It must be reasonably expected that no more than 50 percent of the electricity produced from distributed power assets would be sold to, or used by, unrelated persons. Distributed power property would not include assets used to transport primary fuel to the generating facility or to distribute energy within or outside of the taxpayer's facility.

Distributed power property may also be used to produce usable thermal energy or mechanical power for use in a heating or cooling application. However, if used to produce energy for use in a building, not less than 40 percent of the total useful energy produced must consist of electrical power (whether sold or used by the taxpayer). In an industrial setting, not less than 40 percent of the total useful energy produced must consist of electrical power (whether sold or used by the

taxpayer) and thermal or mechanical energy used in the taxpayer's industrial manufacturing process or plant activity. For this purpose, energy output would be determined on the basis of expected annual output levels and measured in British thermal units (Btu) using standard conversion factors established by the Secretary.

**Electricity Restructuring**

## REVISE TAX-EXEMPT BOND RULES FOR ELECTRIC POWER FACILITIES

**Current Law**

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

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

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

**Reasons for Change**

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

In order to develop efficient nondiscriminatory transmission services, publicly-owned electric utility companies will be required to turn the operation of their transmission facilities over to independent systems operators or use those facilities in a manner that may violate the private use rules. Without relief from the private use rules, publicly-owned electric systems may not choose to open their service areas to competition or to allow their transmission facilities to be operated by a private party.

**Proposal**

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

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

The proposal would be effective on the date of enactment.

## MODIFY TREATMENT OF CONTRIBUTIONS TO NUCLEAR DECOMMISSIONING FUNDS

**Current Law**

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

**Reasons for Change**

The favorable tax treatment of contributions to nuclear decommissioning funds recognizes the national importance of the establishment of segregated reserve funds for paying nuclear decommissioning costs. Although the favorable tax treatment was adopted at a time when nuclear power plants were operated by regulated public utilities, deregulation will not reduce the

need for such funds. Deregulation will, however, generally eliminate traditional cost of service determinations for ratemaking purposes. In many cases, a line charge or other fee will be imposed by a State or local government or a public utility commission to ensure that adequate funds will be available for decommissioning, but there is no assurance that this will be the case under all State deregulation plans.

**Proposal**

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

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

## Modify International Trade Provisions

### EXTEND AND MODIFY PUERTO RICO ECONOMIC-ACTIVITY TAX CREDIT

#### Current Law

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

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

Currently, under the phase-out, beneficiary companies operating in Puerto Rico calculate the allowable credit either: (1) taking 40 percent of the credit as allowed under prior law, subject to a cap based on pre-1996 possessions income; or (2) based on the company's economic activity in Puerto Rico (measured by wages and other compensation, depreciation, and certain taxes paid) subject beginning in 2002 to a cap based on pre-1996 possessions income.

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

#### Reasons for Change

The Administration proposed to reformulate the credit in 1993 and again in 1996 to make it a more efficient incentive for job creation and economic activity in Puerto Rico. The amendments enacted in 1993 moved part way toward the Administration's proposals. The repeal and phase-out enacted in 1996, however, has eliminated all incentives for new investment in Puerto Rico. The Administration continues to believe that there should be a tax credit to encourage increased economic development in Puerto Rico and that the credit should be based on economic activity (as opposed to income).

#### Proposal

To provide a more efficient and effective tax incentive for the economic development of Puerto Rico and to continue the shift from an income-based credit to an economic-activity-based credit that was begun with the 1993 amendments, the proposal would modify the economic-activity-based credit under section 30A by (1) opening it to newly established business operations, effective for taxable years beginning after December 31, 1999, and (2) extending the phase-out to cover taxable years beginning before January 1, 2009.

## Miscellaneous Provisions

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

#### Current Law

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

#### Reasons for Change

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

#### Proposal

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

The proposal would be effective for severance pay received in taxable years beginning after December 31, 2000 and before January 1, 2004.

### EXEMPT HOLOCAUST REPARATIONS FROM FEDERAL INCOME TAX

#### Current Law

Under the Code, gross income is defined as "gross income from whatever source derived," except for certain items specifically exempt or excluded by statute. There is no explicit statutory exception from gross income for reparations received by Holocaust victims or their heirs.

Beginning in the 1950's, the Internal Revenue Service issued a series of rulings providing that certain Holocaust reparations are exempt from Federal income tax. Under Rev. Rul. 56-518, certain compensation paid by the Federal Republic of Germany on account of persecution by the Nazi regime which resulted in damage to life, body, health, liberty, or to professional or economic advancement is reimbursement for the deprivation of civil or personal rights and thus is not treated as taxable income to the recipient. Where the right of property ownership is involved, payments which are measured by the value of property taken from persecuted taxpayers do not constitute taxable income to the extent that the taxpayer has not recovered his basis. Where payments measured by the value of property exceed the basis, the question of

whether the excess constitutes taxable income is determined on the basis of the facts and circumstances of each case.

Under Article 19(1)(c) of the United States - Federal Republic of Germany Income Tax Convention, August 29, 1989, pensions, annuities and other amounts paid by one of the contracting States or a juridical person organized under the public laws of that State as compensation for an injury or damage sustained as a result of hostilities or political persecution are exempt from tax by the other State. See S. Treaty Doc. No. 10, 101st Cong., 2d Sess. (1990). The U.S. and German competent authorities have reached a mutual agreement that monetary compensation or property received by individuals under the German Act Regulating Unresolved Property Claims for property that the National Socialist Regime confiscated or subjected to forced sale represents payments for damages sustained as a result of hostilities or political persecution, and thus are exempt from U.S. taxation under the treaty. Moreover, the Internal Revenue Service has clarified that, to implement this exception where such compensation is provided in the form of property (other than money), the taxpayer's basis for the property received is its fair market value at the time of the receipt.

**Reasons for Change**

In recent years, several countries and organizations within those countries have acknowledged that they have not made adequate compensation or restitution to victims or their heirs or legatees for the deprivations inflicted upon them during the Nazi Holocaust, and have agreed to establish funds or to make direct payments of cash or property to such individuals. To provide certainty the Administration believes that it is appropriate to provide a statutory exemption from gross income for such payments.

**Proposal**

Gross income would not include any amount received from the Swiss Humanitarian Fund established by the government of Switzerland or as a result of the settlement of the action entitled, "In re Holocaust Victims' Asset Litigation," (E.D. N.Y.) C.A. No. 96-4849, or from any similar Holocaust-related fund or action, and the value of property recovered as a result of a settlement or legislative resolution of a claim arising out of the confiscation of such property in connection with the Holocaust. Property would be considered to have been confiscated in connection with the Holocaust if its loss occurred during the years 1933-1945 and was attributable to government action or hostilities in Nazi Germany or in countries controlled or occupied by the Nazis. Following the recovery, the taxpayer's initial basis in the recovered property would be the fair market value of the property on the date of the recovery. The proposal would be effective for amounts received on or after January 1, 2000. No inference is intended as to the tax treatment of amounts received prior to that date.

**Corporate Tax Shelters**

## INCREASE DISCLOSURE WITH RESPECT TO CERTAIN REPORTABLE TRANSACTIONS

**Current Law**

Taxpayers are subject to a 20-percent penalty for certain accuracy-related understatements of tax, including any substantial understatement of income tax. The penalty does not apply to any understatement that is attributable to any item if the relevant facts affecting the tax treatment are adequately disclosed on the tax return and the taxpayer has a reasonable basis for the tax treatment of such item. This exception for disclosed items does not apply to corporate tax shelters.

**Reasons for Change**

Taxpayers that engage in questionable transactions have an incentive not to disclose such transactions to the IRS. Current law provides a disincentive to disclosure of corporate tax shelters by providing the same accuracy-related penalty rules regardless of whether the taxpayer discloses the shelter.

Greater disclosure of corporate tax shelters would aid the IRS in identifying corporate tax shelters and would assist the IRS in its efforts to curb avoidance transactions. Also, greater disclosure would discourage corporations from entering into questionable transactions.

**Proposal**

The proposal would require a corporation to disclose a transaction that has significant tax benefits if it has some combination of the following characteristics: a book/tax difference in excess of a certain amount; a recission clause, unwind provision, or insurance or similar arrangement for the anticipated tax benefits (other than customary representations and warranties found in non-shelter transactions); involvement with a tax-indifferent party; contingent advisor fees or fees in excess of a certain amount; a confidentiality agreement; the offering of the transaction to multiple taxpayers (if known or the taxpayer has reason to know); a difference between the form of the transaction and how its reported (with exceptions for certain specified common transactions where the form and the reporting differ, such as repurchase agreements), etc. These filters are based on the objective characteristics identified by the Treasury Department and others as common in many corporate tax shelters.

Disclosure would be made on a short form or statement filed with the tax return. The form or statement would require the taxpayer to identify which of the filters apply to the transaction and a description of the facts and the return position with respect to the transaction. The disclosure

would be filed with the National Office of the IRS by the unextended due date of the tax return and again with each income tax return that the transaction affects. The proposal would require that the form or statement be signed by a corporate officer who has, or should have, knowledge of the factual underpinnings of the transaction for which disclosure is required. Such officer would be made personally liable for misstatements on the form, with heightened penalties for fraud or gross negligence and the officer would be accorded appropriate due process rights. Failure to satisfy a disclosure requirement would subject the taxpayer to a penalty of $100,000 for each failure, regardless of whether the tax benefits of the transaction are ultimately allowed or disallowed.

Taxpayers would be required to retain all materials relevant to a reportable transaction, including copies of written materials provided in connection with the offering of the transaction by a third party.

The Secretary may prescribe regulations necessary to carry out the purposes of this proposal, including authority to provide exceptions from disclosure.

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

## MODIFY SUBSTANTIAL UNDERSTATEMENT PENALTY FOR CORPORATE TAX SHELTERS

### Current Law

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

### Reasons for Change

Despite the heightened substantial understatement penalty for corporate tax shelters, there continue to be a significant number of abusive tax shelter transactions involving corporate

taxpayers. Accordingly, the substantial understatement penalty and the standards applicable to corporate tax shelters should be increased and tightened, respectively.

**Proposal**

The proposal would increase the penalty applicable to a substantial understatement by corporate taxpayers from 20 percent to 40 percent for any item attributable to a corporate tax shelter. The penalty would be reduced to 20 percent if the corporate taxpayer discloses the transaction in a form and manner described in the Administration's Budget proposal with respect to "reportable transactions" by corporations. The 20-percent penalty for disclosed items could be avoided by a showing that the taxpayer had a strong chance of sustaining its tax position and acted in good faith; that is, the reasonable cause exception of current law would be modified and strengthened.

For this purpose, a corporate tax shelter would be any entity, plan, or arrangement (to be determined based on all facts and circumstances) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction. A tax benefit would be defined to include a reduction, exclusion, avoidance, or deferral of tax, or an increase in a refund, but would not include a tax benefit clearly contemplated by the applicable provision (taking into account the Congressional purpose for such provision, administrative interpretations of the provision, and the interaction of such provision with other provisions). 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. A financing transaction would be considered a tax avoidance transaction if the present value of the tax benefits of the taxpayer to whom the financing is provided are significantly in excess of the present value of the pre-tax profit or return of the person providing the financing.

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

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

## CODIFY THE ECONOMIC SUBSTANCE DOCTRINE

**Current Law**

The income tax effects of a transaction generally are governed by a set of objective statutory rules. However, tax benefits from a transaction can be challenged and disallowed under various judicially-created common law doctrines, even though such benefits would seemingly be allowed under a mechanical application of the relevant Internal Revenue Code provisions. *Gregory v. Helvering,* 293 U.S. 465 (1935); *Goldstein v. Comm'r*, 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967); *Sheldon v. Comm'r,* 94 T.C. 738 (1990). One such doctrine is the economic substance doctrine, which requires that a transaction have economic substance in order

to be respected for tax purposes. The economic substance doctrine generally requires an analysis and balancing of the pre-tax economic profit from a transaction with the tax benefits obtained. See, e.g., *ACM Partnership v. Comm'r*, 73 T.C.M. 2189 (1997), *aff'd in part, rev'd in part*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 119 S.Ct 1251 (1999); *Compaq Computer Corp. v. Comm'r*, 113 T.C. No. 17 (1999); and *Winn-Dixie Stores, Inc. v. Comm'r,* 113 T.C. No. 21 (1999).

**Reasons for Change**

The Administration is concerned about the proliferation of corporate tax shelters that are designed to provide corporate participants substantial tax benefits in transactions in which there is little or no reasonably expected pre-tax economic profit or risk of loss. The Administration believes that, in claiming these tax benefits, corporations and their advisors are relying on literal interpretations of Code provisions to achieve unintended results. In doing so, taxpayers are disregarding the judicially-created doctrines (such as economic substance, substance over form, step transaction, sham transaction and business purpose) that would otherwise deny such benefits, or are aggressively interpreting case law to distinguish the facts of their shelter transactions from the facts of the applicable cases.

Corporate tax shelters thrive by applying the existing substantive provisions of the Code in unintended and distortive ways. It is not possible or advisable to address corporate tax shelters by revising each Code provision that is subject to abuse. Corporate tax shelters take many different forms and have involved the use of many different Code sections. Amending the Code to address particular tax shelters that come to light is an after-the-fact approach that potentially rewards taxpayers and promoters who rush to complete transactions in anticipation of corrective legislation, adds complexity to the Code, does not stop unidentified transactions, and may, in fact, provide fodder for future tax shelters.

Likewise, litigation is an inefficient, after-the-fact method of stopping corporate tax shelters. Litigation is costly and time consuming. A court can only address the transaction before it, several years after the transaction has occurred. The application of judicial standards may vary from court to court. Because courts decide cases one at a time, they cannot make overall tax policy.

Thus, it is clear that a broad-based legislative solution is necessary to properly address corporate tax shelters. Consistent with our system of self-assessment, a solution should require taxpayers to make a careful, before-the-fact determination of the probity of a transaction. To accomplish these goals, the Administration proposes to codify the economic substance doctrine. The economic substance doctrine is the most objective of the judicially-created doctrines that operate to deny tax benefits from abusive transactions. As such, it is the doctrine that is most easily, objectively, and consistently applied by taxpayers and the IRS. The Administration's proposal is not intended to create a new doctrine; rather, it is intended to provide a coherent standard derived from the economic substance doctrine as enunciated in a body of case law to the exclusion of less developed, inconsistent positions. Codification of the economic substance doctrine under the proposal should not affect legitimate business transactions.

**Proposal**

The proposal would codify and clarify the economic substance doctrine. The proposal would disallow tax benefits from 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 taxpayer 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 the taxpayer from such transaction. With respect to financing transactions, tax benefits would be disallowed if the present value of the tax benefits of the taxpayer to whom the financing is provided are significantly in excess of the present value of the pre-tax profit or return of the person providing the financing. This articulation of the economic substance doctrine is incorporated in the definition of "tax avoidance transaction" found in the Administration's proposal to revise the substantial understatement penalty.

The proposal would not apply to disallow any claimed loss or deduction of a taxpayer that had economically been incurred by the taxpayer before the transaction was entered into. The proposal would apply to any transaction entered into in connection with a trade or business or activity engaged in for profit or for the production of income, whether or not by a corporation.

The proposal would not alter or supplant any other existing judicial doctrine or anti-abuse rule.

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

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

## IMPOSE A PENALTY EXCISE TAX ON CERTAIN FEES RECEIVED FROM CORPORATE TAX SHELTERS

**Current Law**

No significant monetary penalty or excise tax applies to fees received with respect to the promotion or furtherance of a corporate tax shelter.

**Reasons for Change**

The Administration has become increasingly concerned with the prevalence of corporate tax shelters. It is necessary to impose impediments to the purchase, promotion and sale of such shelters. All parties to the sheltering transaction -- including promoters and advisors -- should bear responsibility for determining whether a transaction comports with accepted tax principles. The Administration's proposals are intended to change the dynamics on both the supply and demand side of this "market," making it a less attractive one for all participants -- "merchants" of abusive tax shelters, their customers, and those who facilitate these tax-engineered transactions.

## Proposal

The proposal would impose a 25-percent penalty excise tax on fees received in connection with the purchase and implementation of corporate tax shelters (including fees related to underwriting or other fees) and the rendering of certain tax advice related to corporate tax shelters. Only persons who perform services in furtherance of the corporate tax shelter would be subject to the proposal. The proposal would not apply to expenses incurred with respect to representing the taxpayer before the IRS or a court. For purposes of this proposal, "corporate tax shelter" would be defined in the same manner as that provided in the Administration's proposal to revise the substantial understatement penalty. Promoters and advisors would be provided appropriate due process rights to contest any imposition of the excise tax.

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

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

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

## Current Law

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

## Reasons for Change

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

## Proposal

The proposal would provide that any income allocable to a tax-indifferent party with respect to a corporate tax shelter is taxable to such party. The tax on the income allocable to the tax-

indifferent party would be determined without regard to any statutory, regulatory, or treaty exclusion or exception. The corporate participants in the corporate tax shelter would be jointly and severally liable for the tax. For this purpose, a corporate tax shelter would be defined in the same manner as that provided in the Administration's proposal to revise the substantial understatement penalty. A tax-indifferent party would be defined as a foreign person, a state or local government, a Native American tribal organization, a tax-exempt organization, and domestic corporations with expiring loss or credit carryforwards. (For this purpose, loss and credit carryforwards would generally be treated as expiring if the carryforward is more than 3 years old.) In addition, the proposal would provide (1) that only tax-indifferent parties that are trading on their tax exemption are subject to the proposal, and (2) appropriate due process procedures for such parties with respect to any imposition of tax.

In the case of a tax-exempt organization, the income would be characterized as UBTI. In the case of a domestic corporation with expiring loss or credit carryforwards, tax would be computed without regard to such losses or credits. In the case of a foreign person, tax on the income or gain allocable to such person would first be determined without regard to any exclusion or exception (provided in a treaty or otherwise) and any such income or gain that is not U.S. source FDAP would be treated as ECI, regardless of its source. If the foreign person properly claimed the benefit of a treaty, however, the tax otherwise owing by such person would be collected from the corporate participant. Similarly, in the case of a state or local government or a Native American tribal organization, the tax on the income allocable to such person would be determined without regard to any exclusion or exception; however, the tax would be collected only from the corporate participant, rather than from the government or the tribal organization.

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

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

## REQUIRE ACCRUAL OF INCOME ON FORWARD SALE OF CORPORATE STOCK

### Current Law

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

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

### Reason for Change

There is little substantive difference between a corporate issuer's current sale of its stock for deferred payment and an issuer's forward sale of the same stock. The only difference between

the two transactions is the timing of the stock issuance. In a current sale, the stock is issued at the inception of the transaction, while, in a forward sale, the stock is issued at the time the deferred payment is received. In both cases, a portion of the deferred payment economically compensates the corporation for the time-value of the deferred payment. It is inappropriate to treat these two transactions differently.

**Proposal**

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

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

## TREATMENT OF ESOP SHAREHOLDERS OF S CORPORATIONS

**Current Law**

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

**Reasons for Change**

While S corporation employees should be able to share in an employer's equity growth through an ESOP, S corporation owners should not obtain inappropriate tax deferral or avoidance on S corporation earnings. To properly encourage expansion of equity ownership through ESOPs, the Administration's proposal limits the availability of current law tax deferral opportunities to broad-based ESOPs.

**Proposal**

The Administration's proposal would require ESOPs that are not broad based to pay unrelated business income tax (UBIT) on S corporation income (including capital gains on the sale of stock) as the income is earned and to allow the ESOP a tax deduction for distributions of amounts previously subject to tax. An ESOP would be considered broad based if, for the plan year ending with or within the S corporation year, the ESOP account balances allocated to highly compensated employees or 2 percent shareholders (as defined in section 1372(b)) are less than 10 percent of allocated account balances and, during the S corporation year, the total number of shares of "synthetic equities" do not exceed 10 percent of the S corporation's other outstanding shares.

"Synthetic equity" means any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest that gives the holder the right to acquire or receive stock of the S corporation in the future. Except to the extent provided in regulations, synthetic equity also includes a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of the stock or appreciation in the value.

In calculating UBIT for an ESOP that is not broad based, amounts distributed to participants and beneficiaries would be deductible in the year paid. This deduction would apply only to the extent that distributions exceed undistributed amounts allocated to the ESOP that previously were not subject to UBIT (e.g., earnings in taxable years after 1997 in which the ESOP was not broad based reduced by distributions attributable to those years determined on a pro rata basis). Net operating loss rules would be modified to the extent necessary in order for ESOP distribution deductions that exceed net unrelated business income to be carried back or carried forward 20 years to offset S corporation income subject to UBIT pursuant to this rule.

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

## LIMIT DIVIDEND TREATMENT FOR PAYMENTS ON CERTAIN SELF-AMORTIZING STOCK

### Current Law

Distributions of property by a corporation to its shareholders are treated as dividends to the extent of the current or accumulated earnings and profits of the corporation. Treasury previously became aware of certain abusive transactions involving so-called "fast-pay" stock. Under a typical fast-pay arrangement, a corporation that is subject to tax only at the shareholder level (a conduit entity) issued preferred stock to one class of investors and common stock to a second class of investors. The preferred stock would be held by investors that were generally not subject to federal income tax and would be structured so that during an initial period, the dividends paid with respect to the stock were significant (representing all or nearly all of the income earned by the conduit entity) and relatively certain. During this period, the common shareholders would receive no or only nominal dividends from the corporation. After the initial period, the dividend rate of the preferred stock would decline dramatically, and the stock could be redeemed for a nominal amount. As a result, the preferred shareholders have an economic interest in the corporation that declines over time to a nominal amount, while the economic interest of the common shareholders increases over time. As an economic matter, the preferred stock in such an arrangement is self-amortizing because the distributions with respect to the stock are, in part, a return <u>on</u> the investors' investment and, in part, a return <u>of</u> their investment. To limit abuses involving fast-pay stock, the Treasury has issued regulations that automatically recharacterize a fast-pay arrangement involving a domestic conduit entity (i.e., a RIC or REIT) and provide for recharacterization at the Commissioner's discretion in the case of a fast-pay arrangement involving a foreign conduit entity (e.g., a controlled foreign corporation).

**Reasons for Change**

Although the fast-pay regulations appropriately responded to the abuses of fast-pay stock in the domestic context, the Administration believes that legislation limiting the dividend characterization on self-amortizing stock is a better long-term solution. In addition, the regulations do not apply automatically to fast-pay arrangements involving foreign conduit entities (such as controlled foreign corporations), and the Administration remains concerned about the potential for taxpayers to enter into abusive fast-pay transactions in the international context.

**Proposal**

The legislation would provide that, in the case of a distribution with respect to self-amortizing stock issued by a conduit entity, the amount treated as a dividend shall not exceed the amount of the distribution that would have been characterized as a payment of interest had the self-amortizing stock been a debt instrument.

The proposal would be effective for distributions with respect to self-amortizing stock made after the date of enactment.

## PREVENT SERIAL LIQUIDATIONS OF U.S. SUBSIDIARIES OF FOREIGN CORPORATIONS

**Current Law**

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

**Reasons for Change**

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

## Proposal

The proposal generally would treat as a dividend distribution any distribution of earnings by a U.S. holding company to a foreign corporation in a complete liquidation if the U.S. holding company subsidiary of the foreign corporation was in existence for less than 5 years.

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

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

## Current Law

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

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

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

## Reasons for Change

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

## Proposal

For purposes of section 1059, the nontaxed portion of the dividend would include the amount of the dividend that is not subject to current U.S. tax. In the event that a treaty between the United States and a foreign country reduces the rate of U.S. tax imposed on the dividend (and the

dividend is not otherwise subject to U.S. tax), the nontaxed portion would be the amount of the dividend multiplied by a fraction the numerator of which is the tax rate applicable without reference to the treaty less the tax rate applicable under the treaty and the denominator of which is the tax rate applicable without reference to the treaty. Similar rules would apply in the event that the foreign shareholder is not a corporation. No inference is intended as to the treatment of such transactions under current law.

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

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

### Current Law

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

### Reasons for Change

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

### Proposal

The proposal would amend sections 163(e)(3) and 267(a)(3). It would provide that the deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) to related foreign CFCs, PFICs or FPHCs would be allowable only to the extent the amounts accrued by the payor are, for U.S. tax purposes, reflected in the income of the direct or indirect U.S. owners of the related foreign person. An exception would be provided for amounts accrued under circumstances where payment of the amount accrued occurs within a short period after accrual

and the transaction giving rise to the payment is entered into by the payor in the ordinary course of a business in which the payor is predominantly engaged. In addition, the Secretary would be granted regulatory authority to provide exceptions to these rules.

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

## PREVENT DUPLICATION OR ACCELERATION OF LOSS THROUGH ASSUMPTION OF CERTAIN LIABILITIES

### Current Law

Generally, no gain or loss is recognized when one or more persons contribute property in exchange for stock and immediately after the exchange such person or persons control the corporation. However, the person may recognize gain to the extent it receives money or other property ("boot") as part of the exchange. The assumption of liabilities by the controlled corporation generally is not treated as boot received by the transferor, except to the extent that the liabilities assumed exceed the total of the adjusted basis of the property transferred to the controlled corporation.

In general, the transferor's basis in the stock of the controlled corporation is the same as the basis of the contributed property, increased in the amount of gain recognized to the transferor on the exchange, and reduced by the amount of boot received. For this purpose, the assumption of a liability generally is treated as boot.

Special rules apply with respect to the assumption of a liability that would give rise to a deduction. These liabilities are not taken into account in determining whether the transferor has a gain on the exchange, and do not reduce the amount of the transferor's basis in the stock of the controlled corporation. In Rev. Rul. 95-74, 1995-2 C.B. 36, the Internal Revenue Service ruled that the assumption of certain contingent liabilities by an accrual basis corporation is subject to this rule.

### Reasons for Change

The rules permitting certain liabilities or potential liabilities (i.e., liabilities that would give rise to a deduction) to be excepted from the boot and basis reduction rules were intended to facilitate the incorporation of a business together with associated liabilities, in situations where the transferor had not yet obtained the benefits of the tax deduction associated with the liability.

Relying on these special rules and other authority, however, some taxpayers have attempted to accelerate or duplicate deductions for certain losses by separating liabilities from the associated business or assets, having those liabilities assumed by a controlled corporation, and then selling stock in that corporation at a purported loss.

**Proposal**

If the basis of stock received by a transferor in an exchange involving a contribution to a corporation controlled by the transferor (and any other persons participating in the exchange) exceeds its fair market value (without regard to this proposal), then the basis of the stock received would be reduced (but not below its fair market value) by the amount (determined as of the date of the exchange) of any liability that is assumed by the controlled corporation and that did not otherwise reduce the transferor's basis in the stock of the controlled corporation.

For purposes of this proposal, the term "liability" would include any fixed or contingent obligation to make payment, without regard to whether such obligation or potential obligation otherwise is taken into account under the Code. Except as provided by the Secretary of the Treasury, however, the proposal would not apply where the trade or business or substantially all the assets with which the liability is associated also are transferred to the controlled corporation. The determination of whether a liability, as so defined, has been assumed is made in accordance with the provisions of section 357(d)(1) of the Code.

Regulations would be issued to prevent the acceleration or duplication of losses through the assumption of liabilities in transactions involving partnerships, and also may be issued to modify the rules of this proposal as applied to S corporations.

The proposal and the regulations addressing transactions involving partnerships would be effective for assumptions of liability on or after October 19, 1999, the date that a substantially similar proposal was released for markup by the Chairman of the Senate Committee on Finance. Regulations addressing transactions involving S corporations would be effective on or after October 19, 1999, or such later date as may be prescribed by such rules. No inference is intended as to the current law tax treatment of transactions affected by this proposal.

## AMEND 80/20 COMPANY RULES

**Current Law**

A portion of interest and dividends paid by a domestic corporation is effectively exempt from U.S. withholding tax provided the corporation qualifies as a so-called 80/20 corporation. In general, interest or dividends paid by a domestic corporation will be treated as interest or dividends from an 80/20 corporation if at least 80 percent of the gross income of the corporation for the testing period is foreign source income attributable to the active conduct of a foreign trade or business (or the foreign business of a subsidiary). The testing period is the three-year period preceding the year of the dividend.

**Reasons for Change**

The testing period relevant for determining 80/20 company status is subject to manipulation such that certain foreign persons may utilize the 80/20 company rules in order to improperly avoid

U.S. withholding tax with respect to certain distributions attributable to U.S. source earnings of a subsidiary.

**Proposal**

The proposal would prevent taxpayers from manipulating the testing period in order to avoid U.S. withholding tax by limiting the amount of interest and dividends exempt from U.S. withholding tax to the amount of foreign active business income received by the U.S. corporation during the 3-year testing period.

The proposal would apply to interest or dividends paid or accrued more than 30 days after the date of enactment.

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

**Current Law**

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

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

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

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

insurance company are reduced by 15 percent of the inside buildup on certain life insurance, endowment and annuity contracts.

**Reasons for Change**

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

Similar tax arbitrage benefits result when insurance companies invest in certain insurance contracts that cover the lives of their employees, officers, directors or 20 percent shareholders. Life insurance companies can still fund deductible reserves or policyholder dividends with tax-exempt or tax-deferred investment income on insurance contracts with respect to their employees, officers, directors or 20 percent owners. Similarly, property casualty insurance companies can still fund deductible loss reserves with tax-exempt or tax-deferred investment income on insurance contracts with respect to their employees, officers, directors or 20 percent owners.

**Proposal**

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

## INCREASE DEPRECIATION LIFE BY SERVICE TERM OF TAX-EXEMPT USE PROPERTY LEASES

**Current Law**

Under current law, "tax-exempt use property" must be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life and 125 percent of the lease term. For purposes of this rule, "tax-exempt use property" is property that is leased (other than under a short-term lease) to a tax-exempt entity. For this purpose, the term "tax-exempt entity" includes federal, state and local governmental units; charities; and, foreign entities or persons.

In determining the length of the lease term for purposes of the 125 percent calculation, a number of special rules apply. In addition to the stated term of the lease, the lease term includes: (1) any additional period of time in the realistic contemplation of the parties at the time the property is first put in service; (2) any additional period of time for which either the lessor or lessee has the option to renew the lease (whether or not it is expected that the option will be exercised); (3) any

additional period of any successive leases which are part of the same transaction (or series of related transactions) with respect to the same or substantially similar property; and (4) any additional period of time (even if the lessee may not continue to be the lessee during that period), if the lessee (a) has agreed to make a payment in the nature of rent with respect to such period or (b) has assumed or retained any risk of loss with respect to such property for such period.

For certain types of property it may be possible to characterize the relationship between the lessor and the lessee as a service contract rather than a lease. Under a service contract, the owner agrees to operate the property to generate services for the service recipient. The service recipient, in turn, agrees to pay for the services over the term of the contract. Economically, the service recipient's agreement to pay for the services over time is similar to an agreement to pay rent in that it provides a relatively assured source of funds for the repayment of the owner's capital investment. The special depreciation rules that apply to lessors of tax-exempt use property do not apply to service providers under bona fide service contracts.

**Reason for Change**

The tax-exempt-use property rules were intended to spread the lessor's depreciation deductions over the greater of the class life or the economic life of the property. The depreciation rules for tax-exempt use property are tied to the "125 percent of lease term" on the implicit understanding that, in cases where property is leased for 80 percent of its economic life, 125 percent of the lease term is a measure of the economic life of the property.

A lessor may attempt to inappropriately shorten the period over which tax-exempt use property is depreciated by structuring a relatively short-term lease followed by an optional service contract period. Although the combined agreement may extend over the useful life of the property, an lessor may take the position that the optional service contract term is not included in the lease term for purposes of determining the depreciation deductions. This result is inappropriate because the service contract obligates the service recipient to make payments in the nature of rent (the service contract payments) over the service contract period.

**Proposal**

The proposal would require lessors of tax-exempt use property to include the term of optional service contracts and other similar arrangements in the lease term for purposes of determining the recovery period.

The proposal would be effective for leases and other similar arrangements entered into after the date of first committee action. No inference is intended with respect to the tax treatment of leases and other similar arrangements entered into before such date.

## REQUIRE CASH-METHOD BANKS TO ACCRUE INTEREST ON SHORT-TERM OBLIGATIONS

### Current Law

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

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

### Reason for Change

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

### Proposal

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

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

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

### Current Law

Market discount is the excess, if any, of the principal amount of a debt instrument (or the adjusted issue price in the case of a debt instrument originally issued at a discount) over the holder's basis in the instrument immediately after acquisition. In general, if a holder acquires a debt instrument with market discount, the holder must treat any gain on the disposition of the debt instrument as ordinary income to the extent of accrued market discount. The holder generally determines the amount of accrued market discount by spreading the market discount ratably over the term of the instrument. A holder may elect to determine the amount of accrued market discount using constant yield principles. A special rule requires a holder to treat partial principal payments as ordinary income to the extent of economically accrued market discount.

A holder may elect to include market discount in income as it accrues. Absent an election to currently include market discount, a holder that uses an accrual method of accounting need not currently include market discount in income.

### Reasons for Change

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

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

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

### Proposal

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

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

### Current Law

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

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

### Reason for Change

In cases where either the old or the new debt instrument is publicly traded and the issuer's cost of borrowing has declined, the issuer can inappropriately accelerate its future interest deductions by refinancing its outstanding debt through a debt-for-debt exchange.

### Proposal

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

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

The proposal would also modify a holder's tax consequences in a debt-for-debt exchange that is part of a corporate reorganization. Under the proposal, if a holder exchanges an old debt security for a new debt security as part of a reorganization, the holder would treat as taxable boot the excess, if any, of the fair market value of the new security over the fair market value of the old security. The proposal would apply to exchanges occurring on or after the date of enactment.

## MODIFY AND CLARIFY STRADDLE RULES

### Current Law

In general, a "straddle" is a collection of two or more offsetting positions with respect to actively-traded personal property. Positions are offsetting if there is a substantial diminution of the risk of loss from holding one position by reason of holding one or more other positions. A taxpayer that realizes a loss on one leg of a straddle during a taxable year may recognize the loss only to the extent that the loss exceeds the unrecognized gain (if any) on the other leg of the straddle. If a loss is deferred under the straddle rules, the taxpayer must carry the loss forward to the succeeding taxable year.

The straddle provisions generally except straddles involving actively-traded stock from the definition of "position" and, therefore, from the application of the straddle rules. This exception has been limited through regulations. Under current law, the only straddle involving actively traded stock that is still excepted from the application of the straddle rules is a straddle consisting of a direct ownership interest in an actively traded stock and a short sale of the same actively-traded stock.

A taxpayer may not deduct net interest and carrying charges properly allocable to personal property which is part of a straddle. Instead, the taxpayer must capitalize these costs.

### Reasons for Change

The straddle rules were enacted in 1981 to address a specific type of tax-motivated transaction involving offsetting positions in actively-traded property. Since that time, the use of offsetting positions in actively-traded property has increased, focusing additional attention on certain issues under the straddle rules.

### Proposal

The proposal would modify and clarify the straddle rules in five respects. First, under the proposal, the stock exception would be repealed. Thus, under the proposal, offsetting positions with respect to actively-traded stock generally would constitute a straddle.

Second, the proposal would clarify that if a taxpayer issues a debt instrument one or more payments on which are linked to the value of personal property, the taxpayer's obligation under the debt instrument is an interest in personal property and may constitute a leg of a straddle. For example, if a taxpayer holds a long position in actively-traded stock and issues a debt instrument that contains an embedded short position in the same stock, the long position and the debt instrument would be offsetting positions and, therefore, would constitute a straddle.

Third, to appropriately match the timing of straddle losses with related gains, the proposal would provide that loss recognized on one leg of a straddle would be capitalized into the other leg of the straddle. This capitalization would operate as an ordering rule eliminating the need for an identification rule when the legs are of different sizes. In cases where the losses must be

allocated between two or more positions that, together, constitute a single leg of a straddle, the proposal would require loss to be allocated first to the position that would generate the most gain (or income) if terminated for its fair market value. For example, consider a taxpayer that holds two shares of stock; one share having a $30 basis and the other having a $40 basis. If, at a time when the stock is worth $100 per share, the taxpayer realizes a $50 loss on an offsetting position with respect to the stock, the taxpayer must capitalize the first $10 of loss into the share of stock having a $30 basis. The taxpayer capitalizes the remaining $40 of straddle loss pro rata between the two shares. In cases where the losses recognized exceed the unrealized gain (or income) in the other leg of the straddle, the excess losses would be recognized currently.

Fourth, to ensure that the straddle rules are not circumvented in situations where a leg of a straddle is physically settled, the proposal would require a taxpayer that settles an option or forward contract by delivering property to treat the settlement as a two-step transaction for purposes of applying the straddle rules. Specifically, the taxpayer would be required to treat the option or forward contract as if it were terminated for its fair market value immediately before the settlement. For example, consider a taxpayer that holds 100 shares of actively-traded stock with an aggregate basis of $3,000 ($30 per share) and aggregate value of $10,000 ($100 per share) and enters into a two-year contingent forward contract with respect to the stock. Under the terms of the contract, at the end of two years the taxpayer must deliver an amount of stock equal to the excess, if any, of the fair market value of 100 shares of stock over $12,000. In exchange, at the end of the two-year period, the counterparty must deliver to the taxpayer $1,500. If the 100 shares of stock were worth $15,000 ($150 per share) on the date of the settlement, the taxpayer would deliver 20 shares under the forward contract (($15,000 - $12,000))/$150 per share). Under the proposal, the taxpayer would realize loss on the termination of the contract of $1,500 ($3,000 value of shares delivered less $1,500 payment from counterparty). The loss would be capitalized into its basis in the stock, increasing its basis from $3,000 ($30 per share) to $4,500 ($45 per share). The taxpayer would then be treated as selling the 20 shares of stock for their fair market value, realizing gain on the sale of $2,100 (amount realized of $3,000 less basis of $900). Thus, on the disposition of 20 percent of its stock position, the taxpayer would recognize 20 percent of its total built-in gain.

Fifth, the proposal would clarify the situations in which interest and carrying charges are considered properly allocable to a straddle and, therefore, must be capitalized. Specifically, the proposal would clarify that interest is considered properly allocable to a straddle if the interest accrued on a straddle-related debt instrument. For this purpose, a straddle-related debt instrument would be: (1) a debt instrument the proceeds from which are used to directly or indirectly purchase an interest in property that constitutes all or part of one leg of the straddle, (2) a debt instrument that is secured by an interest in property that constitutes all or part of one leg of the straddle, (3) a debt instrument that is issued in connection with the creation of an interest in property that constitutes all or part of one leg of the straddle (for example, debt that is separated from a swap contract under '1.446-3(g)(4)), or (4) a debt instrument that is itself an interest in property that constitutes all or part of one leg of the straddle.

The proposal generally would be effective for straddles entered into on or after the date of enactment. The expense capitalization rules would be effective for interest accruals after date of

enactment. No inference is intended with respect to the tax treatment of transactions entered into before such date.

## PROVIDE GENERALIZED RULES FOR ALL INCOME-STRIPPING TRANSACTIONS

### Current Law

Under current law, it may be possible for a person that holds income-producing property to separate, or "strip," the right to receive income from the property itself. For example, it may be possible for a taxpayer that holds dividend paying stock to separate ownership of the right to receive the dividends from ownership of the stock. Similarly, it may be possible for the lessor of rental property to separate the right to receive the rent payments from the ownership of the underlying property.

In certain cases, income-stripping transactions can be structured to deliberately mismatch income and related deductions. This mismatch is caused by accounting rules that generally treat the assignment of future income as producing current income. Under these accounting rules, if a taxpayer holds income-producing property and sells the right to receive income from the property, the taxpayer generally has current income from the sale in an amount equal to the sale proceeds. Because no basis is allocated to the right to receive income, the taxpayer has a corresponding built-in loss on the stripped property. Conversely, if the taxpayer sells the property retaining the right to receive the income, the taxpayer generally has a loss on the sale of the property because all of the taxpayer's basis is allocated to the sale and no basis is allocated to the retained right to receive income.

In addition to the mismatched income on the strip itself, income-stripping transactions create partial interests in property the accounting rules for which may not clearly reflect income. For example, although there are rules requiring the holder of stripped preferred stock to accrue income, there are no similar rules that apply to holders of stripped common stock.

For certain types of income-stripping transactions, the tax law has developed rules that clearly reflect the participants' income. These rules can be grouped into two approaches – the "coupon-stripping" approach and the "deemed financing" approach. The coupon stripping approach is codified in section 1286. Under this section, a taxpayer that strips the right to receive interest (the coupon) from a bond must allocate its basis in the entire bond between the portion of the bond retained and the portion of the bond sold. This basis allocation rule ensures proper measurement of the economic gain or loss realized on the disposition of a stripped interest in the bond. In addition, section 1286 treats the holder of a stripped bond or coupon as holding a debt instrument with original issue discount (OID) thereby ensuring that holders of stripped interests currently include the economic income from their stripped interests. Section 305(e) applies the coupon stripping approach to certain aspects of stripping transactions involving preferred stock.

The deemed financing approach addresses income-stripping transactions using a different mechanism. Under this approach, the assignment of the future income is characterized as a borrowing secured by the right to the future income, not a sale. The deemed financing approach

is used in section 636 to address income stripping transactions involving mineral property. Under this section, participants in income-stripping transactions of mineral property are required to account for the income strip (commonly referred to as a "production payment") as if it were a debt instrument issued by the owner of the mineral property to the holder of the production payment. By characterizing the production payment as a debt instrument and not an interest in the underlying property, section 636 avoids the need for a basis allocation rule upon the creation of the production payment. In addition, the debt characterization ensures that the participants' ongoing accounting for the transaction clearly reflects income. In particular, this treatment locates all of the income and deductions from the property in the same taxpayer. Specifically, because there was no separation in ownership, the owner/issuer must include all income from the property (including the income purportedly stripped). Consistent with the characterization of the transaction as leveraged current ownership, the owner is allowed depletion deductions for the property and interest deductions on the deemed debt instrument. The deemed financing approach is used in proposed regulations under section 7701(l) to address certain stripping transactions involving leases.

In addition, the idea underlying the deemed financing approach – that certain types of property cannot be stripped – underlies the investment trust classification regulations under section 7701. These regulations characterize certain arrangements that purport to separate (or strip) underlying property as entities themselves. By characterizing the purported stripping arrangement as an entity (and the participants as owning interests in the entity), these rules limit the ability of taxpayers to strip property.

**Reason for Change**

The Administration understands that income-stripping transactions have been used to achieve tax results that do not clearly reflect income of one or more participants to the transaction.

**Proposal**

The proposal generally would characterize a strip of a right to receive future income from income-producing property as a secured borrowing, not a separation in ownership. By characterizing the strip as a debt instrument (and not as an ownership interest in the underlying property), the proposal avoids the need for a basis allocation rule upon the creation of the strip. In addition, this debt characterization ensures that the party's ongoing accounting treatment from the transactions clearly reflects income. To ensure that income-stripping transactions are not used to create foreign tax credit opportunities not available under current law, the proposal would limit or prohibit the owner from crediting taxes paid or deemed paid with respect to the property.

In certain cases, the proposal would not apply the deemed-financing approach. Instead, the proposal would characterize the stripping arrangement as an entity and the holders of the purported income strip and underlying property as holding interests in the entity. Specifically, the proposal would characterize the stripping arrangement as an entity in cases where (1) the characterization of the purported income-strip as debt is inappropriate because the purported strip

represents substantially all of the value of the underlying property or (2) the deemed-financing result would fail to clearly reflect the income of one or more participants to the transaction.

The proposal would apply to income-stripping transactions involving leases, service contracts, stock, and, to the extent provided in regulations, other forms of income-producing property.

To ensure that income-stripping transactions are not used to constructively sell appreciated assets, the proposal would require a taxpayer that enters into a stripping transaction to recognize gain, if any, on the underlying income-producing property. Under this aspect of the proposal, for example, if the value of the strip was equal to 60 percent of the value of the underlying property, the owner of the underlying property would recognize 60 percent of the gain that would be recognized were the underlying property sold for its fair market value.

The proposal would be effective for income-stripping transactions entered into after the date of enactment.

## REQUIRE ORDINARY TREATMENT FOR CERTAIN DEALERS OF EQUITY OPTIONS AND COMMODITIES

### Current Law

Under current law, commodities dealers, within the meaning of section 1402(i)(2)(B), and options dealers, within the meaning of section 1256(g)(8), treat the income from their day-to-day dealer activities as giving rise to capital gain. Under section 1256, these dealers treat 60 percent of their income (or loss) from their dealer activities as long-term capital gain (or loss) and 40 percent of their income (or loss) from their dealer activities as short-term capital gain (or loss). Dealers in other types of property generally treat the income from their day-to-day dealer activities as giving rise to ordinary income.

### Reasons for Change

There is no reason to treat dealers in commodities and equity options differently than dealers in other types of property. Dealers earn their income from their day-to-day dealing activities and should be taxed at ordinary rates.

### Proposal

The proposal would require dealers in equity options and commodities to treat the income from their day-to-day dealer activities as ordinary in character, not capital.

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

# PROHIBIT TAX DEFERRAL ON CONTRIBUTIONS OF APPRECIATED PROPERTY TO SWAP FUNDS

## Current Law

Under current law, a taxpayer generally does not recognize gain upon the transfer of appreciated assets to a partnership in exchange for an interest in the partnership. A taxpayer generally must recognize gain, however, if the transfer (1) results in a diversification of the taxpayer's interest, and (2) more than 80 percent of the partnership's assets are readily-marketable stocks or securities. In 1997, Congress expanded the list of assets that are considered readily-marketable securities for this purpose. The expanded list, while broad, does not include limited and preferred interests in partnerships holding real estate.

A swap fund is an investment partnership that is designed to allow taxpayers holding blocks of appreciated stock to diversify their stock investments without recognizing gain and paying tax. Typically, a fund is established into which a small number of taxpayers transfer their appreciated stock. In exchange for the transferred stock, these taxpayers receive an interest in the fund.

## Reason for Change

Under current law, it is possible to structure a swap fund that holds 21 percent of its assets in limited and preferred partnership interests that are not considered readily marketable stock or securities. In this case, because less than 80 percent of the assets of the fund are readily-marketable stock or securities, the transferring taxpayers do not have to recognize gain. As a result, the transferring taxpayers are able to achieve diversification without gain recognition. This result is inconsistent with prior legislative action. Taxpayers should not be able to exchange tax-free an appreciated asset for an interest in a diversified investment portfolio.

## Proposal

The proposal would add limited and preferred interests in partnerships to the list of readily-marketable securities. In addition, the proposal would require a taxpayer to recognize gain upon the transfer of marketable stock or securities to a corporation or partnership that is essentially a passive investment vehicle. Specifically, under this aspect of the proposal, a taxpayer would be required to recognize gain upon the transfer of marketable stock or securities to a corporation or partnership if the corporation or partnership is: (1) registered under the Investment Company Act of 1940 as an investment company, (2) not required to be registered under the Investment Company Act because the interests in the fund are offered only to qualified purchasers within the meaning of the Act, or (3) marketed or sold to investors as providing a means of tax-free diversification.

To ensure that the proposal would not affect certain transfers involving regulated investment companies (for example, transfers involving the formation of master-feeder fund structures), the proposal would except certain transfers of already diversified pools of stock and securities.

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

**Corporate**

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

### Current Law

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

### Reasons for Change

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

### Proposal

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

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

## TREAT RECEIPT OF CERTAIN TRACKING STOCK AS PROPERTY

### Current Law

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

### Reasons for Change

The use of tracking stock is outside the contemplation of subchapter C and other sections of the Internal Revenue Code. The key feature of tracking stock is that in substance it shares in a discrete portion of a corporation's earnings, whether attributable to a division, a subsidiary or a collection of assets. Thus, when a shareholder receives tracking stock as a distribution or in a recapitalization or similar exchange in which tracking stock is received in exchange for other issuing corporation stock, the shareholder has altered its interest in the issuing corporation. The Administration believes that receipt of the tracking stock by the shareholder should be a recognition event

### Proposal

Under the proposal, the receipt of tracking stock in a distribution made by a corporation with respect to its stock and tracking stock received in exchange for other stock in the issuing corporation (either in a recapitalization or section 1036 exchange) would be treated as the receipt of property by the shareholders. The proposal would not apply to a stock split of tracking stock or any similar transaction. Under this proposal, 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 for other purposes.

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). Factors taken into account include whether (1) the dividends are directly or indirectly determined by reference to the value or performance of the tracked entity or assets, and (2) the stock has liquidation rights directly or indirectly determined by reference to the value of the tracked entity or assets.

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

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

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

### Current Law

No gain or loss is recognized if one or more persons transfer property to a corporation solely in exchange for stock in the corporation and immediately after the exchange such person or persons are in control of the corporation. Similarly, no gain or loss is recognized in the case of a contribution of property in exchange for a partnership interest. Neither the Internal Revenue Code nor the regulations provide the meaning of the requirement that a person transfer property in exchange for stock (or a partnership interest). The Internal Revenue Service interprets the requirement consistent with the "sale or other disposition of property" language in the context of a taxable disposition of property. See, e.g., Rev. Rul. 69-156, 1969-1 C.B. 101. Thus, a transfer of less than "all substantial rights" to use property will not qualify as a tax-free exchange and stock received will be treated as payments for the use of the property rather than for the property itself. These amounts are characterized as ordinary income. However, the Claims Court has rejected the Service's position and held that the transfer of a nonexclusive license to use a patent (or any transfer of "something of value") could be a "transfer" of "property" for purposes of the nonrecognition provision. See E.I. DuPont de Nemours & Co. v. U.S., 471 F.2d 1211 (Ct. Cl. 1973).

### Reasons for Change

The inconsistency between the Service's and the Claims Court's positions has effectively resulted in taxpayers' ability to choose taxable or tax-free treatment. In some cases, in order to achieve tax-free treatment, transferors take the position under DuPont that a transfer of less than all substantial rights is a transfer of property entitled to tax-free treatment. To the extent the intangible has basis, taxpayers generally do not allocate any basis to the partial interest in the intangible that is transferred, thereby allowing for the retention of basis by the transferor even though the value of the transferor's interest in the intangible has been diminished. In other situations, taxpayers follow the Service's position to allow the transferee corporation to deduct the payments made to the transferor. Finally, some transferors bifurcate the treatment of a single transfer, treating the transfer in exchange for stock as tax-free and deferring the receipt of other payments that the transferor will report as ordinary income and the transferee will deduct.

### Proposal

A transfer of an interest in intangible property constituting less than all of the substantial rights of the transferor may qualify as a section 351 or 721 transfer even if the transferor does not transfer all rights, title and interest in an intangible asset. Consistent reporting by the transferor and the transferee would be required. Further, the Administration proposes that, in the case of a transfer of less than all of the substantial rights that is treated as a transfer of property, the transferor must allocate the basis of the intangible between the retained rights and the transferred rights based upon respective fair market values.

No inference is intended as to the treatment of these or similar transactions prior to the effective date.

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

## MODIFY TAX TREATMENT OF CERTAIN REORGANIZATIONS WHERE PORTFOLIO INTERESTS IN STOCK DISAPPEAR

### Current Law

If a target corporation owns stock in the acquiring corporation and wants to combine with the acquiring corporation in a downstream reorganization, the target corporation transfers its assets to the acquiring corporation and the shareholders of the target corporation receive stock of the acquiring corporation in exchange for their target corporation stock. Alternatively, if the acquiring corporation owns stock in the target corporation, the target corporation can merge upstream, transfer its assets upstream, or merge sideways into a subsidiary of the acquiring corporation with the other shareholders of target receiving acquiring corporation stock. Under current law, all of these reorganizations qualify for tax-free treatment.

### Reasons for Change

The Administration believes that, in the context of a tax-free reorganization, an investment interest in stock should not be treated as representing an interest in the underlying assets of the corporation but instead should be treated as a separate asset. Thus, when such an interest disappears in a reorganization in which the two corporations combine, the owner of the investment interest should recognize gain on the appreciation in the stock.

### Proposal

Under the proposal, where a target corporation holds less than 20 percent of the value of the stock of an acquiring corporation and the target corporation combines with the acquiring corporation in a reorganization in which the acquiring corporation is the survivor, the target corporation must recognize gain, but not loss, as if it distributed the acquiring corporation stock immediately prior to the reorganization. Furthermore, where an acquiring corporation owns less than 20 percent of the value of the stock of a target corporation and the target corporation combines with the acquiring corporation or a subsidiary of the acquiring corporation, the acquiring corporation must recognize gain, but not loss, as if it sold its target corporation stock immediately prior to the reorganization. Nonrecognition treatment would continue to apply to other assets transferred by the target corporation and to the target corporation shareholders.

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

## CLARIFY DEFINITION OF NONQUALIFIED PREFERRED STOCK

### Current Law

The Taxpayer Relief Act of 1997 amended sections 351, 354, 355, 356, and 1036 to treat "nonqualified preferred stock" as boot in corporate transactions, subject to certain exceptions. For this purpose, preferred stock is defined as stock which is "limited and preferred as to dividends and does not participate in corporate growth to any significant extent." Nonqualified preferred stock is defined as any preferred stock, that (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase, (3) the issuer or a related person has the right to redeem or purchase and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or similar indices, regardless of whether such varying rate is provided as an express term of the stock (as in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (as in the case of auction rate stock). For this purpose, clauses (1), (2), and (3) apply if the right or obligation may be exercised within 20 years of the issue date and is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

The nonqualified preferred stock provisions were enacted because Congress determined that nonrecognition treatment is inappropriate where taxpayers receive relatively secure instruments in exchange for relatively risky instruments.

### Reasons for Change

Taxpayers attempt to avoid characterizing certain instruments as nonqualified preferred stock by including illusory participation rights or including terms that taxpayers argue create an "unlimited" dividend.

### Proposal

The Administration proposes to clarify the definition of preferred stock to ensure that stock for which there is not a real and meaningful likelihood of actually participating in the earnings and growth of the corporation is included.

The proposal would apply to transactions that occur after the date of first committee action.

No inference is intended as to the characterization of stock under current law that has terms providing for unlimited dividends or participation rights but, based on all the facts and circumstances, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

## CLARIFY RULES FOR PAYMENT OF ESTIMATED TAXES FOR CERTAIN DEEMED ASSET SALES

**Current Law**

In certain circumstances, taxpayers can make an election under section 338(h)(10) to treat a qualifying purchase and sale of 80 percent of the stock of a target corporation as a purchase and sale of the assets of the target corporation. The election must be made jointly by the buyer and seller and is due by the $15^{th}$ day of the ninth month beginning after the month in which the acquisition date occurs. Section 338(h)(13) provides that, for purposes of section 6655 (relating to additions to tax for failure by a corporation to pay estimated income tax), tax attributable to the deemed asset sale shall not be taken into account.

**Reasons for Change**

Some taxpayers are taking the position that, in the case of a sale of the stock of a target corporation that would be eligible for a section 338(h)(10) election, they do not have to pay any estimated taxes (either on the gain from the actual sale of stock in the case no section 338(h)(10) election will be made or on the gain from a deemed asset sale in the case where an election will be made). Typically, because the section 338(h)(10) election is made jointly by the buyer and seller, the parties know at the time of the transaction whether such election will be made, and thus the seller should pay estimated taxes accordingly.

**Proposal**

The proposal would clarify section 338(h)(13) to require that estimated taxes be paid based upon the deemed asset sale where there is an agreement to make the section 338(h)(10) election, or upon the stock sale where there is no such agreement.

No inference is intended as to the applicability of the penalty for nonpayment of estimated taxes for these transactions prior to the effective date.

This proposal applies to transactions that occur after the date of first committee action.

## MODIFY TREATMENT OF TRANSFERS TO CREDITORS IN DIVISIVE REORGANIZATIONS

**Current Law**

In order to separate businesses in a section 355 tax-free distribution, the distributing corporation (distributing) will not recognize gain or loss on the contribution of property to a controlled corporation (controlled) solely in exchange for stock or securities of controlled. This exchange is a reorganization described in section 368(a)(1)(D). If distributing also receives other property or money, section 361(b) generally requires distributing to recognize gain with respect to the assets it transfers to controlled. However, pursuant to section 361(b)(3), distributing will not

recognize gain if it distributes the property or money to its shareholders or its creditors in connection with the reorganization. The amount of property or money that may be distributed to creditors without gain recognition by distributing under section 361(b) is unlimited.

Under section 357(c), distributing will recognize gain if the amount of the liabilities assumed by controlled exceeds the total of the adjusted basis of the property transferred pursuant to the reorganization exchange. Section 357(c) also applies in the case of a reorganization described in section 368(a)(1)(D) that is not accompanied by a section 355 distribution (an acquisitive Type D reorganization).

**Reasons for Change**

Because distributing may receive an unlimited amount of property or money without gain recognition under section 361(b) as long as it distributes such property or money to its creditors, taxpayers may avoid gain that otherwise would be recognized under section 357(c) if liabilities are assumed by controlled that exceed the basis of assets contributed. For example, if distributing transfers property with a basis of $100 to controlled and controlled assumes a $500 liability of distributing in a Type D reorganization, distributing will recognize gain of $400 under section 357(c). If instead, distributing transfers the assets with $100 basis to controlled in exchange for stock and $500 that controlled borrows from a third-party lender, distributing can pay the $500 to its creditors without gain recognition under section 361(b).

Because in an acquisitive Type D reorganization, the target corporation does not receive property for which it would receive a substituted basis, the concerns underlying section 357(c) are not present.

**Proposal**

Consistent with section 357(c), the Administration proposes to limit the amount of property or money that a distributing corporation can distribute to creditors without gain recognition under section 361(b) to the amount of basis of the assets contributed to a controlled corporation in the reorganization. In addition, the proposal would provide that acquisitive Type D reorganizations would no longer be subject to section 357(c).

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

## Pass-throughs

### PROVIDE MANDATORY BASIS ADJUSTMENTS WHERE PARTNERS HAVE A SIGNIFICANT NET BUILT-IN LOSS IN PARTNERSHIP PROPERTY

## Current Law

The basis of partnership property is not adjusted upon a distribution of property to a partner or upon the transfer of a partnership interest unless an election under section 754 is in effect. Under section 734(b), if such an election is in effect, a partnership must decrease the basis of retained partnership property by (1) the amount of loss recognized by the distributee partner and (2) the excess of the basis of the distributed property to the distributee over the adjusted basis of the distributed property to the partnership. Under section 743(b), if such an election is in effect, the partnership must reduce the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership. Sections 734(b) and 743(b) also provide for positive basis adjustments in converse situations where an election under section 754 is in effect.

## Reasons for Change

The electivity of adjustments under sections 734(b) and 743(b) provide substantial opportunities for taxpayer abuse. The primary abuse relates to the duplication of losses. Where a partner contributes loss property to a partnership and subsequently recognizes a loss upon receipt of cash in liquidation of that partner's interest in the partnership or upon a transfer of the partner's interest in the partnership, the loss is attributable to the adjusted basis of the property that was contributed to the partnership. Unless a section 754 election has been made so that the basis of the contributed property, which remains in the partnership, is adjusted, the partnership will recognize the loss again when the property is sold.

## Proposal

The Administration proposes that sections 734(b) and 743(b) would be made mandatory with respect to any partner whose share of net built-in loss in partnership property is equal to the greater of $250,000 or ten percent of the partner's total share of partnership assets. For purposes of this proposal, persons described in section 267(b) and 707(b)(1) would be treated as one person, and "20 percent" would be substituted for "50 percent" where applicable in applying those provisions. Net built-in loss would be measured as the net loss that would be allocated to the partner if the partnership sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property. A partner's share of partnership assets would be determined as the amount that the partner would receive if a partnership sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property and then liquidated. Property acquired by the partnership with a principal purpose of allowing a partner or partners to avoid the ten-percent threshold would be disregarded.

This proposal would apply to distributions and transfers made after the date of enactment.

## MODIFY TREATMENT OF CLOSELY-HELD REITS

### Current Law

When originally enacted, the real estate investment trust ("REIT") legislation was intended to provide a tax-favored vehicle through which small investors could invest in a professionally managed real estate portfolio. H.R. Rep. No. 2020, 86th Cong., 2d Sess., 2 (1960). REITs are intended to be widely-held entities, and certain requirements of the REIT rules are designed to ensure this result. Among other requirements, in order for an entity to qualify for REIT status, the beneficial ownership of the entity must be held by 100 or more persons. In addition, a REIT cannot be closely held, which is determined by reference to the stock ownership requirement in the personal holding company rules. Under these rules, generally no more than 50 percent of the value of the REIT's stock can be owned by five or fewer individuals during the last half of the taxable year. Certain attribution rules apply in making this determination.

### Reasons for Change

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

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

### Proposal

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

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

## APPLY RIC EXCISE TAX TO UNDISTRIBUTED PROFITS OF REITS

### Current Law

Prior to the Tax Relief Extension Act of 1999 (1999 Act), a REIT was required to distribute 95 percent of its REIT taxable income (adjusted for certain amounts) in order to maintain qualification as a REIT. As a result of changes made by the 1999 Act, a REIT, like a regulated investment company (RIC), now is only required to distribute 90 percent of its REIT taxable income (adjusted for certain amounts) in order to maintain REIT status. A RIC is subject to a four-percent excise tax on the excess of the required distribution for a calendar year over the distributed amount for such calendar year. The required distribution is equal to the sum of 98 percent of the RIC's ordinary income for the calendar year and 98 percent of the RIC's capital gain net income for the one-year period ending on October 31st of such calendar year. REITs are subject to a similar rule, except that the required distribution is equal to the sum of 85 percent of the REIT's ordinary income for the calendar year and 95 percent of the REIT's capital gain net income for such calendar year.

### Reasons for Change

In lowering the amount that a REIT must distribute in order to maintain its REIT status from 95 percent of REIT taxable income to 90 percent of REIT taxable income, Congress indicated that the purpose for the change was to create conformity with the RIC rules. In order to create true conformity with such rules, it is necessary also to conform the excise tax rules relating to distributions by such entities.

### Proposal

The proposal would require a REIT to distribute 98 percent of its ordinary income and capital gain net income for a calendar year in order to avoid the four-percent excise tax imposed under section 4981.

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

## ALLOW RICS A DIVIDENDS PAID DEDUCTION FOR REDEMPTIONS ONLY IN CASES WHERE THE REDEMPTION REPRESENTS A CONTRACTION IN THE RIC

### Current Law

Under current law, a regulated investment company (RIC) determines its federal income tax liability by reference to its "investment company taxable income." In computing investment company taxable income, a RIC is permitted a deduction for dividends paid.

There are two primary ways in which a RIC generates a deduction for dividends paid. First, a RIC deducts as dividends amounts distributed out of earnings and profits to shareholders with

respect to their RIC shares. Second, if stock in a RIC is redeemed, a RIC generally may deduct the portion of the redemption distribution that is properly chargeable to accumulated earnings and profits.

To avoid the imposition of a corporate level of tax, RICs generally attempt to zero-out their investment company taxable income by distributing amounts sufficient to ensure that the dividends paid deduction completely eliminates their income.

**Reason for Change**

In situations where a RIC redeems shares and the redemption represents a contraction in the size of the RIC, it is appropriate to allow a dividends paid deduction for the portion of accumulated earnings and profits properly chargeable to the redeemed shares. Absent such a deduction, the RIC would be required to distribute to the remaining shareholders amounts that exceed their pro-rata share of the RIC's income.

In situations where a RIC redeems shares and the redemption is accompanied by near simultaneous investments in the RIC by other investors, the RIC is in essentially the same position it would be in had the redeeming shareholder sold its shares in the RIC directly to the new investors. In this case, if the RIC is allowed to deduct a portion of the redeeming distribution, this dividend allows the RIC to reduce the dividends it otherwise would make to shareholders at the end of the year. This reduction results in smaller dividend distributions to historic shareholders (shareholders that were in the fund for the entire year).

**Proposal**

Under the proposal, a RIC would be allowed to claim a dividends paid deduction with respect to a redemption only if the redemption represents a net contraction of the RIC (as measured by the number of shares outstanding). The proposal would be effective for taxable years beginning after the date of enactment.

## REQUIRE REMICS TO BE SECONDARILY LIABLE FOR THE TAX LIABILITY OF REMIC RESIDUAL INTEREST HOLDERS

**Current Law**

A Real Estate Mortgage Investment Conduit (REMIC) is a statutory pass-through vehicle designed to facilitate the securitization of mortgages. A REMIC holds mortgages and issues one or more classes of debt instruments, called REMIC regular interests, that are entitled to the cash flows from the underlying mortgages. A REMIC also issues a single equity class of interest, called a REMIC residual interest. Although a REMIC computes its tax liability (and files a tax return), a REMIC is not subject to tax itself. Instead, the holder of the REMIC residual interest includes in income the daily portions of the REMIC's taxable income.

There is no requirement that a REMIC residual interest be allocated a portion of the cash flow generated by the underlying mortgages. In cases where the REMIC residual interest is entitled to few, if any, cash flows, the residual interest can have a negative value when issued. This negative value occurs because the reasonably anticipated net tax liability associated with holding the residual interest is greater than the value of the cash flows on the residual.

The REMIC provisions contain three rules designed to ensure that the tax on a REMIC residual interest is paid when due. First, the REMIC provisions impose a tax on the transfer of a REMIC residual interest to a governmental entity or organization that is exempt from tax. Second, under regulations, certain transfers of negative value residual interests are ignored if, at the time of the transfer, the transferor knew or should have known that the transferee would be unwilling or unable to pay taxes due on its share of share of the income. Third, under regulations, a transfer of a REMIC residual interest to a foreign person is ignored if the transfer has tax avoidance potential.

**Reason for Change**

Congress created the REMIC residual interest to ensure that the taxable income of the REMIC would be subject to tax. The Treasury Department understands that, despite the rules designed to ensure that the tax on REMIC residual interest is paid when due, some holders of REMIC residual interests do not pay the tax on the REMIC residual interests when due.

**Proposal**

To ensure that the tax on REMIC residuals is paid when due, the proposal would require the REMIC to be secondarily liable for the tax liability of its REMIC residual interest. Under the proposal, if the tax on the residual is not paid when due, the REMIC would be liable for the tax plus additions to tax in the following tax year. Similar rules would apply with respect to Financial Asset Securitization Investment Trusts (FASITs). The proposal would be effective for REMICs and FASITs created after the date of enactment.

## Tax Accounting

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

### Current Law

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

Under current law, section 381 does not apply to the tax-free contribution to a corporation described in section 351 or the tax-free contribution to a partnership described in section 721. Consequently, taxpayers who transfer assets to a subsidiary or a partnership may avail themselves of a new method of accounting without obtaining the consent of the Commissioner.[16]

### Reasons for Change

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

### Proposal

The proposal would expand the transactions to which the carryover of method of accounting rules in section 381(c)(4) and (5) and the regulations thereunder apply to include section 351 and section 721 transactions.

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

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

## DENY DEDUCTION FOR PUNITIVE DAMAGES

**Current Law**

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

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

**Reasons for Change**

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

**Proposal**

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

## REPEAL LOWER OF COST OR MARKET INVENTORY ACCOUNTING METHOD

**Current Law**

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

**Reasons for Change**

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

understates taxable income. In addition, the market value used under LCM generally is the replacement or reproduction cost of inventory, not its net realizable value as required for financial accounting purposes. As a result, a taxpayer can write down an item of inventory even though the item of inventory still may be sold at a profit. Finally, the operation of the retail inventory method with LCM allows retailers to obtain deductions for write-downs even though market value has not declined below historical cost, a benefit inconsistent with the purpose of LCM.

**Proposal**

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

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

**Current Law**

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

**Reasons for Change**

The current rules applicable to securities dealers and financial intermediaries other than banks permit them to reduce their tax liabilities inappropriately through double Federal tax benefits of interest expense deductions and tax-exempt interest income, notwithstanding that they operate

similarly to banks. The treatment of banks should be applicable to other taxpayers engaged in the business of financial intermediation, such as securities dealers. There is no reason to distinguish between banks and other financial intermediaries in this context. In both cases, it is difficult to trace funds within the institution and nearly impossible to assess the taxpayer's purpose in accepting deposits or making other borrowings.

**Proposal**

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

## CAPITALIZATION OF COMMISSIONS BY MUTUAL FUND DISTRIBUTORS

**Current Law**

A taxpayer generally is allowed to deduct all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on a trade or business. However, expenditures that result in the creation or acquisition of an asset having a useful life substantially beyond the taxable year must be capitalized and generally may be recovered over the useful life of the asset. An expenditure that results in significant future benefits generally must be capitalized in order to match the expenditure with the revenues of the taxable period to which it is properly attributable and, thus, more accurately calculate net income for tax purposes.

Mutual funds generally distribute new shares to the public through a Principal Underwriter/Distributor. Traditionally, if an investor purchased mutual fund shares through a broker, the investor had to pay the broker a stock-purchase commission (front-end load). Today, however, the distributor may pay the brokerage commissions. When the distributor pays the brokerage commissions, the distributor typically recovers this cost by collecting a distribution fee from the mutual fund itself and possibly by receiving a sales charge (back-end load, or contingent deferred sales load) from the investor when the shares are redeemed. In general, shares where the investor is subject to a front-end load are called "Class A shares," and shares where an investor is subject to a distribution fee and a back-end load are called "Class B shares."

Distributors take the position that they are "dealers in securities" and, thus, brokerage commissions are deductible in the year paid pursuant to Treasury regulations that provide that ordinary and necessary business expenses include commissions that dealers in securities pay in selling securities.[17]

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[17] Reg. section 1.263(a)-2(e). *See* TAM 9345003 (July 15, 1993).

**Reason for Change**

Distribution fees combined with back-end loads effectively compensate a distributor over a specified period for paying a broker an upfront commission for helping the investor purchase Class B shares. The Administration believes that to clearly reflect income it is necessary to capitalize the commissions that distributors pay to brokers in order to properly match the commission expense with the related distribution fee income and back-end loads, if any, to be earned over the period specified in the distribution agreement (usually six years). Capitalization of these commissions also would be consistent with generally accepted accounting principles, which require incremental direct costs related to distribution activities, such as sales commissions, to be deferred and amortized over six years (the period investors would have to hold shares without incurring a fee on redemption).[18]

**Proposal**

Commissions paid to a broker by a distributor would be capitalized and recovered over the period investors would have to hold the shares without incurring a fee on redemption (usually six years). The proposal would be effective for commissions paid or incurred in taxable years ending after the date of enactment. No inference is intended with respect to the treatment of distributor's commissions under current law.

[18] EITF Issue 85-24: Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge

## Cost Recovery

### PROVIDE CONSISTENT AMORTIZATION PERIODS FOR INTANGIBLES

#### Current Law

Under current law, start-up expenditures for a new trade or business and organizational expenditures for either a corporation or a partnership are amortized at the election of the taxpayer over a period of not less than 60 months beginning with the month in which the conduct of a trade or business begins pursuant to sections 195 and either 248 or 709. Section 197 requires certain acquired intangible assets (goodwill, trademarks, franchises, patents, etc.) held in connection with the conduct of a trade or business or an activity for the production of income to be amortized over 15 years beginning with the month in which the intangible was acquired.

#### Reasons for Change

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

#### Proposal

The proposal would allow a taxpayer to elect to deduct up to $5,000 of start-up expenditures, and up to $5,000 of organizational expenditures of either a corporation or partnership, 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 for a particular trade or business and the organizational expenditures exceeds $50,000, respectively.

Start-up and organizational expenditures that are not deductible in the year in which the trade or business begins would be amortized over a 15-year period consistent with the amortization period for section 197 intangibles.

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

### CLARIFY CLASS LIFE OF UTILITY CLEARING AND GRADING COSTS

#### Current Law

A taxpayer is allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or held for the production of income. For most tangible property placed in service after 1986, the amount of the

depreciation deduction is determined under the modified accelerated recovery system (MACRS) using a statutorily prescribed depreciation method, recovery period, and placed in service convention. For some assets, the recovery period for the asset is provided in section 168. In other cases, the recovery period of an asset is determined by reference to its class life. The class life of an asset may be provided in section 168, or may be determined with regard to the list of class lives provided by the Treasury Department that was in effect on January 1, 1986.[19]

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

**Reason for Change**

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

**Proposal**

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

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

## EXTEND THE CURRENT LAW INTANGIBLE AMORTIZATION PROVISIONS TO ACQUISITIONS OF SPORTS FRANCHISES

**Current Law**

In general, the purchase price allocated to intangible assets (including franchise rights) acquired in connection with the acquisition of a trade or business must be capitalized and amortized over a 15-year period under section 197. These rules were enacted in 1993 to minimize disputes

[19] Rev. Proc. 87-56, 1987-2 C.B. 674

[20] Rev. Rul. 72-403, 1972-2 C.B. 102

regarding the proper treatment of acquired intangible assets. These rules do not apply to acquisitions of professional sports franchises; rather, special rules apply.

Under section 1056, when a franchise to conduct a sports enterprise is sold or exchanged, the basis of a player contract acquired as part of the transaction is generally limited to the adjusted basis of such contract in the hands of the transferor, increased by the amount of gain, if any, recognized by the transferor on the transfer of the contract. Moreover, not more than 50 percent of the consideration from the transaction may be allocated to player contracts unless the transferee establishes to the satisfaction of the Commissioner that a specific allocation in excess of 50 percent is proper. However, these basis limitations may not apply where a sale or exchange of a franchise to conduct a sports enterprise is effected through a partnership.[21] Basis allocated to the franchise or to other valuable intangible assets acquired with the franchise may not be amortizable if these assets lack a determinable useful life.

**Reasons for Change**

The limitations on basis allocations to player contracts were enacted in 1976 to prevent taxpayers from inappropriately allocating most of the aggregate purchase price of a sports franchise to player contracts. Because player contracts had relatively short lives (whereas any value allocated to the franchise was not amortizable), the distortions of taxable income generated by excessive allocations to player contracts may have provided an unwarranted incentive for investments in sports franchises.[22]

Section 197 was enacted to reduce controversies over allocations of purchase price and determinations of useful lives for acquired intangibles. Because franchises to conduct a sports enterprise were excluded from section 197, the possibility for continuing controversy exists. The existing limitations on allocations to player contracts do not fully address valuation concerns and taxpayers may argue they are not applicable to acquisitions effected through a partnership. More importantly, there exists no apparent justification for treating acquisitions of franchises to conduct sports enterprises differently than acquisitions of other trades or businesses.

**Proposal**

In order to provide consistent treatment among different trades or businesses and to minimize disputes regarding intangibles acquired in connection with a professional sports franchise, the Administration proposes to repeal the special rules and limitations applicable to sports franchise acquisitions, thus allowing all intangible assets acquired as part of the acquisition of a sports franchise to be amortized over a uniform period under section 197. The proposal would be effective for acquisitions occurring after the date of enactment.

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**21** P.D.B. Sports, Ltd v. Comm., 109 T.C. 423 (1997).

**22** H.Rept. 94-658, at 115-117 (1975), 1976-3 C.B. (Vol. 2) 695, 807-809; S. Rept. 94-938 at 87-88 (1976), 1976-3 C.B. (Vol. 3) 49, 125-126.

## Insurance

### REQUIRE RECAPTURE OF POLICYHOLDERS SURPLUS ACCOUNTS

#### Current Law

Between 1959 and 1983, stock life insurance companies deferred tax on a portion of their profits. These untaxed profits were added to a policyholders surplus account ("PSA"). In 1984, Congress precluded life insurance companies from continuing to defer tax on any future profits through PSAs. However, companies were permitted to continue their existing PSA accounts, subject to the longstanding requirement that these profits be taxed when they are distributed to shareholders. To ensure that these untaxed profits would ultimately be taxed, Congress expressly stated that the profits would be taxed when there were constructive distributions, which were intended to be "construed broadly" to occur whenever policyholders surplus account funds were used to benefit the shareholders indirectly, even if there was no shareholder distribution within the meaning of sections 301 or 302.

After the 1984 modifications, previously untaxed profits are taxed when and to the extent they are distributed or treated as being distributed to shareholders. Amounts are treated as being distributed from a PSA if a company ceases being an insurance company for a single taxable year, or if the company is not a life insurance company for two consecutive taxable years. Similarly, shareholders would be treated as receiving an indirect distribution from the policyholders surplus account under various circumstances, including where the life insurance company purchased its shareholders' stock or lent funds to a shareholder.

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

#### Reasons for Change

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

There is no remaining justification for allowing stock life insurance companies to continue to defer tax on profits they earned between 1959 and 1983. Most pre-1984 policies have terminated, because pre-1984 policyholders have surrendered their pre-1984 contracts for cash,

ceased paying premiums on those contracts, or died. Life insurance companies rarely, if ever, paid cash surrender values, death benefits or other benefits that exceeded the aggregated reserves they established for those pre-1984 contracts. To the extent pre-1984 contracts have not terminated, some companies that issued those contracts have reinsured them with other insurance companies, while either retaining their PSAs or distributing their PSAs to parent life insurance companies. Thus, PSAs typically have been separated from any remaining pre-1984 contracts. Companies generally take the position that these transactions do not trigger inclusion of PSAs into their gross income under current law.

**Proposal**

Companies would be required to include in their gross income over five years their PSA balances as of the beginning of the first taxable year starting after the date of enactment. Under the proposal, companies that had no direct or indirect distributions to shareholders generally would be required to include 5 percent of the original amount in the first taxable year beginning after the date of enactment, 10 percent in the next year, 15 percent in the next year, 30 percent in the next year, and 40 percent in the last year. To the extent that a company was required to include a portion of its PSA balance in income during this five-year period due to a direct or indirect distribution, this schedule would be adjusted so that the company would include a corresponding portion of its remaining PSA balance over the remainder of the 5-year period.

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

**Current Law**

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

Under section 848(h), Treasury has the authority to modify these percentages and categories if the deferral of acquisition expenses for a type of contract under these provisions is substantially greater than the deferral of acquisition expenses that would have resulted if actual acquisition expenses (including indirect expenses) and the actual useful life for such type of contract had been used. If Treasury exercises this authority with respect to contracts in one of these statutory categories, the percentage of net premiums that is capitalized for the remaining contracts in that

category must be adjusted so that Treasury's exercise of its authority does not decrease the amount of tax revenue received for any fiscal year.

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

Life insurance companies deduct a tax reserve with respect to life insurance and annuity contracts they issue. The tax reserve equals the greater of the actuarial reserve or the cash surrender value, but cannot exceed the reserve reported on the company's annual statement filed with state insurance regulators. The sum of the deduction for the tax reserve and the deduction for non-capitalized commissions and other policy acquisition costs with respect to a newly issued policy often result in the recognition of a tax loss when a deferred annuity or cash value life insurance policy is issued, even though the insurance company presumably believes that it will earn a profit from issuing the policy.

**Reasons for Change**

Current tax law fails to accurately reflect the economic income of life insurance companies for several reasons. First, life insurance companies generally capitalize only a fraction of their actual policy acquisition costs, based on data reported annually by the life insurance companies to State insurance commissioners. Policy acquisition costs also include other amounts that vary directly with the amount of new policies issued, such as expense and overhead reimbursements to agents and amounts paid to agents' supervisors. Even if one assumed that policy acquisition expenses were limited to commissions, current tax law requires capitalization of only a small portion of total commissions paid over the past five years (1994 through 1998):

| Type of Insurance Contract | Percentage of Net Premiums Capitalized Under Current Law | Ratio of Commissions to Net Premiums, 1994-1998 |
|---|---|---|
| Individual life insurance | 7.70% | 13.4% |
| Individual annuities | 1.75% | 6.0% |
| Group annuities | generally 0% | 1.8% |
| Group health, including disability and long-term care | 7.70% | 7.9% |
| Individual health, including disability and long-term care | 7.70% | 17.7% |
| Group life insurance | 2.05% | 4.0% |
| Credit life insurance | generally 2.05% | 52.9% |
| Credit health insurance | 7.70% | 58.6% |

In contrast, when preparing their financial statements using generally accepted accounting principles (GAAP), life insurance companies generally capitalize their actual policy acquisition costs, including but not limited to commissions.

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

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

**Proposal**

Insurance companies generally would be required to capitalize modified percentages of net premiums for five categories of insurance contracts. These modified percentages more closely reflect both the historic ratio of commissions to net premiums from 1994 through 1998 shown above and the typical useful lives for the policies included in each of these categories. These capitalization percentages would be lower than the ratio of total policy acquisition costs (not limited to commissions) to net premiums, and therefore would generally require companies to capitalize less for tax purposes than they capitalize for financial statement purposes. As under current law, capitalized amounts would be required to be amortized on a straight-line basis over a 10-year period (5 years for small companies).

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

The proposal would modify current law in several respects. First, companies would be required to capitalize 2.05 percent of the net premiums on group or individual term life insurance. Second, companies would be required to capitalize 4.8 percent of the net premiums on non-pension annuity contracts beginning in the first taxable year after the date of enactment. Third, companies would be required to capitalize 10.3 percent of net premiums on cash value life insurance, credit life insurance, credit health insurance and any other specified insurance contracts (as defined under current law) beginning in the first taxable year after the date of enactment. In addition, these changes in the percentage of net premiums capitalized would be

treated as changes in a company's method of accounting, which would be reflected in a section 481(a) adjustment that would be included ratably in a company's income over five years.

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

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

### Current Law

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

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

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

## Reasons for Change

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

## Proposal

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

# MODIFY RULES THAT APPLY TO SALES OF LIFE INSURANCE CONTRACTS

## Current Law

The sale of an interest in a life insurance contract generally results in taxable income to the seller equal to the difference between the purchase price and the buyer's adjusted basis in the contract. The rule generally does not apply if the insured person is terminally or chronically ill. This exception to the rule generally does not apply if the seller has an insurable interest with respect to the life of the insured by reason of the insured being a director, officer, or employee of the seller or by reason of the insured being financially interested in any trade or business carried on by the seller.

The buyer of a previously-issued life insurance contract who subsequently receives a death benefit generally is subject to tax on the difference between the total death benefit and the actual value of the consideration paid to the seller plus premiums and other amounts paid by the buyer. This rule does not apply if the buyer's basis is determined in whole or in part by reference to the seller's basis. It also does not apply if the buyer is the insured, a partner of the insured, or a corporation in which the insured is a shareholder or officer.

Persons engaged in a trade or business that make a payment of premiums, compensations, renumerations, other fixed or determinable gains, profits and income and certain other types or payments in the course of that trade or business to another person generally are required to report such payments of $600 or more to the Service. However, if the payor does not have access to information needed to determine the amount of income that is part of such payment, the IRS has ruled that this reporting obligation does not apply. Rev. Rul. 80-22, 1980-1 C.B. 286.

## Reasons for Change

Viatical companies originally purchased policies only where the insured person was terminally ill or chronically ill. Recently, viatical companies have started to buy life insurance policies

where the insured is neither terminally nor chronically ill, but can be expected to die within 20 years. These transactions are sometimes referred to as "high net worth" transactions.

The typical high net worth transaction involves a policy with a death benefit of at least $1,000,000. Typical sellers include businesses that no longer need the life insurance contract because the insured person is no longer a valued employee or a shareholder, and trusts and natural persons that no longer want to pay mortality charges on policies they no longer need. Because buyers typically do not know the seller's basis in the life insurance policies, buyers generally are not required to report these sales to the Service. Moreover, buyers generally do not report the amount they paid the seller to the life insurance company, so life insurance companies generally do not know the buyer's basis in the acquired life insurance contracts. Thus, the life insurance company generally does not report to the Service the taxable portion of the death benefit paid to the buyer when the insured dies. Because no information is reported to the Service with respect to the sale from the original policyholder to the buyer, the Service cannot readily ascertain whether the seller is paying tax on the taxable portion of the sales proceeds. Similarly, because no information is reported to the Service regarding the subsequent benefit payment to the buyer, the Service cannot readily ascertain whether the buyer is paying tax on its profits. Marketing literature of some viatical companies states that the payment of tax on these profits is "voluntary," because no information is reported to the Service.

Moreover, the current law exceptions to the "transfer for value" rules may give buyers of interests in life insurance policies the ability to structure themselves to avoid paying tax on the profit when the insured person dies.

**Proposal**

The proposal would require persons or entities who purchase interests in an existing life insurance policy with a death benefit equal to or exceeding $1,000,000 to report the purchase price, the buyer's and seller's taxpayer identification numbers, and the issuer and policy number to the Service, to the insurance company that issued the policy, and to the seller. The seller would be required to file a separate schedule with its tax return computing the taxable portion of such payment.

The proposal would modify section 101(a)(2) so that the exceptions to the "transfer for value" rules would not apply to buyers of policies. Upon the payment of any policy benefits to the buyer, the insurance company would be required to report the gross benefit payment, the buyer's taxpayer identification number, and the insurance company's estimate of the buyer's basis in such policy to the Service and to the payee. Persons or entities that purchased interests in such life insurance policies would be required to file a separate schedule with their tax return that computed the taxable portion of the payments under the modified version of section 101(a)(2). To limit the potential for circumvention of these rules, the proposal would determine the "death benefit" of a policy for purposes of this provision based on the highest death benefit in the prior years three years with respect to such policy or any policy exchanged for such policy.

This proposal would apply to sales or assignments of interests in life insurance policies and payments of death benefits after the date of enactment.

## MODIFY QUALIFICATION RULES FOR TAX-EXEMPT PROPERTY CASUALTY INSURANCE COMPANIES

### Current Law

Section 501(c)(15) provides that an insurance company with up to $350,000 of premium income is tax-exempt. There is no limit on the amount of investment income or assets, other than the requirement that the entity be primarily engaged in the insurance business in order to qualify as an insurance company. Section 831(b) allows companies with premiums that exceed $350,000 but do not exceed $1,200,000 during a taxable year to elect to be taxed on their net investment income.

In determining whether a property casualty insurance company is tax-exempt under section 501(c)(15) or qualifies for the elective tax regime in section 831(b), premiums of companies in the same controlled group are aggregated. For purposes of these provisions, a controlled group is defined in accordance with the rules contained in section 1563, with certain modifications. These controlled group rules do not aggregate premium income of affiliated tax-exempt entities and certain affiliated foreign entities.

Section 4371 imposes a 1 percent excise tax on premiums paid for property casualty reinsurance or life insurance contracts issued by foreign companies with respect to U.S. risks. It also imposes a 4 percent excise tax on property casualty insurance policies directly insuring U.S. risks.

Section 953(d) allows foreign companies to elect to be taxed as domestic companies if they meet certain requirements, including the requirement that the foreign corporation "would qualify under Part I or II of subchapter L for the taxable year if it were a domestic corporation."

### Reasons for Change

Section 501(c)(15) originally was designed to provide a tax exemption for small bona fide mutual property casualty insurance companies, such as entities that insured farmers who formed mutual insurance companies against crop losses. Since section 501(c)(15) was expanded in 1986, however, Treasury has become aware that the expanded version of the section 501(c)(15) tax exemption has been abused by persons who use the tax exemption to accumulate investment income tax-free.

### Proposal

The proposal would modify section 501(c)(15) so that the tax exemption for small property casualty insurance companies would apply only to U.S. property casualty insurance companies with no more than $350,000 of gross receipts. For purposes of section 501(c)(15), gross receipts would include investment and other types of income. In addition, gross receipts would include all income of insurance companies in the same controlled group, plus premium income of any

related non-insurance companies. This portion of the proposal would be effective for taxable years beginning after the date of enactment.

The proposal would modify section 831(b) so that the election to be taxed on net investment income is available to property casualty insurance companies with annual premiums up to $350,000, as well as annual premiums in excess of $350,000 but no greater than $1,200,000. For purposes of determining the eligibility of the insurance company to make an election under section 831(b), the proposal would modify the applicable controlled group rules to aggregate the premium income of U.S. and of foreign companies, as well as the income of any related tax-exempt companies. This portion of the proposal would be effective for taxable years beginning after the date of enactment.

The proposal also would modify section 953(d) so that a foreign insurance company could not elect to be taxed as a domestic corporation if the foreign company would be tax exempt under section 501(c). This portion of the proposal would be effective beginning the first taxable year after date of enactment for companies formed after the date of first committee action. It would be effective beginning the second taxable year after date of enactment for companies formed before the date of first committee action.

**Exempt Organizations**

## SUBJECT INVESTMENT INCOME OF TRADE ASSOCIATIONS TO TAX

### Current Law

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

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

### Reasons for Change

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

## Proposal

Trade associations and other organizations described in section 501(c)(6) would generally be subject to tax (at applicable corporate income tax rates) on their net investment income in excess of $10,000. For this purpose, "net investment income" would be computed by adding all items of income described in paragraphs 1, 2, and 3 of section 512(b) (e.g., dividends, interest, royalties, and rents) and certain gains and losses from dispositions of property described in section 512(b)(5), and deducting all expenses directly connected with such items of income.

As under current-law section 512(a)(3), tax would not be imposed under the proposal to the extent that income is set aside to be used exclusively for a charitable purpose specified in section 170(c)(4). In addition, if an organization described in section 510(c)(6) sells property that is used directly in the performance of its exempt function, any gain from such sale is subject to tax under the proposal only to the extent that the association's sales price of the old property exceeds the association's cost of purchasing certain replacement property (see sec. 512(a)(3)(D)).

Under current-law section 6033(e)(1)(C), any lobbying and electioneering expenditures made by an organization described in section 501(c)(6) would be deemed to be made first out of the dues payments made by the members, which could result in a portion of dues payments being nondeductible under section 162(e) (or, as an alternative, the organization could elect to pay a proxy tax under sec. 6033(e)(2) on its lobbying and electioneering expenditures.)

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

## PENALTY FOR FAILURE TO FILE FORM 5227

## Current Law

Split-interest trusts[23] described in section 4947(a)(2) (such as charitable remainder trusts, charitable lead trusts, and pooled income funds) and certain trusts claiming charitable contribution deductions under section 642(c) are required under section 6034 to file an annual information return, Form 1041-A. Section 6652(c)(2)(A) imposes a penalty for failure to file Form 1041-A of $10 for each day the failure continues, up to a maximum of $5,000 with respect to any one return.

Split-interest trusts are also required to file an annual information return, Form 5227, which provides more information than is reported on Form 1041-A regarding the trust's financial activities and whether the trust is subject to certain excise taxes imposed upon private foundations under chapter 42. However, because the requirement to file Form 5227 appears in regulations under section 6011, rather than section 6034, the penalties imposed under section 6652(c)(2) arguably do not apply.

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**23** Split-interest trusts are trusts in which some, but not all, of the interests are devoted to charitable purposes. Although split-interest trusts are not private foundations, they are subject to some of the private foundation rules.

**Reasons for Change**

Recent attempts by taxpayers to avoid the recognition of gain from appreciated assets through the use of charitable remainder trusts[24] illustrate the need for improved reporting by split-interest trusts. Imposing a penalty for failure to file Form 5227 would encourage voluntary compliance by split-interest trusts and would assist the Internal Revenue Service in its enforcement efforts.

**Proposal**

The proposal would impose a penalty for failure to file Form 5227 of $20 for each day the failure continues (up to a maximum of $10,000 per return) or, in the case of any trust with income in excess of $250,000, $100 for each day the failure continues (up to a maximum of $50,000 per return). These penalty amounts are generally consistent with the penalties imposed on private foundations for failure to file Form 990-PF, which, like Form 5227, includes reporting of chapter 42 excise taxes. In addition, any trustee who knowingly fails to file Form 5227, unless such failure is not willful and is due to reasonable cause, would be jointly and severally liable for the amount of the penalty.

The proposal would be effective for any return the due date for which is after the date of enactment.

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**24** See Notice 94-78, 1994-2 C.B. 555; and Prop. Treas. Reg. §1.643(a)-8, published in the Federal Register on December 21,1999 (64 FR 56718).

## Estate and Gift

### RESTORE PHASE-OUT OF UNIFIED CREDIT FOR LARGE ESTATES

#### Current Law

Prior to the Taxpayer Relief Act of 1997, the five-percent surtax added to the estate tax gradually phased out two benefits for estates with a value above $10 million: the benefit of the estate tax brackets below 55 percent and the benefit of the unified credit. The Taxpayer Relief Act of 1997 amended the unified credit, increasing it gradually over the years 1998 through 2006 and effectively increasing the amount exempt from the estate and gift tax from $600,000 (in 1997) to $1,000,000 (in 2006). In attempting to amend the surtax provision to accommodate the scheduled increases to the unified credit, the Taxpayer Relief Act of 1997 inadvertently altered the operation of the surtax such that it currently phases out only the graduated estate tax brackets and does not phase out the benefit of the unified credit.

#### Reasons for Change

As evidenced by the legislative history of the Taxpayer Relief Act of 1997, there was no intention to change the application of the five percent surtax. The inadvertent reduction in the surtax gave an estate tax reduction to estates in excess of $17,184,000.

#### Proposal

The proposal would increase the range of the five-percent surtax in order to restore its purpose of phasing out the benefit of the unified credit as well as the benefit of the graduated estate tax brackets. The phase-out range would increase as the unified credit continues to rise until 2006.

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

### REQUIRE CONSISTENT VALUATION FOR ESTATE AND INCOME TAX PURPOSES

#### Current Law

Under current law, the basis of property acquired from a decedent is the fair market value of the property on the date of death. In addition, property included in the gross estate of a decedent generally is valued at its fair market value on the date of death. However, there is no requirement that the determination of fair market value for estate tax purposes and the determination of fair market value for income tax purposes be consistent. The only current duty of consistency for estates concerns the duty of the beneficiary of a trust or estate to report for income tax purposes consistent with the Form K-1 information received from the trust or estate (section 6034A). The K-1, however, does not include basis information.

When a lifetime gift of property is made, the donee generally takes a carryover basis in the property. (Adjustments are made if gift tax is paid on the transfer, and the dual basis rules apply if the property is later sold at a loss.) However, there is no duty on the donor to notify the donee of the basis.

**Reasons for Change**

Taxpayers should be required to take consistent positions when dealing with the Internal Revenue Service. The rationale for the step-up in basis at death is linked to the inclusion of the property in the estate of the decedent. Therefore, the reported estate tax value and the new basis should be the same. In the case of a gift in which the donee takes a carryover basis, the donor is in the best position to notify the donee of the basis. If such information is not passed on to the donee at the time of the gift, such information may be lost or unavailable by the time the property is sold by the donee.

**Proposal**

The proposal would impose both a duty of consistency and a reporting requirement. First, a person taking a basis under section 1014 (property acquired from a decedent) would be required to use fair market value as reported on the estate tax return (if one is filed) as the basis for the property for income tax purposes. Second, a reporting requirement would be imposed on the estate (the executor) and the donor of a lifetime gift. The estate, by its executor, would be required to notify each heir of the fair market value on the date of death as reported on the estate tax return for any property distributed to such heir. This requirement would include property not passing under the will if such property is included in the gross estate. Donors of gifts (other than annual exclusion gifts) would be required to notify donees of the donors basis in the property at the time of the transfer, as well as any payment of gift tax that would increase basis. Copies of these notices must be furnished to the IRS.

The proposal would be effective for transfers after the date of enactment in the case of lifetime gifts, and decedents dying after the date of enactment in the case of transfers at death.

## REQUIRE BASIS ALLOCATION FOR PART SALE/PART GIFT TRANSACTIONS

**Current Law**

Under current law, where there is a transaction that is part gift, part sale, the treatment of the donor and the donee are as follows: The donee takes a basis equal to the greater of the amount paid by the donee or the donors adjusted basis at the time of the transfer. (As in any gift transaction, however, there is a "dual basis," that is, if the property is later sold at a loss, the basis is limited to the fair market value at the time of the gift.) No special treatment of the donor is specified under current law. Thus donors presumably take the position that their basis is adjusted cost basis. This treatment by the donor and donee is not necessarily consistent.

## Reasons for Change

The donor and the donee in a part gift, part sale transaction should be required to take consistent positions so that no basis is lost or created by the transaction. Simple and rational rules are needed to allocate basis between the gift portion and the sale portion of the transaction.

## Proposal

This proposal would rationalize basis allocation in a part gift, part sale transaction by adopting the rule applied to bargain sales to charity under Code section 1011: the basis of part gift, part sale property would be allocated ratably between the gift portion and the sale portion based on the fair market value on the date of transfer and the consideration paid. For example, if the donor transferred property with a basis of $40,000 and a fair market value of $100,000 to child, and child paid consideration of $50,000, child would take a basis of $70,000 ($50,000 for the consideration plus $20,000 allocated portion of the donors basis) and the donor would take a basis of $20,000 (allocated portion of donors basis on the date of transfer) for the purpose of reporting the gain on the sale part of the transaction. The donor would realize gain in the amount of $30,000 ($50,000 less $20,000). The dual basis rule would continue to apply if there is a loss transaction and the fair market value on the date of the gift was less than basis. For example, take the facts from above except the donors basis just prior to the transfer was $140,000. The donor would have a loss of $20,000 ($50,000 of consideration less allocated basis of $70,000). Child's unadjusted basis would be $120,000, but if child sold the property at a loss, basis would be limited to $100,000. As under present law, if the amount realized from the sale by child is between the basis for loss and the basis for gain, no gain or loss is realized.

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

# CONFORM TREATMENT OF SURVIVING SPOUSES IN COMMUNITY PROPERTY STATES

## Current Law

Subject to limited exceptions, property acquired from a decedent at death is assigned a new basis equal to the fair market value of the property at the date of the decedents death (a "stepped-up basis"). In a common law (non-community property) State, property jointly owned by husband and wife at the time one of them dies is treated as owned one-half by the deceased spouse and one-half by the surviving spouse. The surviving spouse receives a stepped-up basis in the deceased spouses half. The half already owned by the surviving spouse, however, is not eligible for a step up in basis. Similarly, in a community property State, each spouse is treated as owning one-half of the community property. Under section 1014(b)(6), however, the surviving spouse is entitled to a stepped-up basis in the portion of the community property owned by the surviving spouse, as well as the portion owned by the decedent.

At present, there are 9 community property States and at least one other State with an elective community property regime.

**Reasons for Change**

When enacted in 1948, the stepped-up basis for community property was premised on the fact that "the usual case was that practically all the wealth of the married couple was the property of the husband." S. Rep. 1013, 80th Cong., 2d Sess. (1948), 1948-1 C.B. 285, 304. Societal changes and changes to the estate tax treatment of jointly held property in 1981 have undermined the premises on which section 1014(b)(6) was based. Consequently, surviving spouses in community property States now enjoy an unwarranted tax advantage over those in common law States.

**Proposal**

The proposal would eliminate the stepped-up basis in the part of the community property owned by the surviving spouse prior to the deceased spouses death. The half of the community property owned by the deceased spouse would continue to be entitled to a stepped-up basis.

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

## INCLUDE QUALIFIED TERMINABLE INTEREST PROPERTY (QTIP) TRUST ASSETS IN SURVIVING SPOUSE'S ESTATE

**Current Law**

A marital deduction is allowed for qualified terminable interest property (QTIP) passing to a qualifying trust for a spouse either by gift or by bequest. Under section 2044, the value of the recipient spouse's estate includes the value of any such property in which the decedent had a qualifying income interest for life and a deduction was allowed under the gift or estate tax. Under section 2519, any disposition of all or part of a spouse's qualifying income interest for life for which a gift or estate tax marital deduction was allowed is treated as a transfer of all other interests in the property. Property treated as transferred under section 2519 is not included in the spouse's estate under section 2044.

**Reasons for Change**

The marital deduction is intended to defer the estate tax until the death of the surviving spouse, not to excuse payment of the tax permanently. In some cases, taxpayers have attempted to whipsaw the government by claiming the marital deduction for QTIP property in the first estate and then, after the statute of limitations for assessing tax on the first estate has elapsed, arguing against inclusion under section 2044 in the second estate due to some technical flaw in the QTIP eligibility or election in the first estate. Since the surviving spouse has benefitted from the deferral of estate tax due to the marital deduction taken in the first estate, the property should be

includible in the surviving spouse's estate even if the surviving spouse later discovers that the marital trust did not in fact qualify for the QTIP election in the first estate. If there is a transfer of the spouse's interest during the spouse's life, the same potential for whipsaw exists. Therefore, the existence of a qualifying income interest for life should not be determinative under section 2519. Rather, if a marital deduction is allowed for QTIP property, the property should be treated as QTIP for 2519 purposes as well.

**Proposal**

The proposal would amend section 2044 to provide that, if a marital deduction is allowed with respect to property under section 2523(f) or 2056(b)(7), inclusion is required in the beneficiary spouse's estate under section 2044. The proposal would also amend section 2519 so that if there is a disposition of a spouse's interest in property for which a deduction under 2523(f) or 2056(b)(7) was allowed, there is a deemed disposition of all other interests in the property.

The proposal would be effective for decedents (i.e., surviving spouses) dying and dispositions of property after the date of enactment.

## ELIMINATE NON-BUSINESS VALUATION DISCOUNTS

**Current Law**

Under current law, taxpayers making gratuitous transfers of fractional interests in entities routinely claim discounts on the valuation of such interests. The concept of valuation discounts originated in the context of active businesses, where it has long been accepted that a willing buyer would not pay a willing seller a proportionate share of the value of the entire business when purchasing a minority interest in a non-publicly traded business.

Without legislation in this area, tax planners have carried this concept over into the family estate planning area, where a now common planning technique is to contribute marketable assets to a family limited partnership or limited liability company and make gifts of minority interests in the entity to other family members. Taxpayers then claim large discounts on the valuation of these gifts.

**Reasons for Change**

The use of family limited partnerships and similar devices is eroding the transfer tax base. Taxpayers take the position that they can make value disappear by making contributions of marketable assets to an entity, and then making gifts of interests in such entity to family members. This disappearing value is illusory, because family members are not minority interest holders in any meaningful sense. Moreover, it is implausible that the donor would intentionally take an action (contribution of the property to an entity) if the donor really believed that such action would cause the family's wealth to decline substantially.

**Proposal**

The proposal would eliminate valuation discounts except as they apply to active businesses. Interests in entities would be required to be valued for transfer tax purposes at a proportional share of the net asset value of the entity to the extent that the entity holds non-business assets (such as cash, cash equivalents, foreign currency, publicly traded securities, real property, annuities, royalty-producing assets, non-income producing property such as art or collectibles, commodities, options and swaps) at the time of the gift or death. To the extent the entity conducts an active business, the reasonable working capital needs of the business would be treated as part of the active business (i.e., not subject to the limits on valuation discounts). No inference is intended as to whether these discounts are allowable under current law.

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

## ELIMINATE GIFT TAX EXEMPTION FOR PERSONAL RESIDENCE TRUSTS

**Current Law**

Under section 2702, if an interest is retained by a grantor in a trust when other interests are transferred to family members, the retained interest is valued at zero for gift tax purposes unless it takes the form of an annuity (a GRAT), a unitrust (a GRUT), or a remainder interest after a GRAT or a GRUT. However, section 2702(a)(3)(A)(ii) provides an exception for a trust "all the property in which consists of a residence to be used as a personal residence by persons holding term interests in such trust." As written, this exemption completely removes personal residence trusts from the purview of section 2702.

**Reasons for Change**

Because the exemption under section 2702 completely removes personal residence trusts from section 2702, such trusts receive more favorable gift tax treatment than that given to the statutorily authorized GRATs and GRUTs. Specifically, when valuing the gift made to the remainderman in a personal residence trust, the value of any reversionary interest in the grantor can be taken into account, and such value reduces the amount of the taxable gift. In contrast, even if the grantor has a reversionary interest in a GRAT or a GRUT, section 2702 prohibits the actuarial value of that interest from being taken into account in valuing the gift.

Furthermore, by requiring a grantors retained interest in a trust to take the form of an annuity or a unitrust, section 2702 was attempting to make sure that the grantor would actually receive the interest valued by the actuarial tables. This requirement was designed to prohibit the pre-2702 grantor retained *income* trust (GRIT), in which the actuarial tables were used to value the grantors retained income interest even when the projected income was zero or minimal.

Experience has shown that the use value of the residence retained by the grantor is a poor substitute for an annuity or unitrust interest. In the personal residence trust, the grantor

ordinarily remains responsible for the insurance, maintenance and property taxes on the residence. Therefore, the true rental value of the house should be less than fair market rent. In these circumstances, the actuarial tables overstate the value of the grantors retained interest in the house.

**Proposal**

The proposal would repeal the personal residence exception of section 2702(a)(3)(A)(ii). If a residence is used to fund a GRAT or a GRUT, the trust would be required to pay out the required annuity or unitrust amount; otherwise the grantors retained interest would be valued at zero for gift tax purposes.

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

## MODIFY REQUIREMENTS FOR ANNUAL EXCLUSION GIFTS

**Current Law**

Under section 2503(b), gifts of "present interests" of a value of up to $10,000 (indexed for inflation) per donor per donee each year are excepted from the gift tax (the "annual exclusion"). Generally, a transfer in trust is not considered a transfer of a present interest to the beneficiary of the trust. Under the decision in Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968), however, a transfer in trust is considered a transfer of a present interest if the trust instrument permits the beneficiary to withdraw the transferred amount for a limited period of time (often 30 days or less). Thus so-called "Crummey powers" are often used to enable a transfer of a $10,000 gift to a trust to qualify for the annual exclusion under section 2503(b).

In the Crummey case, the holder of the withdrawal power was the ultimate beneficiary of the trust. In more recent cases, such as Estate of Cristofani v. Commissioner, 97 TC 74 (1991), and Estate of Kohlsaat v. Commissioner, 73 TCM 2732 (1997), the trust agreement has been drafted to give withdrawal rights to individuals who do not have substantial economic interests in the trust. Typically, by pre-arrangement or understanding, none of these withdrawal rights will be exercised.

An annual exclusion is also available under the generation-skipping transfer tax (GST). The GST annual exclusion provides that it does not apply to any transfer to a trust for the benefit of an individual unless (i) during the life of such individual, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such individual, and (ii) if the trust does not terminate before the individual dies, the assets of such trust will be includible in the gross estate of such individual. See Section 2642(c).

**Reasons for Change**

The granting of a withdrawal right to a person who does not have a primary interest in the trust in order to obtain the use of an additional annual exclusion constitutes an unreasonable

expansion of the annual exclusion provision and the Crummey decision. Thus, the Cristofani and Kohlsaat decisions should be overruled. In addition, the mechanics of issuing withdrawal notices under Crummey are burdensome. Finally, the differing requirements for an annual exclusion under the gift tax and the GST provide a trap for the unwary. The area would be simplified if the gift tax rules and the GST rules were conformed.

**Proposal**

The proposal would conform the gift tax annual exclusion rule to the generation-skipping transfer tax rule. That is, the gift tax annual exclusion would not apply to any transfer to a trust for the benefit of an individual unless (i) during the life of such individual, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such individual, and (ii) if the trust does not terminate before the individual dies, the assets of such trust will be includible in the gross estate of such individual. No withdrawal right or notice to the beneficiary would be necessary for a transfer to such a trust to qualify for the annual exclusion. The proposal would be effective for transfers to trusts after December 31, 2000. A grandfather rule would apply to trusts in existence on the date of enactment. The grandfather rule would maintain existing law (allowing the use of Crummey powers to create a present interest) but would disallow any annual exclusion attributable to a withdrawal right in a person who is not a primary, noncontingent beneficiary of the trust.

The Secretary may prescribe regulations necessary to carry out the purposes of this proposal, including rules for determining whether an annual exclusion is attributable to a withdrawal right.

## Pensions

### INCREASE ELECTIVE WITHHOLDING RATE FOR NONPERIODIC DISTRIBUTIONS FROM DEFERRED COMPENSATION PLANS

#### Current Law

Under current law, section 3405 provides that the payor of any designated distribution that is a nonperiodic distribution must withhold ten percent of the amount of the distribution unless the individual to whom the distribution is to be made elects not to have any amount withheld from the distribution. The term designated distribution means any distribution from an employer deferred compensation plan (including a qualified plan), an individual retirement account or annuity, and a commercial annuity. The term does not include any amount otherwise treated as wages, the portion of any distribution that it is reasonable to believe is not includible in gross income, any amount subject to withholding of tax on nonresident aliens and foreign corporations, and certain dividends paid with respect to employee stock ownership plans. This ten-percent elective withholding under section 3405 does not apply in the case of eligible rollover distributions from qualified plans (which are subject to 20-percent mandatory withholding unless the participant elects a direct rollover).

#### Reasons for Change

The ten-percent withholding rate for nonperiodic distributions is generally too low for taxpayers who wish to have the proper amount withheld from such distributions. Because this withholding is elective, the withholding rate should more closely approximate the amount of tax liability that the taxpayer will have with respect to the distribution.

#### Proposal

The proposal would increase the 10 percent elective withholding rate on nonperiodic distributions (such as lump sum distributions) from pensions, IRAs and annuities to 15 percent. Thus, a nonperiodic distribution from a deferred compensation plan would be subject to 15-percent Federal income tax withholding unless the recipient of the distribution elected not to have withholding apply.

The proposal would be effective for distributions made after December 31, 2001.

### INCREASE SECTION 4973 EXCISE TAX FOR EXCESS IRA CONTRIBUTIONS

#### Current Law

A taxpayer's regular contributions to all of his or her IRAs for a year are limited to the lesser of $2,000 or the taxpayer's compensation for that year. A special rule for married taxpayers permits one spouse to treat the other spouse's compensation as his or her own for purposes of the limit on regular contributions. Any contribution in excess of the contribution limit is subject to the six-percent excise tax under section 4973 unless it is distributed to the taxpayer (with allocable net

income) under section 408(d)(4) by the Federal income tax return due date (with extensions) for the year of the contribution.

Qualified distributions from a Roth IRA are not includible in gross income. A qualified distribution is a distribution that is both (1) made after the end of the five-taxable-year period that begins with the first taxable year for which an individual first makes any regular or conversion contribution to a Roth IRA and (2) made at any time after the Roth IRA owner has reached age 59-1/2, made to a beneficiary (or to the Roth IRA owner's estate) after the Roth IRA owner's death, attributable to the Roth IRA owner's being disabled, or made for certain first-time home purchases. The statute does not preclude amounts attributable to excess contributions (other than excess contributions and net allocable income distributed under section 408(d)(4)) from constituting qualified distributions if they satisfy these requirements.

**Reasons for Change**

The potential to secure qualified-distribution treatment for amounts attributable to excess Roth IRA contributions may encourage taxpayers to attempt to make regular Roth IRA contributions in excess of the applicable limits on regular contributions. As a policy matter, it is inappropriate for taxpayers intentionally to make excess contributions. If the Roth IRA has significant investment returns, the annual six-percent excise tax under section 4973 may not provide adequate disincentive for making such contributions.

**Proposal**

The proposal would increase the section 4973 excise tax for excess contributions to IRAs (including Roth and traditional IRAs). Under the proposal, the excise tax would remain at six percent for the first taxable year after an excess contribution is made but would be increased to ten percent for each subsequent taxable year.

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

## PLACE LIMITATION ON PRE-FUNDING OF WELFARE BENEFITS

**Current Law**

Sections 419 and 419A generally limit the deduction available for contributions to welfare benefit funds used to fund and pre-fund welfare benefit expenses. Section 419A(f)(6) provides an exception to these deduction rules for amounts contributed to multiple employer welfare benefit funds that (i) have at least 10 employers, none of whom normally contributes more than 10 percent of the total contributions, and (ii) do not maintain experience rating arrangements with respect to individual employers. In 1995, Notice 95-34, 1995-1 C.B. 309 was issued informing taxpayers that certain severance pay and death benefit arrangements did not satisfy the requirements of the Section 419A(f)(6) exemption and thus did not provide the deductions claimed by the promoters for a number of reasons. In 1997, the Tax Court ruled that an employer's deductions for contributions to certain of these arrangements were limited because

the arrangements did not qualify as 10 or more employer plans. See *Robert D. Booth and Janice Booth v. Commissioner*, 108 T.C. No. 25 (1997). Several other cases are in progress.

**Reasons for Change**

Sections 419 and 419A were enacted to limit abusive practices associated with the pre-funding of welfare benefits, and generally limit the prefunding of welfare benefits, including severance benefits and benefits provided pursuant to life insurance contracts. Congress permitted a limited exception to the general limitations for certain multiple employer welfare benefit funds with 10 or more participating employers where the relationship of participating employers to the fund would be closer to the relationship of insureds to an insurer than to the relationship of an employer to a fund.

Promoters have been aggressively marketing multiple employer welfare benefit funds that they claim qualify for the 10-or-more-employer exception, even though these arrangements lack the risk-shifting characteristics of insurance. In particular, the requirement of the exception that there not be experience rating with respect to participating employers has proven to be difficult to enforce with respect to certain types of benefits, such as severance and certain death benefits, because the complexities of the arrangements disguise experience rating. As a result, it appears that in many cases this requirement has effectively been ignored, and there has been extensive activity involving programs that rely on the expectation of each participating employer that its contributions will be used to fund or purchase benefits for its own employees.

The arrangements being promoted to high-income taxpayers sometimes are sold as alternatives to qualified retirement plans and are designed to avoid the deduction rules applicable to traditional welfare benefit and nonqualified deferred compensation arrangements, which would generally require that the deduction for the employer be deferred until benefits are paid. In many cases, these arrangements claim to offer employee-owners tax-deductible cash value life insurance, with the cash value to be transferred to the employee-owner at a later date. Thus, a participating employer (typically a closely held corporation owned by one or more high-income taxpayers) that contributes to such a shelter arrangement is promised a current deduction for benefits to be paid to its employee-owners in the future, a deduction that has been foreclosed in most cases by other provisions of the Code.

In contrast, medical, disability, and certain group term life insurance benefits do not present the same potential for abuse as severance pay and death benefits (other than certain group term life insurance). Thus, the exception for 10-or-or-more-employer plans providing solely medical, disability, and certain group term life insurance benefits should not be eliminated.

**Proposal**

The exception contained in section 419A(f)(6) would be limited to plans that provide only medical benefits, disability benefits, and qualifying group term life insurance benefits to plan beneficiaries. The 10-or-more employer plan exception would no longer be available with respect to plans that provide supplemental unemployment compensation, severance pay, or life

insurance (other than qualifying group-term life insurance) benefits. Thus, the generally applicable deduction limits (sections 419 and 419A) apply to plans providing these benefits.

Group-term life insurance benefits that qualify for the 10-or-more-employer exception are group-term life insurance benefits that do not allow any direct or indirect access to any cash surrender value, or to any part of the account value of any life insurance contract, or to other money that can be paid, assigned, borrowed, or pledged for collateral for a loan. It is intended that qualifying group-term life insurance benefits not include any arrangement whereby a current or former plan beneficiary may receive a policy without a stated account value (or with a nominal account value) that has the potential to give rise to an account value whether through the exchange of the policy for another policy that would have an account value, or through insubstantial conditions on the creation of an account value, or otherwise.

However, it is intended that group-term life insurance benefits not fail to be qualifying group-term life insurance benefits solely as a result of the inclusion of de minimis ancillary benefits, as described in Treasury regulations. Such ancillary benefits include one-year term insurance coverages (e.g., accidental death and dismemberment insurance, group term life insurance coverage for dependents and directors, business travel insurance, and 24-hour accident insurance) as long as the total premiums for all such insurance coverages for the year do not exceed 2 percent of the total contributions to the plan for the year. Of course, any ancillary benefits provided would be in the nature of compensation, which would be includible in income unless expressly excluded under a specific provision under the Code.

In addition, if any portion of a welfare benefit fund attributable to contributions that are deductible pursuant to the 10-or-more-employer exception (and earnings thereon) is used for a purpose other than for providing medical benefits, disability benefits, or qualifying group-term life insurance benefits to plan beneficiaries, that portion is treated as reverting to the benefit of the employers maintaining the fund, and is subject to the imposition of the 100-percent excise tax. Thus, for example, cash payments to employees upon termination of the fund, and loans or other distributions to the employee or employer, would be treated as giving rise to a reversion that is subject to the excise tax.

No inference should be drawn regarding the validity of certain 10-or-more-employer arrangements under current law.

The proposal would be effective with respect to contributions paid or accrued after the date of first committee action.

## SUBJECT SIGNING BONUSES TO EMPLOYMENT TAXES

### Current Law

Bonuses paid to individuals for signing their first contracts of employment are ordinary income in the year received. However, Revenue Ruling 58-145, 1958-1 C.B. 360, provides that bonuses that do not require the performance of later services do not represent remuneration for services

and thus are not wages for purposes of income tax withholding. Similarly, to the extent that a bonus payment is not remuneration for services, the bonus would not be wages for purposes of FICA taxes.

**Reasons for Change**

Withholding on signing bonuses could improve compliance and enforcement and eliminate the deferral of the tax payment. These bonuses are inextricably tied to the employment of the individual and are more appropriately treated as remuneration for services.

**Proposal**

The proposal would impose income tax withholding on signing bonuses and clarify that signing bonuses are subject to other employment taxes, without regard to whether the bonus is conditioned on any additional action by the recipient. No inference is intended with respect to the application of prior law withholding rules to signing bonuses.

The proposal would be effective for signing bonuses paid after the date of enactment.

## CLARIFY EMPLOYMENT TAX TREATMENT OF CHOREWORKERS EMPLOYED BY STATE WELFARE AGENCIES

**Current Law**

Choreworkers are individuals paid by State agencies to provide domestic services for disabled and elderly individuals. Choreworkers often provide services for more than one disabled or elderly individual. Different State agencies provide disparate employment tax treatment for choreworkers. Some States pay employment taxes on all wages paid by the State to the choreworker. In other States, the clients pay the choreworkers directly.

**Reasons for Change**

It is important to ensure that choreworkers' social security benefits accurately reflect the full time nature of their work. Taking into account the total remuneration paid by the State agency for purposes of employment taxes more accurately reflects the choreworkers' income for purposes of income replacement.

**Proposal**

The proposal would clarify that State agencies, and not the disabled or elderly individual receiving the services, are responsible for withholding and employment taxes for choreworkers. For this purpose, all wages paid to a choreworker are treated as paid by a single employer (the State agency). No inference is intended with respect to the application of prior law withholding rules for choreworkers. The proposal would be effective for wages paid after December 31, 2000.

## PROHIBIT IRAS FROM INVESTING IN FOREIGN SALES CORPORATIONS

### Current Law

Certain foreign subsidiaries of U.S. companies qualify as Foreign Sales Corporations (FSCs). Pursuant to sections 921-927, certain foreign income earned through a FSC is partially exempt from U.S. tax.

An individual retirement account (IRA) is a tax-favored retirement savings vehicle. An IRA generally is exempt from taxation, although the account is subject to unrelated business income tax. Amounts distributed from a traditional IRA are generally subject to tax upon distribution. In the case of a Roth IRA, no tax is due on accumulations in the Roth IRA or upon distribution if the Roth IRA has been held for at least five years and certain other conditions are satisfied.

### Reasons for Change

The Administration believes that allowing an IRA or Roth IRA to invest in a FSC permits an inappropriate avoidance of tax on the income from the FSC's activities.

### Proposal

The proposal would prohibit an IRA or Roth IRA from investing in a FSC. No inference should be drawn about the proper valuation of FSC stock for purposes of the current law IRA contribution limits and other rules.

The proposal would be effective for the acquisition of FSC stock on or after the date of first committee action. IRAs holding FSC stock on the date of first committee action would be required to divest themselves of the investment within 6 months after the date of enactment.

## Compliance

### TIGHTEN THE SUBSTANTIAL UNDERSTATEMENT PENALTY FOR LARGE CORPORATIONS

#### Current Law

Currently, taxpayers may be penalized for erroneous, but non-negligent, return positions only if the taxpayer did not have "substantial authority" for the claimed position, the taxpayer did not disclose the position in a statement or return, and the amount of the understatement is "substantial." (Special rules apply in the case of tax shelters.) "Substantial" is defined for this purpose as the greater of $5,000 ($10,000 for certain corporations) or 10 percent of the taxpayer's total tax liability.

#### Reasons for Change

Under the current definition of "substantial," large corporations are allowed to have a very sizable understatement that does not exceed 10 percent of their total tax bill. This may encourage them to take very aggressive tax positions. In effect, they can "play the audit lottery" without any downside risk of a penalty if they are caught, even if huge amounts of potential tax liability are at stake.

#### Proposal

The proposal would treat a corporation's deficiency of more than $10 million as substantial for purposes of the substantial understatement penalty, whether or not it exceeds 10 percent of the taxpayer's total tax liability. This proposal should help to deter aggressive tax planning by large corporate taxpayers that have tax liabilities of $100 million or more.

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

### REQUIRE WITHHOLDING ON CERTAIN GAMBLING WINNINGS

#### Current Law

Proceeds of most wagers with odds of less than 300 to 1 are exempt from withholding, as are all bingo and keno winnings.

#### Reasons for Change

Withholding on gambling winnings would improve compliance and enforcement.

**Proposal**

The proposal would impose withholding on proceeds of bingo or keno in excess of $5,000 at a rate of 28 percent, regardless of the odds of the wager. The proposal would be effective for payments made after the beginning of the first month that begins at least 10 days after the date of enactment.

## INFORMATION REPORTING FOR PRIVATE SEPARATE ACCOUNTS

**Current Law**

Earning from direct investment in securities generally results in taxable income to the holder. In contrast, investments in comparable assets through separate accounts of life insurance companies generally give rise to tax-free or tax-deferred income. This favorable tax treatment for investing through life insurance companies is not available if the policyholder has too much control over the contract's investments. In that case, the policyholder is taxed as if he owned the underlying assets directly. See, e.g., Rev. Proc. 99-44. See also Christofferson v. United States, 749 F.2d 513 (8th Cir. 1984).

**Reasons for Change**

Private separate accounts are being used to avoid tax that would be imposed if the assets were held directly. Better reporting of investments in private separate accounts will help the Service to ensure that income is properly reported. Moreover, such reporting will enable the Service to identify more easily which variable insurance contracts qualify as insurance contracts under current law and which variable contracts should be disregarded under the investor control doctrine.

**Proposal**

The proposal would require life insurance companies to report to the IRS the policyholder taxpayer identification number, the policy number, the total contract account value and the amount of inside buildup for each contract whose cash value was partially or wholly invested in a private separate account for any portion of the taxable year, and the portion of the total contract account value for each such contract that was invested in one or more private separate accounts. For information reporting purposes, a private separate account would be defined as any account with respect to which a related group of persons owned policies whose cash values, in the aggregate, represented at least 10 percent of the value of the separate account.

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

## INCREASE PENALTIES FOR FAILURE TO FILE CORRECT INFORMATION RETURNS

### Current Law

Any person who fails to file required information returns in a timely manner or incorrectly reports such information is subject to penalties. The amount of the penalty is generally $50 for each return with respect to which a penalty is incurred, not to exceed $250,000 during any calendar year. If any failure or error is corrected within 30 days after the required filing date, the penalty imposed is $15 per return, not to exceed $75,000. Failures corrected more than 30 days after the required filing date but before August 1 are subject to a $30 per return penalty, not to exceed $150,000 in any calendar year.

### Reasons for Change

For taxpayers filing large volumes of information returns or reporting significant payments, the general penalty provisions may not be sufficient to encourage timely and accurate reporting. By basing the penalty amount on either the number of returns or amount to be reported, the proposal encourages taxpayers to assure both the accuracy and timeliness of information on each return and in the aggregate.

### Proposal

The proposal would increase the general penalty amount for any failure to the greater of $50 per return or 5 percent of the total amount required to be reported, subject to the overall dollar limitations. The increased penalty would not apply if the aggregate amount actually reported by the taxpayer on all returns filed for that calender year was at least 97 percent of the amount required to be reported. The proposal would be effective for returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment of the proposal.

## Miscellaneous

### MODIFY DEPOSIT REQUIREMENT FOR FUTA

#### Current Law

The Federal Unemployment Tax Act (FUTA) currently imposes a Federal payroll tax on employers of 6.2 percent of the first $7,000 paid annually to each employee. The tax funds a portion of the Federal/State unemployment benefits system. States also impose an unemployment tax on employers. Employers in States that meet certain Federal requirements are allowed a credit for State unemployment taxes of up to 5.4 percent, making the minimum net Federal tax rate 0.8 percent. Generally, Federal and State unemployment taxes are collected quarterly and deposited in Federal trust fund accounts.

#### Reasons for Change

Slower collection increases the risk of nonpayment, an even greater financial risk in the case of large employers. Accelerating collections may reduce losses to the Federal unemployment trust funds caused by employer delinquencies. Limiting the application of acceleration to larger employers would avoid imposing additional burdens on small businesses.

#### Proposal

The proposal would require an employer to pay Federal and State unemployment taxes on a monthly basis in a given year if the employer's FUTA tax liability in the prior year was $1,100 or more (reflecting approximately 20 employees earning at least $7,000). A safe harbor would be provided for the required deposits for the first two months of each calendar quarter. For the first month in each quarter, the payment would be required to be the lesser of 30 percent of the actual FUTA liability for the quarter or 90 percent of the actual FUTA liability for the month. The cumulative deposits paid in the first two months of each quarter would be required to be the lesser of 60 percent of the actual FUTA liability for the quarter or 90 percent of the actual FUTA liability for the two months. The employer must pay the balance of the actual FUTA liability for each quarter by the last day of the month following the quarter. States would be allowed to provide a similar mechanism for paying State unemployment taxes.

The collection proposal would be effective for months beginning after December 31, 2005.

### REINSTATE OIL SPILL LIABILITY TRUST FUND TAX

#### Current Law

Before January 1, 1995, a five-cents-per-barrel excise tax was imposed on domestic crude oil and imported petroleum products. The tax was dedicated to the Oil Spill Liability Trust Fund to finance the cleanup of oil spills and pay other costs associated with oil pollution. The tax was

not imposed for a calendar quarter if the unobligated balance in the Trust Fund exceeded $1 billion at the close of the preceding quarter.

**Reasons for Change**

It is essential that the Oil Spill Liability Trust Fund remain funded because of the continuing potential for oil spills and the magnitude of damages such spills can cause. Moreover, the full funding level was last changed by the Omnibus Budget Reconciliation Act of 1989 and is no longer adequate. After the enactment of the current $1 billion limitation, the Oil Pollution Act of 1990 permitted the use of amounts in the Trust Fund for additional expenditure purposes and doubled the limits on Trust Fund expenditures with respect to a single incident (increasing the overall limit from $500 million to $1 billion and the limit for natural resource damages payments from $250 million to $500 million). In addition, the Department of the Treasury's authority to advance up to $1 billion to the Trust Fund expired in 1994.

**Proposal**

The Oil Spill Liability Trust Fund excise tax would be reinstated for the period after September 30, 2001 and before October 1, 2010. In addition, the full funding limitation would be increased from $1 billion to $5 billion, effective on the date of enactment.

## REPEAL PERCENTAGE DEPLETION FOR NON-FUEL MINERALS MINED ON FEDERAL AND FORMERLY FEDERAL LANDS

**Current Law**

Taxpayers are allowed to deduct a reasonable allowance for depletion relating to certain hard mineral deposits. The depletion deduction for any taxable year is calculated under either the cost depletion method or the percentage depletion method, whichever results in the greater depletion allowance for the year.

Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the property that is equal to the ratio of the units sold from that property during the taxable year to the estimated total units remaining at the beginning of that year.

Under the percentage depletion method, a deduction is allowed in each taxable year for a statutory percentage of the taxpayer's gross income from the property. The percentage depletion deduction for these minerals may not exceed 50 percent of the net income from the property for the taxable year (computed without allowance for depletion). Percentage depletion is not limited to the taxpayer's basis in the property; thus, the aggregate amount of percentage depletion deductions claimed may exceed the amount expended by the taxpayer to acquire and develop the property.

The 1872 mining act has allowed investors to acquire mining rights on Federal lands at a cost of $5.00 per acre or less.

## Reasons for Change

The percentage depletion provisions under current law generally are viewed as an incentive for mineral production rather than as a normative rule for recovering the taxpayer's investment in the property. This incentive is excessive, however, with respect to minerals acquired under the 1872 mining act, in light of the minimal costs of acquiring these mining rights. In addition, the measurement of income in the affected industries will be improved by the repeal of these percentage depletion provisions.

## Proposal

The proposal would repeal percentage depletion provisions under current law for non-fuel minerals mined on Federal lands where the mining rights were originally acquired under the 1872 law, and on private lands acquired under the 1872 law. The proposal would be effective for taxable years beginning after the date of enactment.

# IMPOSE EXCISE TAX ON PURCHASE OF STRUCTURED SETTLEMENTS

## Current Law

Current law facilitates the use of structured personal injury settlements by permitting a defendant to assign to a structured settlement company ("SSC") the liability to make periodic payments to an injured person, such that the defendant can deduct the payment immediately, but the SSC does not include the amount received from the defendant in income. This favorable treatment is conditioned on a requirement that the periodic payments cannot be accelerated, deferred, increased or decreased by the injured person. If the SSC purchases a deferred annuity contract to fund the liability, it is exempted from the section 72(u) inclusion of inside buildup, and is subject to the more favorable rules of annuity taxation usually applicable only to individual owners. As a result, the income under the annuity is taxable to the SSC only upon receipt by the SSC, at which time the SSC is entitled to an offsetting deduction for corresponding payments to the injured person. The exclusion for physical personal injury damages applies also to amounts received periodically, thus effectively exempting the interest income in the hands of the injured person from tax as well.

## Reasons for Change

Congress enacted favorable tax rules intended to encourage the use of structured settlements – and conditioned such tax treatment on the injured person's inability to accelerate, defer, increase or decrease the periodic payments – because recipients of structured settlements are less likely than recipients of lump sum awards to consume their awards too quickly and require public assistance.

Consistent with the condition that the injured person not be able to accelerate, defer, increase or decrease the periodic payments, SSC agreements with injured persons uniformly contain

anti-assignment clauses. Notwithstanding these contractual provisions, however, many injured persons are willing to accept heavily discounted lump sum payments from certain "factoring" companies in consideration for their payment streams. These "factoring" transactions directly undermine the Congressional objective to create an incentive for injured persons to receive periodic payments as settlements of personal injury claims.

**Proposal**

Under the proposal, any person purchasing (or otherwise acquiring for consideration) a structured settlement payment stream would be subject to a 40 percent excise tax on the difference between the amount paid by the purchaser to the injured person and the undiscounted value of the purchased income stream, unless such purchase is pursuant to a court order finding that the extraordinary and unanticipated needs of the original intended recipient render such a transaction desirable. The proposal would apply to purchases occurring after the date of enactment. No inference is intended as to the contractual validity of the factoring transaction or its effect on the tax treatment of any party other than the purchaser.

## REQUIRE TAXPAYERS TO INCLUDE RENTAL INCOME OF RESIDENCE IN INCOME WITHOUT REGARD TO PERIOD OF RENTAL

**Current Law**

Gross income generally includes all income from whatever source derived, including rents. Section 280A provides rules for determining deductibility of expenses attributable to rental property. Section 280A(g) provides a *de minimis* exception to these rules where a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year. In this case, the income from such rental is not included in gross income and no expenses arising from such rental use are allowed as a deduction.

**Reasons for Change**

The 15-day rule allows certain taxpayers to exclude from income large rental payments for the short-term rental of the taxpayer’s residence. Similar exclusions are not provided for other types of passive income such as interest, dividends or capital gains. Such amounts generally should be included in income of the taxpayers.

**Proposal**

The proposal would repeal the 15-day rule of section 280A(g). Consequently, a taxpayer would be required to include in gross income the rental income received with respect to the rental of the residence without regard to the period of rental. The rules of section 280A would be applied to determine deductibility of expenses attributable to the rental of such property. The proposal would apply to taxable years beginning after December 31, 2000.

## ELIMINATE INSTALLMENT PAYMENT OF HEAVY VEHICLE USE TAX

**Current law**

An annual tax is imposed on the use of heavy (at least 55,000 pounds) highway vehicles. The amount of tax increases from $100 (for a 55,000 pound vehicle) to $550 (for vehicles over 75,000 pounds). The tax year is July 1 through June 30 and the tax return is generally due on August 31 of the year to which it relates. A taxpayer may, however, elect to pay the tax in installments. The installment option generally permits payment of one quarter of the tax on each of the following dates: August 31, December 31, March 31, and June 30. States are required to obtain evidence, before issuing tags for a vehicle, that the use tax return has been filed and any tax due with the return has been paid.

**Reasons for Change**

The requirement that States obtain evidence of tax payment before issuing tags is the most cost-effective method of enforcing the heavy vehicle use tax. Under current law, however, tags can be issued if the tax due with the return (the first installment) has been paid even if the taxpayer is delinquent with respect to subsequent installments.

**Proposal**

The installment option would be eliminated for tax years beginning after June 30, 2001. Thus, heavy vehicle owners would be required to pay the entire tax with their returns and would be unable to obtain State tags without providing proof of full payment.

## REQUIRE RECOGNITION OF GAIN FROM THE SALE OF A PRINCIPAL RESIDENCE IF ACQUIRED IN A LIKE-KIND EXCHANGE WITHIN FIVE YEARS OF THE SALE

**Current Law**

Gain of up to $250,000 ($500,000 in the case of a joint return) from the sale or exchange of property is excluded from income if, during the five-year period ending on the date of the sale or exchange, the property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more.

No gain or loss is recognized if property held for use in a trade or business or for investment is exchanged solely for other like-kind property held for use in a trade or business or for investment.

**Reasons for Change**

The current-law exclusion for principal residences, in combination with the tax-free like-kind exchange provision, allows taxpayers exclude gain attributable to real property that has never been owned and used by the taxpayer as the taxpayer's principal residence. This is beyond the intended scope of the principal residence exclusion.

**Proposal**

Taxpayers would be required to recognize gain on the sale of property that has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more if the property was acquired in a tax-free like-kind exchange within five years of the sale. The proposal would be effective for sales of principal residences occurring after the date of enactment.

## International

### REQUIRE REPORTING OF PAYMENTS TO "IDENTIFIED TAX HAVENS"

## Current Law

Current law contains no provisions that specifically require information reporting of payments to tax havens.

## Reasons for Change

The Administration is concerned about the use of tax havens. Tax havens facilitate tax avoidance and evasion and many of them, through strict confidentiality rules and restrictive information exchange practices, inhibit the United States from effectively enforcing its domestic laws. To address these concerns, the Administration proposes several provisions intended to reduce the attractiveness of, and increase access to information about activity in, certain tax havens that have been identified in a list of jurisdictions to be published by the Secretary of the Treasury ("Identified Tax Havens"). Jurisdictions will be considered tax havens and included on the list of Identified Tax Havens based on certain criteria, including, but not limited to, whether a jurisdiction (1) imposes no or nominal taxation, either generally or on specific classes of capital income, and (2) has strict confidentiality rules and practices, and/or has ineffective information exchange practices. As the proposals dealing with Identified Tax Havens are limited to jurisdictions included on a published list, these provisions, although effective after their enactment, would only apply to taxable years beginning after the publication of the list (or in the case of the proposal providing for reporting requirements for payments to Identified Tax Havens, to payments made after the publication of the list).

## Proposal

The proposal would a require that all payments (including money and tangible and intangible property) to entities (including corporations, partnerships and disregarded entities, branches, trusts and estates), accounts or individuals resident or located in Identified Tax Havens be reported on the taxpayer's annual income tax return. The proposal would not apply to payments if: (1) the Identified Tax Haven has in force with the United States an agreement providing for the exchange of tax information that is effective for both criminal tax and civil tax administration purposes, (2) the payee certifies to the payor that, through a legally effective confidentiality waiver or otherwise, information about the payment would be available to the Internal Revenue Service upon request therefor, or (3) the payment is less than $10,000. An anti-abuse rule would require related payments to be aggregated for purposes of determining whether a payment is under the $10,000 limitation. Failure to report a covered payment would result in the imposition of a penalty on the payor equal to 20 percent of the amount of the payment. Special rules would apply to certain financial services businesses that would permit reporting of specified payments on an aggregate basis.

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

## RESTRICT TAX BENEFITS FOR INCOME FLOWING THROUGH "IDENTIFIED TAX HAVENS"

### Current Law

Current law restricts tax benefits for income arising in certain identified jurisdictions in order to discourage U.S. taxpayers from engaging, directly or indirectly, in activity in these jurisdictions. For example, section 901(j) denies a credit for foreign taxes paid to jurisdictions with which the U.S. does not have relations or which provide support for international terrorism. In addition, section 901(j) provides that sections (a), (b), and (c) of section 904 (dealing with the foreign tax credit limitation) and sections 902 and 960 (dealing with the indirect tax credit) shall be applied separately to income attributable to countries to which section 901(j) applies. Similarly, sections 908(a), 927(e)(2) and 952(a) reduce a taxpayer's otherwise allowable foreign tax credit, FSC benefit, and foreign income eligible for deferral, respectively, if the taxpayer, or a member of the taxpayer's controlled group participates in, or cooperates with, an international boycott. The reduction of tax benefits is based on a fraction (the "international boycott factor"), the numerator of which is the sum of the taxpayer's purchases, sales and payroll in boycotting countries and the denominator of which is the taxpayer's total non-U.S. purchases, sales, and payroll. The Treasury Department periodically publishes a list of countries it believes may require participation in, or cooperation with, an international boycott.

### Reasons for Change

The Administration is concerned with the use by taxpayers of Identified Tax Havens. To discourage U.S. taxpayers from engaging, directly or indirectly, in activity in Identified Tax Havens, and to encourage Identified Tax Havens to reform certain harmful practices, including bank secrecy and restrictive information exchange policies, the Administration proposes to impose restrictions, similar to the restrictions imposed by current law that discourage activity in certain other jurisdictions, on tax benefits for income arising in Identified Tax Havens.

### Proposal

The proposal would deny a foreign tax credit for taxes paid to Identified Tax Havens and would apply the foreign tax credit limitation rules (including section 904(d)) separately to income earned in or through an Identified Tax Haven. The proposal also would reduce by a factor (similar to the international boycott factor) a taxpayer's (1) otherwise allowable foreign tax credit or FSC benefit attributable to income from an Identified Tax Haven, and (2) the income, attributable to an Identified Tax Haven, that is otherwise eligible for deferral. This reduction of tax benefits would be based on a fraction, the numerator of which is the sum of the taxpayer's income and gains from an Identified Tax Haven, and the denominator of which is the taxpayer's total non-U.S. income and gains.

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

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

**Current Law**

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

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

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

**Reasons for Change**

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

minimized. A taxpayer should not obtain the benefit of favorable tax attributes for U.S. purposes in circumstances where such taxpayer has not previously been subject to U.S. taxing jurisdiction. The same may be said of unfavorable tax attributes.

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

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

**Proposal**

The proposal would provide taxpayers with a "fresh start" by eliminating tax attributes (including built-in items) and marking to market bases, as applicable, when an entity or an asset becomes "relevant" for U.S. tax purposes. An entity would become relevant for U.S. tax purposes when (1) a "tax-exempt entity" becomes a "taxable U.S. entity," or (2) a foreign corporation that is not a controlled foreign corporation (CFC) but is a "taxable U.S. entity" becomes a CFC or a U.S. person.

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

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

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

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

The proposal would provide the Secretary with authority to prescribe regulations to carry out the purposes of the proposal, including regulations governing the proper treatment of deficits that existed in an entity prior 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 statute. This would include, for example, trafficking in favorable attributes among CFCs.

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

## SIMPLIFY TAXATION OF PROPERTY THAT NO LONGER PRODUCES INCOME EFFECTIVELY CONNECTED WITH A U.S. TRADE OR BUSINESS

### Current Law

Under sections 871(b) and 882, a foreign person is subject to taxation in the United States on net income that is effectively connected with a U.S. trade or business (ECI). Section 864(c)(1)(B) provides that a foreign person generally will have no ECI if it is not engaged in a trade or business in that taxable year. Section 864(c)(6) and (c)(7) provide two exceptions to this general rule. Under section 864(c)(6), the United States continues to treat as ECI certain deferred income that relates to transactions that took place while the taxpayer was engaged in a U.S. trade or business, even if such income is not recognized until a taxable year in which the taxpayer is no longer so engaged. Under section 864(c)(7), the U.S. treats as ECI gains from property sold or disposed of within 10 years after it ceases to be held in connection with a U.S. trade or business if it would have been ECI if the property had been sold immediately before it ceased to be so held.

## Reasons for Change

The current rules are difficult to administer and, in the case of section 864(c)(7), may in some cases result in the United States taxing gain that economically accrues after the property is removed from U.S. taxing jurisdiction. The rule also is more complicated than the approach taken by many other countries, which recognize gain at the time property is transferred out of their taxing jurisdiction.

## Proposal

The proposal would mark to market property (including rights to deferred income) at the time that the property ceases to be used in, or attributable to, a U.S. trade or business. Current section 864(c)(6) and (c)(7) would be eliminated, except that the proposal would not change the treatment under current law of deferred compensation for the personal services of an individual.

The proposal would be effective for property that ceases to be used in, or attributable to, a U.S. trade or business after the date of enactment.

# PREVENT AVOIDANCE OF TAX ON U.S.-ACCRUED GAINS (EXPATRIATION)

## Current Law

Section 877 and related provisions, as in effect prior to 1996, established a special income, estate and gift tax regime applicable to certain former U.S. citizens for 10 years following their expatriation. That regime applied if the individual expatriated with a principal purpose of avoiding U.S. taxation. If applicable, the regime expanded the types of U.S. source income and gain on which the taxpayer was taxable during the 10-year period. In August 1996, the law was amended to modify the existing regime and to extend it to certain former long-term green card holders.

In September 1996, the Immigration and Nationality Act was amended (the "Reed Amendment") to provide that, if the Attorney General determines that a former U.S. citizen renounced citizenship for the purpose of avoiding U.S. taxation, that individual is an excludable person and, in general, is not allowed to re-enter the United States.

## Reasons for Change

While the 1996 amendments to section 877 attempted to address some of the flaws in the previously existing regime, the provision continues to be easily avoided and imposes significant administrative burdens on both taxpayers and the government. For example, even after the 1996 amendments, to the extent an expatriate's income is treated as foreign source under section 877, the expatriate can avoid U.S. tax by recognizing that income immediately after expatriation, even if the expatriation was admittedly tax-motivated. Moreover, even if a tax-motivated expatriate's income is treated as U.S. source under section 877, a "patient" expatriate potentially can avoid

the section 877 tax by borrowing against the assets and waiting 10 years before disposing of the assets. Also, while the 1996 amendments introduced objective criteria for determining whether some taxpayers' expatriations have a principal purpose of tax avoidance, a fact-specific inquiry into certain other expatriates' states of mind must still be made. The inherently factual and subjective nature of this inquiry imposes significant administrative burdens on both taxpayers and the government. In addition, because the current law purports to impose tax for 10 years on individuals who may have little ongoing contact with the United States, it may be avoided by non-compliant taxpayers.

**Proposal**

The proposal would simplify the taxation of expatriates by repealing the current regime and imposing a one-time tax on accrued gains at the time of expatriation, regardless of the taxpayer's subjective motivation for expatriating. The proposal would provide certain rules and exclusions similar to those provided in the Senate amendment to the Health Insurance Portability Act of 1996 (H.R. 3103). In addition, if an expatriate subsequently makes a gift or bequest to a U.S. person, the proposal would treat the gift as gross income to the U.S. recipient, taxable at the highest marginal rate applicable to gifts and bequests. Finally, the proposal would amend the Reed Amendment to coordinate it with the tax proposal, thereby improving the enforceability of both the tax proposal and the Reed Amendment.

The proposal would apply to individuals expatriating on or after the date of first committee action.

## EXPAND ECI RULES TO INCLUDE MORE FOREIGN-SOURCE INCOME

**Current Law**

Under sections 871(b) and 882, a foreign person is subject to taxation in the United States on a net income basis with respect to income that is effectively connected with a U.S. trade or business (ECI). A foreign person may also be subject to a 30 percent gross basis tax with respect to U.S. source fixed or determinable annual or periodical gains, profits or income (FDAP) and certain capital gains that do not constitute ECI. A foreign person generally is not subject to U.S. tax on foreign source income that does not constitute ECI.

Section 864(c) provides rules for determining whether income is ECI. The test for determining whether income is effectively connected with a U.S. trade or business differs depending on whether the income at issue is U.S. source or foreign source. U.S. source income that is FDAP is ECI if it is derived from assets used in or held for use in the active conduct of a trade or business in the United States or from business activities conducted in the United States. All U.S. source income other than FDAP automatically is ECI.

Foreign source income may constitute ECI only if it consists of certain enumerated types of income—rents, royalties, dividends, interest, gains from the sale of inventory property, and insurance income—and certain other conditions are met.

**Reasons for Change**

Economic equivalents of certain enumerated types of foreign source income, e.g., interest equivalents (including letter of credit fees) and dividend equivalents, are not ECI under current law. Moreover, some excluded foreign source income can in large part be attributable to business activities that take place in the United States. For example, a foreign satellite corporation with an office, satellite ground station or other fixed place of business in the United States may earn income with respect to the leasing of a satellite. Under current rules, such foreign source income would not be subject to U.S. tax as ECI even if it is attributable to the foreign corporation's U.S. office.

**Proposal**

The proposal would expand the categories of foreign-source income that could constitute ECI under section 864(c) to include economic equivalents of the currently enumerated categories of income, e.g., interest equivalents and dividend equivalents In addition, the proposal would include (as U.S. source income) any income that is attributable to a U.S. office or other fixed place of business.

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

## LIMIT BASIS STEP-UP FOR IMPORTED PENSIONS

**Current Law**

In general, deferred compensation is taxed only when actually or constructively received. Under section 402(b), amounts set aside in a nonqualified deferred compensation trust (and, in the case of highly compensated employees, earnings on those amounts) are taxable to employees currently as ordinary income; the employee then has basis in the taxed amount. Section 72 generally excludes from subsequent taxation the portion of a distribution that is attributable to an employee's basis in the trust and provides that the portion not attributable to an employee's basis is included in gross income.

In the case of a foreign individual who becomes a U.S. resident for tax purposes and who receives a distribution from a pension trust that is not qualified for U.S. tax purposes, basis for purposes of section 72 is reconstructed as the basis the individual would have had had he or she been subject to U.S. taxation at the time amounts were set aside in trust (and earnings accrued), regardless of whether U.S. or non-U.S. tax was actually imposed on such amounts. Under the 1996 U.S. Model Income Tax Treaty and the majority of U.S. tax treaties in force, pension distributions generally are taxable only by the State of residence.

**Reasons for Change**

A U.S. resident individual who, at a time when the individual was a nonresident, has accrued benefits under a foreign pension plan that is not a U.S. qualified plan may escape any tax on distributions from the foreign pension plan both in the United States and in the foreign country in which the amounts were earned and accumulated. The basis rules should be modified to ensure that tax is imposed on these pension distributions.

**Proposal**

Under the proposal, an individual would have basis in a foreign pension plan distribution only to the extent the individual previously has been subject to tax (either in the United States or the foreign jurisdiction) on the amounts being distributed.

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

## REPLACE SALES-SOURCE RULES WITH ACTIVITY-BASED RULES

**Current Law**

The foreign tax credit generally reduces U.S. tax on foreign source income, but does not reduce U.S. tax on U.S. source income. If a taxpayer manufactures products in the United States and sells them abroad, Treasury regulations provide that 50 percent of the income from the transaction is treated as earned in production activities, and sourced on the basis of the location of assets held or used to produce income derived from the export sales. The remaining 50 percent of the income is treated as earned in sales activities and sourced based on where title to the inventory transfers. Thus, if a U.S. manufacturer sells inventory abroad, half of the income generally is treated as derived from domestic sources, and half of the income generally is treated as derived from foreign sources. However, the taxpayer may use a more favorable method if it can establish to the satisfaction of the IRS that more than half of the export activity occurred in a foreign country. Different rules apply to the export of natural resources.

**Reasons for Change**

The existing 50/50 rule provides a benefit for U.S. exporters that also operate in high-tax foreign countries. Thus, U.S. multinational exporters have a competitive advantage over U.S. exporters that conduct all of their business activities in the United States. Different categories of exporters should be treated equally.

In addition, the United States has established an income tax treaty program that encompasses approximately 50 countries during the 70 years since the 50/50 rule of current law has been in place. These treaties protect export sales income from local taxation in the country where the goods are sold. Now that export sales income generally is not subject to foreign tax, it is not appropriate to maintain the existing allowance of foreign tax credits against that income.

**Proposal**

Under the proposal, the 50/50 rule would be replaced by a rule requiring that the allocation between production activities and sales activities be based on actual economic activity. The proposal would not change the tax rules that apply to the export of natural resources.

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

## MODIFY RULES RELATING TO FOREIGN OIL AND GAS EXTRACTION INCOME

**Current Law**

The United States taxes U.S. persons on their worldwide income. A credit against U.S. tax on foreign income is allowed for foreign income taxes paid by the U.S. person. In addition, a credit is allowed to a U.S. corporation for foreign taxes paid by certain foreign subsidiary corporations upon payment of an actual or deemed dividend by the subsidiary (the "deemed paid" or "indirect" foreign tax credit).

To be a creditable income tax, a foreign levy must be the substantial equivalent of an income tax in the U.S. sense, regardless of the label the foreign government attaches to it. Under regulations, a foreign levy is a tax if it is a compulsory payment under the authority of a foreign government to levy taxes and is not compensation for a specific economic benefit provided by the foreign country. Taxpayers that are subject to a foreign levy and that also receive (directly or indirectly) a specific economic benefit from the levying country are referred to as "dual capacity" taxpayers and may not claim a credit for that portion of the foreign levy paid as compensation for the specific economic benefit received. Under a regulatory safe-harbor test, if a country has a generally imposed income tax, the dual-capacity taxpayer may treat as a creditable tax the portion of the levy that application of the generally imposed income tax would yield (to the extent the levy otherwise constitutes an income tax or an "in lieu of" tax); the balance is treated as compensation for the specific economic benefit. If there is no generally imposed income tax, the regulation treats as a creditable tax that portion of the payment that does not exceed the applicable U.S. tax rate applied to net income. A foreign tax is treated as "generally imposed" even if it applies only to persons who are not residents or nationals of that country.

There is no separate section 904 foreign tax credit "basket" for oil and gas income. However, under section 907, the amount of creditable foreign taxes imposed on FOGEI is limited in any year to the applicable U.S. tax on that income.

**Reasons for Change**

The purpose of the foreign tax credit is to avoid double taxation of income by both the United States and a foreign jurisdiction. When a payment to a foreign government is made as compensation for a specific economic benefit, there is no incidence of double taxation. Current law recognizes the distinction between creditable taxes and non-creditable payments for a specific economic benefit but fails to achieve the appropriate split between the two in a case

where a foreign country imposes a levy on, for example, oil and gas income only, but has no generally imposed income tax.

**Proposal**

The proposal would treat payments by a dual-capacity taxpayer to a foreign country that would otherwise qualify as income taxes or "in lieu of" taxes as taxes only if there is a "generally applicable income tax" in that country. For this purpose, a generally applicable income tax is an income tax (or a series of income taxes) that applies to trade or business income from sources in that country, so long as the levy has substantial application both to non-dual-capacity taxpayers and to persons who are citizens or residents of that country. The proposal thus would replace that part of the regulatory safe harbor that treats a foreign levy as a tax up to the amount of the U.S. tax where the foreign country has no generally applicable income tax. The proposal generally would retain the rule of present law where the foreign country does generally impose an income tax. In that case, credits would be allowed up to the level of taxation that would be imposed under that general tax, so long as the tax satisfies the statutory definition of a "generally applicable income tax." The proposal also would convert the special foreign tax credit limitation rules of present-law section 907 into a new foreign tax credit basket within section 904 for foreign oil and gas income.

The proposal would be effective for taxable years beginning after the date of enactment. The proposal would yield to U.S. treaty obligations that allow a credit for taxes paid or accrued on certain oil or gas income.

## RECAPTURE OVERALL FOREIGN LOSSES WHEN CFC STOCK IS DISPOSED

**Current Law**

Section 904(f) establishes a regime for the treatment of overall foreign losses (OFLs). Under section 904(f)(3), if a taxpayer disposes of trade or business property used predominantly outside the United States, any gain arising from such disposition may be recharacterized as U.S. source income up to the lesser of the amount of the gain, or the amount of outstanding OFLs (without being subject to the 50 percent limitation on recapture in section 904(f)(1)). However, for purposes of section 904(f), stock is not treated as trade or business property for purposes of the recapture rules. If, therefore, a domestic corporation disposes of stock in a subsidiary, gain on such disposition is not subject to the section 904(f)(3) disposition rules.

**Reasons for Change**

A U.S. corporation may choose to conduct its operations through a subsidiary controlled foreign corporation (CFC), rather than directly through ownership of foreign assets. Under the interest allocation rules of section 864(e) and §1.861-9T, interest is allocated to foreign sources based not only on the value of foreign assets, but also on the tax book value of the stock of any CFCs owned by the U.S. corporation. Ownership of stock in a foreign subsidiary can, therefore, lead to, or increase, an overall foreign loss by increasing interest deductions allocated against foreign

income.  If, however, following the creation of this OFL the CFC is, for example, spun off to unaffiliated shareholders, OFLs  which relate to ownership of the CFC may never be recaptured. The proposal corrects this asymmetry.

**Proposal**

For purposes of section 904(f), the property subject to the recapture rules upon disposition under section 904(f)(3) would include stock in a controlled foreign corporation.

The proposal would be effective from date of enactment.

## MODIFY FOREIGN OFFICE MATERIAL PARTICIPATION EXCEPTION APPLICABLE TO INVENTORY SALES ATTRIBUTABLE TO NONRESIDENT'S U.S. OFFICE

**Current Law**

Foreign corporations and nonresident alien individuals engaged in a trade or business within the United States are taxable on a net basis on their taxable income that is effectively connected with the conduct of a U.S. trade or business.  The determination of whether income is effectively connected depends in part on whether the income is from sources within the United States or without the United States.  In general, if a nonresident maintains an office or other fixed place of business in the United States, income from any sale of personal property (including inventory property) attributable to such place of business is sourced in the United States.  As a result, such income is treated as effectively connected with the conduct of the U.S. trade or business and is subject to net basis taxation.

However, this general rule does not apply to any sale of inventory property that is sold for use, disposition, or consumption outside the United States if an office or other fixed place of business of the taxpayer in a foreign country materially participates in the sale.  Under these circumstances, the source of the income depends on where title to the inventory property passes. As a result, if title passes outside the United States, the income is not treated as effectively connected with the conduct of a U.S. trade or business, and is not subject to tax by the United States.

**Reasons for Change**

As a result of this material participation exemption, the sale of inventory property for use, disposition, or consumption outside the United States may not be subject to United States taxation even though the sale is attributable to an office or other fixed place of business in the United States.  Moreover, the sale may not be subject to taxation in any other jurisdiction.  The United States should not cede its jurisdiction to tax sales of inventory property that are attributable to an office or other fixed place of business in the United States unless the sale is actually taxed by a foreign country at some minimal level.

**Proposal**

The proposal would provide that the source rule exception for sales of inventory property for use, disposition, or consumption outside the United States in which the nonresident's foreign office or other fixed place of business materially participates shall apply only if an income tax equal to at least 10 percent of the income from the sale is actually paid to a foreign country with respect to such income.

The proposal would be effective for transactions occurring on or after the date of enactment.

**Other Provisions That Affect Receipts**

## REINSTATE SUPERFUND ENVIRONMENTAL INCOME TAX

**Current Law**

For taxable years beginning before January 1, 1996, a corporate environmental income tax was imposed at a rate of 0.12 percent on the amount by which the modified alternative minimum taxable income of a corporation exceeded $2 million. Modified alternative minimum taxable income was defined as a corporation's alternative minimum taxable income, determined without regard to the alternative minimum tax net operating loss deduction and the deduction for the corporate environmental income tax.

The tax was dedicated to the Hazardous Substance Superfund Trust Fund (the Superfund Trust Fund). Amounts in the Superfund Trust Fund are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment under specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (as amended). Spending from the Superfund Trust Fund is classified as discretionary domestic spending for Federal budget purposes.

**Reasons for Change**

The corporate environmental income tax should be reinstated because of the continuing need for funds to remedy damages caused by releases of hazardous substances.

**Proposal**

The corporate environmental income tax would be reinstated for taxable years beginning after December 31, 1999, and before January 1, 2011.

## REINSTATE SUPERFUND EXCISE TAXES

**Current Law**

The following Superfund excise taxes were imposed before January 1, 1996:

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

(2) An excise tax on listed hazardous chemicals at a rate that varied from $0.22 to $4.87 per ton; and

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

Amounts equivalent to the revenues from these taxes were dedicated to the Hazardous Substance Superfund Trust Fund (the Superfund Trust Fund). Amounts in the Superfund Trust Fund are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment under specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (as amended). Spending from the Superfund Trust Fund is classified as discretionary domestic spending for Federal budget purposes.

**Reasons for Change**

The Superfund excise taxes should be reinstated because of the continuing need for funds to remedy damages caused by releases of hazardous substances.

**Proposal**

The three Superfund excise taxes would be reinstated for the period after the date of enactment and before October 1, 2010.

## CONVERT A PORTION OF THE EXCISE TAXES DEPOSITED IN THE AIRPORT AND AIRWAY TRUST FUND TO COST-BASED USER FEES ASSESSED FOR FEDERAL AVIATION ADMINISTRATION (FAA) SERVICES

**Current Law**

The Airport and Airway Trust Fund is supported by taxes on air passenger transportation, domestic air freight transportation, and aviation fuel. The current tax on domestic air passenger transportation is 7.5 percent of the amount paid for the transportation plus $2.25 for each segment of the transportation, the current tax on international departures and arrivals is $12.40 per person, and the tax on domestic air freight transportation is 6.25 percent of the amount paid for the transportation. The domestic segment fee is phased up in three steps to a fully phased-in fee of $3.00 per segment after December 31, 2001. In addition, the segment fee is indexed for inflation beginning in calendar year 2003 and the international arrival and departure fees are currently indexed for inflation. The tax on aviation fuel, to the extent dedicated to the Trust Fund, is 4.3 cents per gallon in the case of commercial aviation fuel, 19.3 cents per gallon in the case of gasoline used in noncommercial aviation, and 21.8 cents per gallon in the case of noncommercial aviation fuel other than gasoline.

**Reasons for Change**

As part of the Administration's effort to create a more business-like Federal Aviation Administration, the excise taxes on domestic air passenger transportation, international departures and arrivals, and domestic air freight transportation should be reduced and cost-based user fees imposed.

**Proposal**

The Administration will propose legislation to reduce the excise taxes on domestic air passenger transportation, international departures and arrivals, and domestic air freight transportation as more efficient cost-based user fees for air traffic services are phased in beginning in fiscal year 2001. The excise taxes would be reduced as necessary to ensure that the amount collected each year from the new user fees and from the excise taxes dedicated to the Airport and Airway Trust Fund is, in the aggregate, equal to the total budget resources requested for the FAA in the succeeding year.

## INCREASE TOBACCO TAXES AND IMPOSE YOUTH SMOKING ASSESSMENT

**Current Law**

The following is a listing of the Federal excise taxes imposed on tobacco products under current law:

| Calendar year | Article | Tax imposed |
| --- | --- | --- |
| 2000 and 2001 | Cigars: | |
| | Small cigars | $1.594 per thousand |
| | Large cigars | 18.063% of manufacturer's price, up to $42.50 per thousand |
| | Cigarettes: | |
| | Small cigarettes | $17.00 per thousand (34 cents per pack of 20 cigarettes) |
| | Large cigarettes | $35.70 per thousand |
| | Cigarette papers | $0.0106 per 50 papers |
| | Cigarette tubes | $0.0213 per 50 tubes |
| | Chewing tobacco | $0.17 per pound |
| | Snuff | $0.51 per pound |
| | Pipe tobacco | $0.9567 per pound |
| | Roll-your-own tobacco | $0.9567 per pound |

| | | |
|---|---|---|
| 2002 or later | Cigars: | |
| | Small cigars | $1.828 per thousand |
| | Large cigars | 20.719% of manufacturer's price, up to $48.75 per thousand |
| | Cigarettes: | |
| | Small cigarettes | $19.50 per thousand (39 cents per pack of 20 cigarettes) |
| | Large cigarettes | $40.95 per thousand |
| | Cigarette papers | $0.0122 per 50 papers |
| | Cigarette tubes | $0.0244 per 50 tubes |
| | Chewing tobacco | $0.195 per pound |
| | Snuff | $0.585 per pound |
| | Pipe tobacco | $1.0969 per pound |
| | Roll-your-own tobacco | $1.0969 per pound |

Under current law there are no financial penalties that would induce tobacco companies to discourage youth smoking.

**Reasons for Change**

Too many children and teenagers pick up the deadly habit of smoking when young, only to regret it later in life. Price increases have been shown to be an effective way to reduce underage smoking, and so stop the health damage from tobacco before it begins. An increase in the excise tax is generally believed to be substantially passed forward into the price of tobacco, and so is an effective way to help reduce youth smoking. Assessments for failing to meet youth smoking reduction targets also would reduce underage smoking, both by increasing the price of cigarettes and by inducing tobacco manufacturers to find other methods of restricting sales to minors.

**Proposal**

Tobacco products would be taxed at the following rates:

| Article | Tax Imposed |
|---|---|
| Cigars: | |
| Small cigars | $3.00 per thousand |
| Large cigars | 34% of manufacturer's price, up to $80.00 per thousand |
| Cigarettes: | |
| Small cigarettes | $32.00 per thousand (64 cents per pack of 20 cigarettes) |
| Large cigarettes | $67.20 per thousand |
| Cigarette papers | $0.02 per 50 papers |
| Cigarette tubes | $0.04 per 50 tubes |
| Chewing tobacco | $0.32 per pound |
| Snuff | $0.96 per pound |
| Pipe tobacco | $1.80 per pound |
| Roll-your-own tobacco | $1.80 per pound |

The new rates would take effect on October 1, 2000, with appropriate floor stocks imposed on tobacco products held on that date. The proposed increase would replace the tax increase on tobacco products currently scheduled to occur in calendar year 2002. In addition, the Administration will propose a nondeductible assessment on tobacco companies that fail to meet youth smoking reduction targets.

## CONVERT HARBOR MAINTENANCE TAX TO COST-BASED USER FEE

### Current Law

Under the Internal Revenue Code, an ad valorem excise tax (the Harbor Maintenance Tax) is imposed on the use of U.S. ports. The rate of tax is 0.125 percent of the value of the commercial cargo loaded or unloaded (or, in the case of passenger ships, 0.125 percent of the amount paid for the transportation). Exceptions are provided for cargo shipped between the U.S. mainland and Alaska, Hawaii, or a U.S. possession (or between or within Alaska, Hawaii, and U.S. possessions). These exceptions do not apply to cargo destined for a foreign country or to crude oil loaded or unloaded in Alaska. Exceptions are also provided for previously taxed cargo, cargo being loaded on or unloaded from a vessel subject to the tax on inland waterway fuel, cargo entering the United States for direct re-export, cargo intended for overseas humanitarian and development assistance, and fish not previously landed.

Receipts from the Harbor Maintenance Tax are deposited in the Harbor Maintenance Trust Fund to provide for the operation and maintenance of channels and harbors (other than inland waterways). Amounts in the Trust Fund may be used to finance up to 100 percent of the Corps of Engineers' harbor operation and maintenance costs, including costs associated with Great Lakes navigational projects, to finance the operation and maintenance of the Saint Lawrence Seaway Development Corporation, and to construct dredged-material disposal facilities in connection with Federal dredging projects for commercial navigation. In addition, amounts in

the Trust Fund may be used, subject to a $5 million annual cap, to pay administrative expenses incurred by the Treasury Department, the Corps of Engineers, and the Commerce Department related to administration of the Harbor Maintenance Tax.

In *United States v. United States Shoe Corp.*, the Supreme Court held that the Harbor Maintenance Tax, as applied to exports, violates the Export Clause of the Constitution, which states: "No Tax or Duty shall be laid on Articles exported from any State." At the same time, however, the Court made it clear that the Export Clause does not exempt exporters from user fees designed to defray the cost of harbor development and maintenance and bearing a reasonable correlation to the harbor services used or usable by exporters.

As a result of the Supreme Court's decision, the Harbor Maintenance Tax is no longer being collected on goods in export transit. The tax is, however, currently being collected on imports, domestic cargo, and passenger transportation.

**Reasons for Change**

Users of the network of U.S. ports served by Federal channel and harbor projects should continue to be responsible for the costs of ensuring a safe and economically competitive port system. Under current law, however, exporters no longer bear their appropriate share of these costs. In addition, our trading partners have questioned whether the Harbor Maintenance Tax, as applied to imports, is consistent with our international obligations.

**Proposal**

The Administration proposes to repeal the Harbor Maintenance Tax for periods after September 30, 2000, and replace it with the Harbor Services User Fee, a cost-based user fee. The new fee will 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. The proposed fee structure will be designed to withstand challenge under the Export Clause of the Constitution and to be consistent with our international obligations.

**Revenue Estimates**
**FY 2001 Proposals Affecting Receipts 1/**

| 2/7/2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2001-2005 | 2001-2010 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Provide tax relief | | | | | | | | | | | | |
| **Expand educational initiatives** | | | | | | | | | | | | |
| College Opportunity Tax Cut | -395 | -2009 | -2323 | -3103 | -3262 | -3420 | -3580 | -3772 | -3891 | -4089 | -11092 | -29844 |
| Provide incentives for public school construction and modernization | -36 | -174 | -419 | -739 | -1020 | -1127 | -1127 | -1127 | -1127 | -1127 | -2388 | -8023 |
| Expand exclusion for employer-provided educational assistance to include graduate education | -341 | -90 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | -431 | -431 |
| Eliminate 60-month limit on student loan interest deduction | -23 | -80 | -87 | -89 | -93 | -103 | -105 | -109 | -112 | -113 | -372 | -914 |
| Eliminate tax when forgiving student loans subject to income contingent repayment | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Tax treatment of education awards under certain Federal programs | -3 | -7 | -7 | -7 | -6 | -6 | -6 | -6 | -7 | -7 | -30 | -62 |
| **Subtotal, Expand educational initiatives** | **-798** | **-2360** | **-2836** | **-3938** | **-4381** | **-4656** | **-4818** | **-5014** | **-5137** | **-5336** | **-14313** | **-39274** |
| **Provide poverty relief and revitalize communities:** | | | | | | | | | | | | |
| Expand and simplify the earned income tax credit 2/ | -2308 | -2240 | -2281 | -2318 | -2340 | -2368 | -2382 | -2421 | -2461 | -2475 | -11487 | -23594 |
| Increase and index low-income housing tax credit per capita cap | -6 | -55 | -168 | -306 | -448 | -591 | -736 | -906 | -1114 | -1336 | -983 | -5666 |
| Provide New Markets tax credit | -30 | -222 | -515 | -743 | -940 | -960 | -768 | -474 | -247 | -197 | -2450 | -5096 |
| Extend and expand empowerment zone incentives | -36 | -167 | -333 | -452 | -568 | -629 | -618 | -618 | -610 | -345 | -1556 | -4376 |
| Bridge the "digital divide" | -107 | -272 | -344 | -289 | -207 | -169 | -170 | -171 | -172 | -173 | -1219 | -2074 |
| Provide tax credits for holders of Better America Bonds | -8 | -41 | -112 | -214 | -315 | -410 | -479 | -511 | -512 | -513 | -690 | -3115 |
| Make permanent the expensing of Brownfields remediation costs | 0 | -98 | -152 | -146 | -140 | -133 | -125 | -116 | -104 | -93 | -536 | -1107 |
| SSBIC tax incentives | -* | -* | -* | -* | -* | -* | -* | -* | -* | -* | -* | -* |
| **Subtotal, Provide poverty relief and revitalize communities** | **-2495** | **-3095** | **-3905** | **-4468** | **-4958** | **-5260** | **-5278** | **-5217** | **-5220** | **-5132** | **-18921** | **-45028** |
| **Make health care more affordable** | | | | | | | | | | | | |
| Assist taxpayers with long-term care needs 2/ | -114 | -1199 | -1753 | -2532 | -3161 | -3492 | -3573 | -3618 | -3606 | -3532 | -8759 | -26580 |
| Encourage COBRA continuation coverage | -- | -41 | -858 | -1149 | -1286 | -1323 | -1370 | -1393 | -1412 | -1434 | -3334 | -10266 |
| Provide tax credit for Medicare buy-in program | -- | -5 | -105 | -140 | -164 | -196 | -224 | -246 | -261 | -270 | -414 | -1611 |
| Provide tax relief for workers with disabilities 2/ | -21 | -151 | -169 | -187 | -196 | -199 | -200 | -202 | -203 | -206 | -724 | -1734 |
| Provide tax relief to encourage small business health plans | -1 | -9 | -22 | -35 | -38 | -35 | -35 | -40 | -46 | -52 | -105 | -313 |
| Encourage the development of vaccines for targeted diseases | 0 | 0 | 0 | 0 | 0 | -25 | -175 | -176 | -264 | -360 | 0 | -1000 |
| **Subtotal, Make health care more affordable** | **-136** | **-1405** | **-2907** | **-4043** | **-4845** | **-5270** | **-5577** | **-5675** | **-5792** | **-5854** | **-13336** | **-41504** |
| **Strengthen families and improve work incentives** | | | | | | | | | | | | |
| Provide marriage penalty relief and increase the standard deduction 3/ | -246 | -831 | -1503 | -2070 | -4537 | -6696 | -6684 | -6959 | -7082 | -7353 | -9187 | -43961 |
| Increase, expand, and simplify the child and dependent care tax credit 2/ | -121 | -589 | -922 | -2715 | -3144 | -4118 | -4336 | -4630 | -4680 | -5027 | -7491 | -30282 |
| Provide tax incentives for employer-provided child-care facilities | -42 | -88 | -121 | -140 | -148 | -157 | -167 | -177 | -187 | -198 | -539 | -1425 |
| **Subtotal, Strengthen families and improve work incentives** | **-409** | **-1508** | **-2546** | **-4925** | **-7829** | **-10971** | **-11187** | **-11766** | **-11949** | **-12578** | **-17217** | **-75668** |
| **Promote Savings, Retirement Security, and Portability** | | | | | | | | | | | | |
| Retirement Savings Accounts | -- | -657 | -2185 | -2290 | -4034 | -8097 | -8679 | -9010 | -9309 | -9586 | -9166 | -53847 |
| Small business tax credit for qualified retirement plan contributions | 0 | -157 | -648 | -1,878 | -3,074 | -3,116 | -2,135 | -1,294 | -1,496 | -1,560 | -5757 | -15358 |
| Small business tax credit for expenses of starting new retirement plans; promote IRA contributions through payroll deduction | -17 | -35 | -61 | -92 | -135 | -164 | -180 | -192 | -198 | -203 | -340 | -1,277 |
| The SMART plan -- a simplified pension plan for small business | -44 | -65 | -66 | -68 | -70 | -55 | -49 | -50 | -51 | -53 | -313 | -571 |

| 2/7/2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2001-2005 | 2001-2010 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Enhancements to SIMPLE 401(k) plan nonelective contribution alternative | -25 | -61 | -108 | -161 | -236 | -264 | -266 | -266 | -264 | -261 | -591 | -1,912 |
| Eliminate IRS user fees for initial determination letters for small businesses adopting a qualified retirement plan for the first time | -2 | -7 | -7 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | -16 | -16 |
| Simplify prohibited transaction provisions for loans to individuals who are S-corporation owners or self-employed | -2 | -7 | -14 | -24 | -32 | -34 | -35 | -36 | -36 | -37 | -79 | -257 |
| Provide faster vesting for employer contributions to qualified retirement plans | 214 | 137 | 104 | 66 | 29 | -10 | -48 | -88 | -127 | -167 | 550 | 110 |
| Increase defined contribution plan percentage of pay limitation | -3 | -6 | -8 | -10 | -13 | -17 | -19 | -21 | -23 | -25 | -40 | -145 |
| Certain elective contributions not taken into account for purposes of deduction limits | -50 | -91 | -121 | -162 | -209 | -261 | -297 | -326 | -359 | -388 | -633 | -2,264 |
| Conform definition of compensation for purposes of deduction limits | -2 | -3 | -4 | -5 | -6 | -8 | -9 | -10 | -11 | -12 | -20 | -70 |
| Improve benefits of non-highly compensated employees under 401(k) safe harbor plans | -11 | -15 | -18 | -23 | -26 | -29 | -32 | -35 | -38 | -41 | -93 | -268 |
| Simplify the definition of highly compensated employee | -1 | -1 | -1 | -2 | -2 | -2 | -2 | -2 | -2 | -2 | -7 | -17 |
| Tax treatment of the division of section 457 plan benefits upon divorce | | | | | | | | | | | | |
| Require joint and seventy-five percent survivor annuity option for pension plans | -9 | -13 | -13 | -13 | -13 | -13 | -13 | -13 | -13 | -13 | -61 | -126 |
| Encourage pension asset preservation by default rollover to IRAs | -7 | -17 | -27 | -31 | -32 | -33 | -34 | -35 | -36 | -36 | -114 | -288 |
| Portability provisions | 59 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 63 | 68 |
| Thrift savings plan portability proposals | -13 | -19 | -21 | -24 | -26 | -29 | -32 | -35 | -38 | -41 | -103 | -278 |
| Permit accelerated funding of DB plans | -1 | -1 | -8 | -20 | -24 | -24 | -24 | -24 | -24 | -24 | -54 | -174 |
| Simplify full funding limitation for multiemployer plans | -6 | -8 | -8 | -8 | -8 | -8 | -8 | -8 | -8 | -8 | -38 | -78 |
| Simplify benefit limits for multiemployer plans under section 415 | -7 | -19 | -36 | -50 | -52 | -53 | -53 | -51 | -52 | -51 | -164 | -424 |
| Increase disclosure for pension amendments that reduce pension accruals | 0 | -1 | -3 | -6 | -8 | -9 | -9 | -9 | -10 | -10 | -18 | -65 |
| **Subtotal, Promote savings, retirement security and portability** | **73** | **-1045** | **-3252** | **-4800** | **-7970** | **-12225** | **-11923** | **-11504** | **-12094** | **-12517** | **-16994** | **-77257** |
| | | | | | | | | | | | | |
| **Provide AMT relief for families and simplify the tax laws** | | | | | | | | | | | | |
| Alternative minimum tax relief for individuals | -449 | -544 | -996 | -1312 | -1650 | -2096 | -2524 | -3942 | -8200 | -11124 | -4951 | -32837 |
| Simplify and increase standard deduction for dependents | -49 | -29 | -33 | -51 | -37 | -38 | -37 | -39 | -44 | -46 | -199 | -403 |
| Simplification of definition of child dependent | -66 | -97 | -102 | -107 | -112 | -116 | -122 | -128 | -134 | -141 | -484 | -1125 |
| Index maximum exclusion for capital gains on sale of principal residence | 0 | -2 | -5 | -8 | -12 | -18 | -28 | -42 | -65 | -100 | -27 | -280 |
| Tax credit to encourage electronic filing of individual income tax returns 2/ | 0 | -495 | -531 | -539 | -548 | -563 | -580 | 0 | 0 | 0 | -2113 | -3256 |
| Clarification of tax treatment of individuals in sheltered workshops | -4 | -3 | -3 | -3 | -3 | -3 | -3 | -3 | -3 | -3 | -16 | -31 |
| Enhance section 179 expensing for small businesses | -217 | -206 | -19 | -86 | -135 | -178 | -222 | -259 | -292 | -410 | -663 | -2024 |
| Optional Self-employment Contributions Act (SECA) computations | * | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 4 | 9 |
| Clarify certain disclaimer rules | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Simplify the foreign tax credit limitation for dividends from 10/50 companies | -248 | -102 | -46 | 10 | 27 | 28 | 22 | 18 | 15 | 12 | -359 | -264 |
| Provide interest treatment for dividends paid by certain regulated investment companies to foreign persons | -14 | -19 | -20 | -20 | -21 | -21 | -22 | -22 | -23 | -24 | -94 | -206 |
| Extend section 7428 to non-charities that claim tax-exemption under 501(c) | | | | | Negligible Revenue Effect | | | | | | | |
| Modify translation of foreign withholding taxes by accrual basis taxpayers | | | | | Negligible Revenue Effect | | | | | | | |
| Eliminate duplicate penalties for failure to file annual reports | | | | | Negligible Revenue Effect | | | | | | | |
| Treat corporations in an affiliated group as a single corporation | | | | | Negligible Revenue Effect | | | | | | | |
| **Subtotal, Provide AMT relief for families and simplify the tax laws** | **-1047** | **-1496** | **-1754** | **-2115** | **-2490** | **-3004** | **-3515** | **-4416** | **-8745** | **-11835** | **-8902** | **-40417** |
| | | | | | | | | | | | | |
| **Encourage philanthropy** | | | | | | | | | | | | |
| Allow deduction for charitable contributions for non-itemizing taxpayers 3/ | -507 | -1039 | -710 | -741 | -791 | -1206 | -1788 | -1866 | -1943 | -2016 | -3788 | -12607 |
| Simplify and reduce excise tax on private foundations (1.25%) | -49 | -70 | -71 | -73 | -75 | -78 | -81 | -84 | -87 | -90 | -338 | -758 |
| Increase limit on charitable donations of appreciated property | -7 | -47 | -29 | -20 | -12 | -8 | -8 | -9 | -9 | -10 | -115 | -159 |
| Clarify publicly charity status of donor advised funds | | | | | | | | | | | | |

| 2/7/2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2001-2005 | 2001-2010 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Subtotal, Encourage philanthropy** | **-563** | **-1156** | **-810** | **-834** | **-878** | **-1292** | **-1877** | **-1959** | **-2039** | **-2116** | **-4241** | **-13524** |
| **Promote energy efficiency and improve the environment** | | | | | | | | | | | | |
| Provide tax credit for energy-efficient building equipment | -18 | -35 | -49 | -71 | -28 | -3 | 1 | 1 | 1 | 0 | -201 | -201 |
| Provide tax credit for new energy-efficient homes | -82 | -150 | -194 | -134 | -73 | -28 | 0 | 0 | 0 | 0 | -633 | -661 |
| Extend tax credit for electric vehicles and provide tax credit for certain hybrid vehicles | 0 | -4 | -182 | -700 | -1192 | -1930 | -1863 | -125 | 12 | 49 | -2078 | -5935 |
| Extend and modify tax credit for producing electricity from certain sources | -91 | -173 | -220 | -231 | -261 | -245 | -218 | -225 | -230 | -237 | -976 | -2131 |
| Provide tax credit for solar energy systems | -9 | -19 | -25 | -34 | -45 | -78 | -116 | -51 | 0 | 0 | -132 | -377 |
| Provide a 15-year depreciable life of distributed power property | -1 | -1 | -2 | -3 | -3 | -4 | -5 | -5 | -6 | -7 | -10 | -37 |
| **Subtotal, Promote energy efficiency and improve the environment** | **-201** | **-382** | **-672** | **-1173** | **-1602** | **-2288** | **-2201** | **-405** | **-223** | **-195** | **-4030** | **-9342** |
| **Electricity restructuring** | | | | | | | | | | | | |
| Revise tax-exempt bond rules for electric power facilities; modify treatment of contributions to nuclear decommissioning funds. | 3 | 11 | 20 | 30 | 41 | 51 | 61 | 72 | 84 | 95 | 105 | 468 |
| **Modify international trade provisions** | | | | | | | | | | | | |
| Extend and modify Puerto Rico economic activity tax credit | -35 | -67 | -101 | -134 | -166 | -974 | -1544 | -1620 | -937 | 0 | -503 | -5578 |
| Africa initiative | -63 | -67 | -72 | -84 | -117 | -123 | -131 | -139 | -147 | -155 | -403 | -1098 |
| Caribbean Basin Initiative | -373 | -407 | -445 | -471 | -122 | 0 | 0 | 0 | 0 | 0 | -1818 | -1818 |
| OECD Shipbuilding | -8 | -12 | -11 | -10 | -9 | -9 | -9 | -8 | -8 | -7 | -50 | -91 |
| Levy tariff on certain textiles/apparel produced in the CNMI | 0 | 169 | 169 | 169 | 169 | 169 | 169 | 169 | 169 | 169 | 676 | 1521 |
| GSP extension through 6/30/04 | 0 | -362 | -402 | -309 | 0 | 0 | 0 | 0 | 0 | 0 | -1073 | -1073 |
| Balkan initiative | -20 | -10 | -10 | -10 | 0 | 0 | 0 | 0 | 0 | 0 | -50 | -50 |
| **Subtotal, Modify international trade provisions** | **-499** | **-756** | **-872** | **-849** | **-245** | **-937** | **-1515** | **-1598** | **-923** | **7** | **-3221** | **-8187** |
| **Miscellaneous provisions** | | | | | | | | | | | | |
| Make first $2,000 of severance pay exempt from income tax | -43 | -174 | -180 | -138 | 0 | 0 | 0 | 0 | 0 | 0 | -535 | -535 |
| Exempt holocaust reparations from federal income tax | -21 | -18 | -19 | -15 | 0 | 0 | 0 | 0 | 0 | 0 | -73 | -73 |
| **Subtotal, Miscellaneous provisions** | **-64** | **-192** | **-199** | **-153** | **0** | **0** | **0** | **0** | **0** | **0** | **-608** | **-608** |
| **Total** | **-6136** | **-13384** | **-19733** | **-27268** | **-35157** | **-45852** | **-47830** | **-47482** | **-52038** | **-55461** | **-101678** | **-350341** |

| 2/7/2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2001-2005 | 2001-2010 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Eliminate unwarranted benefits and adopt other revenue measures | | | | | | | | | | | | |
| **Corporate Tax Shelters** | | | | | | | | | | | | |
| 1) Increase disclosure and modify substantial understatement penalty for corporations participating in tax shelters; 2) Codify economic substance doctrine; 3) Impose excise tax on promoters and advisors; 4) Tax income from tax indifferent parties | 1872 | 1392 | 1357 | 1351 | 1374 | 1402 | 1425 | 1437 | 1443 | 1444 | 7346 | 14497 |
| Require accrual of income on forward sale of corporate stock | 6 | 10 | 15 | 21 | 26 | 32 | 37 | 40 | 42 | 44 | 78 | 273 |
| Modify treatment of ESOP as S corporation shareholder | 15 | 47 | 67 | 88 | 104 | 111 | 117 | 123 | 128 | 133 | 321 | 933 |
| Limit dividend treatment for payments on certain self-amortizing stock | 22 | 37 | 39 | 40 | 42 | 44 | 45 | 47 | 49 | 51 | 180 | 416 |
| Prevent serial liquidation of U.S. subsidiaries of foreign corporations | 32 | 19 | 19 | 19 | 18 | 18 | 17 | 18 | 18 | 18 | 107 | 196 |
| Prevent capital gain avoidance through basis shift transactions involving foreign shareholders | 399 | 121 | 65 | 45 | 26 | 17 | 16 | 14 | 9 | 3 | 656 | 715 |
| Prevent mismatching of deductions and income in transactions involving foreign shareholders | 62 | 108 | 112 | 117 | 122 | 127 | 132 | 137 | 142 | 147 | 521 | 1206 |
| Prevent duplication or acceleration of loss through assumption of certain liabilities | 38 | 36 | 37 | 38 | 40 | 41 | 43 | 44 | 46 | 48 | 189 | 411 |
| Amend 80/20 company rules | 21 | 46 | 53 | 54 | 56 | 57 | 58 | 60 | 61 | 63 | 230 | 529 |
| Modify COLI rules | 176 | 340 | 417 | 489 | 548 | 593 | 631 | 664 | 695 | 726 | 1970 | 5279 |
| Increase depreciation life by service term of tax-exempt use property leases | 6 | 11 | 17 | 24 | 30 | 38 | 45 | 53 | 62 | 71 | 88 | 357 |
| Interaction | -281 | -175 | -157 | -157 | -160 | -167 | -176 | -188 | -198 | -205 | -930 | -1864 |
| **Financial Products** | | | | | | | | | | | | |
| Require banks to accrue interest on short-term obligations | 69 | 21 | 4 | 5 | 5 | 5 | 5 | 6 | 6 | 6 | 104 | 132 |
| Require current accrual of market discount by accrual method taxpayers | 8 | 13 | 19 | 25 | 31 | 38 | 45 | 52 | 60 | 68 | 96 | 359 |
| Modify and clarify rules relating to debt-for-debt exchanges | 82 | 74 | 71 | 70 | 70 | 69 | 69 | 69 | 68 | 68 | 367 | 710 |
| Modify and clarify straddle rules | 44 | 34 | 33 | 34 | 35 | 35 | 36 | 38 | 40 | 41 | 180 | 370 |
| Provide generalized rules for all stripping transactions | 25 | 22 | 21 | 19 | 18 | 17 | 15 | 14 | 12 | 10 | 105 | 173 |
| Provide ordinary income treatment for dealers in equity options and commodities | 45 | 31 | 31 | 31 | 31 | 32 | 32 | 33 | 34 | 36 | 169 | 336 |
| Prohibit tax deferral on contributions of appreciated property to swap funds | 2 | 5 | 8 | 10 | 11 | 12 | 13 | 14 | 16 | 17 | 36 | 108 |
| **Corporate** | | | | | | | | | | | | |
| Conform control test for tax-free incorporations, distributions and reorganizations | 47 | 41 | 39 | 38 | 39 | 39 | 39 | 39 | 39 | 39 | 204 | 399 |
| Treat receipt of certain tracking stock as property | 136 | 158 | 153 | 149 | 151 | 155 | 158 | 159 | 160 | 161 | 747 | 1540 |
| Require consistent treatment and provide basis allocation rules for transfers of intangibles in certain non-recognition transactions | 42 | 51 | 53 | 55 | 57 | 61 | 64 | 66 | 69 | 72 | 258 | 590 |
| Modify tax treatment of reorganizations involving portfolio stock | 66 | 66 | 71 | 77 | 83 | 90 | 96 | 103 | 110 | 117 | 363 | 879 |
| Modify definition of nonqualified preferred stock | 64 | 61 | 64 | 67 | 54 | 27 | 17 | 18 | 19 | 20 | 310 | 411 |
| Modify estimated tax provision of section 338 | 314 | 90 | -23 | -15 | -8 | -3 | 1 | 4 | 7 | 9 | 358 | 376 |
| Repeal section 361(b)(3) for divisive reorganizations | 18 | 18 | 19 | 20 | 21 | 22 | 23 | 24 | 25 | 26 | 96 | 216 |
| **Pass-throughs** | | | | | | | | | | | | |
| Modify partnership distribution rules | 9 | 52 | 55 | 60 | 58 | 57 | 55 | 53 | 50 | 48 | 234 | 497 |
| Modify treatment of closely held REITs | 1 | 4 | 8 | 12 | 17 | 24 | 32 | 41 | 53 | 68 | 42 | 260 |
| Apply RIC excise tax to undistributed profits of REITS | 0 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 4 | 9 |
| Allow DPD only when redemptions represents contraction of RIC | 99 | 489 | 457 | 429 | 405 | 384 | 368 | 356 | 349 | 346 | 1879 | 3682 |
| Require REMICs to be secondarily liable for tax liability on residual interests | 5 | 17 | 29 | 42 | 55 | 69 | 83 | 98 | 114 | 130 | 148 | 642 |

| 2/7/2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2001-2005 | 2001-2010 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Tax Accounting** | | | | | | | | | | | | |
| Deny change in method treatment to tax-free formations | 62 | 59 | 59 | 61 | 63 | 66 | 69 | 72 | 75 | 78 | 304 | 664 |
| Deny deduction for punitive damages | 108 | 130 | 137 | 144 | 151 | 158 | 166 | 175 | 183 | 193 | 670 | 1545 |
| Repeal lower-cost-or-market inventory method | 459 | 447 | 371 | 372 | 154 | 57 | 59 | 61 | 62 | 64 | 1803 | 2106 |
| Disallow interest on debt allocable to tax-exempt obligations | 15 | 18 | 24 | 30 | 35 | 39 | 43 | 46 | 47 | 48 | 122 | 345 |
| Require capitalization of RIC selling commissions | 23 | 111 | 98 | 83 | 64 | 43 | 24 | 26 | 29 | 32 | 379 | 533 |
| **Cost Recovery** | | | | | | | | | | | | |
| Provide consistent amortization periods for intangibles | -216 | -220 | 34 | 259 | 445 | 464 | 387 | 308 | 222 | 132 | 302 | 1815 |
| Clarify recovery period of utility grading costs | 52 | 65 | 82 | 91 | 99 | 108 | 112 | 108 | 101 | 93 | 389 | 911 |
| Apply section 197 rules to acquisitions of sports franchises | 45 | 73 | 113 | 141 | 139 | 124 | 106 | 88 | 68 | 46 | 511 | 943 |
| **Insurance** | | | | | | | | | | | | |
| Require recapture of policyholder surplus accounts | 65 | 174 | 285 | 522 | 782 | 374 | 23 | 0 | -9 | -13 | 1828 | 2203 |
| Modify rules for capitalizing policy acquisition costs of life insurance companies | 536 | 1820 | 2191 | 2413 | 1328 | 606 | 675 | 722 | 755 | 773 | 8288 | 11819 |
| Increase proration percentage for P&C insurance companies | 48 | 82 | 98 | 115 | 133 | 150 | 169 | 188 | 210 | 232 | 476 | 1425 |
| Modify rules that apply to sales of life insurance contracts | 13 | 35 | 39 | 43 | 48 | 55 | 63 | 72 | 80 | 89 | 178 | 537 |
| Modify qualification rules for section 501(c)(15) status | 12 | 22 | 23 | 24 | 25 | 26 | 26 | 27 | 28 | 28 | 106 | 241 |
| **Exempt Organizations** | | | | | | | | | | | | |
| Subject investment income of trade associations to tax | 180 | 309 | 325 | 341 | 358 | 376 | 395 | 414 | 435 | 457 | 1513 | 3590 |
| Provide sanctions for form 5227 failures | 0 | 24 | 23 | 22 | 21 | 19 | 17 | 15 | 13 | 10 | 90 | 164 |
| **Estate and Gift** | | | | | | | | | | | | |
| Restore phase-out of unified credit for large estates | 33 | 70 | 78 | 83 | 106 | 125 | 139 | 148 | 157 | 166 | 370 | 1105 |
| Require consistent valuation for estate and income tax purposes | 6 | 10 | 14 | 18 | 21 | 23 | 26 | 29 | 32 | 35 | 69 | 214 |
| Require basis allocation for part sale/part gift transactions | 2 | 3 | 4 | 5 | 5 | 6 | 6 | 7 | 8 | 9 | 19 | 55 |
| Conform treatment of surviving spouses in community property states | 22 | 42 | 59 | 75 | 92 | 110 | 130 | 151 | 174 | 199 | 290 | 1054 |
| Include QTIP trust assets in surviving spouses estate | 0 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 8 | 18 |
| Eliminate non-business valuation discounts | 271 | 575 | 600 | 636 | 618 | 621 | 644 | 683 | 725 | 767 | 2700 | 6140 |
| Eliminate gift tax exemption for personal residence trusts | -1 | -1 | 0 | 5 | 14 | 30 | 51 | 75 | 102 | 133 | 17 | 408 |
| Limit use of Crummey powers | 0 | 20 | 20 | 22 | 20 | 21 | 23 | 26 | 27 | 29 | 82 | 208 |
| **Pensions** | | | | | | | | | | | | |
| Increase elective withholding rate for non-periodic distributions from deferred compensation plans | 0 | 47 | 3 | 3 | 3 | 4 | 4 | 4 | 4 | 4 | 56 | 76 |
| Increase section 4973 excise tax for excess IRA contributions | 1 | 12 | 13 | 14 | 14 | 15 | 16 | 17 | 17 | 18 | 54 | 137 |
| Place limitation on pre-funding of welfare benefits | 92 | 156 | 159 | 151 | 150 | 148 | 145 | 132 | 121 | 105 | 708 | 1359 |
| Subject signing bonuses to employment taxes | 5 | 3 | 3 | 3 | 2 | 2 | 2 | 2 | 3 | 3 | 16 | 28 |
| Clarify employment tax treatment of choreworkers | 48 | 64 | 64 | 63 | 63 | 62 | 62 | 61 | 61 | 61 | 302 | 609 |
| Prohibit IRAs from investing in foreign sales corporations | 19 | 29 | 30 | 32 | 33 | 35 | 37 | 39 | 41 | 43 | 143 | 338 |

| 2/7/2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2001-2005 | 2001-2010 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Compliance** | | | | | | | | | | | | |
| Tighten the substantial understatement penalty for large corporations | 26 | 44 | 45 | 41 | 37 | 27 | 28 | 29 | 30 | 31 | 193 | 338 |
| Require withholding on certain gambling winnings | 20 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 24 | 29 |
| Require information reporting for private separate accounts | 5 | 10 | 14 | 18 | 21 | 24 | 28 | 31 | 35 | 39 | 68 | 225 |
| Increase penalties for failure to file correct information returns | 6 | 15 | 15 | 9 | 10 | 10 | 10 | 10 | 10 | 11 | 55 | 106 |
| **Miscellaneous** | | | | | | | | | | | | |
| Modify deposit requirement for FUTA | 0 | 0 | 0 | 0 | 1583 | 79 | 72 | 12 | 53 | 63 | 1583 | 1862 |
| Reinstate Oil Spill Liability Trust Fund taxes | 35 | 258 | 261 | 264 | 266 | 269 | 272 | 274 | 277 | 278 | 1084 | 2454 |
| Repeal percentage depletion for nonfuel minerals on certain Federal lands | 94 | 96 | 97 | 99 | 101 | 103 | 105 | 107 | 109 | 111 | 487 | 1022 |
| Impose excise tax on purchase of structured settlements | 13 | 5 | 2 | 0 | -2 | -3 | -3 | -3 | -4 | -5 | 18 | 0 |
| Require taxpayers to include rental income of residence in income without regard to the period of rental | 4 | 11 | 12 | 12 | 13 | 14 | 14 | 15 | 16 | 17 | 52 | 128 |
| Eliminate installment payment of heavy vehicle use tax | 0 | 378 | 27 | 30 | 32 | 35 | 34 | 37 | 39 | 42 | 467 | 654 |
| Require recognition of gain on principal residence if acquired in a tax-free exchange within five years of the sale | 10 | 13 | 11 | 11 | 11 | 11 | 11 | 12 | 12 | 12 | 56 | 114 |
| **International** | | | | | | | | | | | | |
| Limit benefits from using "Identified Tax Havens" | 36 | 52 | 40 | 36 | 35 | 35 | 33 | 32 | 29 | 27 | 199 | 355 |
| Mark-to-Market proposals | | | | | | | | | | | | |
| Modify treatment of built-in losses and other attribute trafficking | 79 | 136 | 143 | 151 | 161 | 170 | 179 | 189 | 198 | 209 | 670 | 1615 |
| Taxation of property that no longer produces income effectively connected with a U.S. trade or business | | | | | | | | | | | | |
| Prevent avoidance of tax on U.S.-accrued gains (expatriation) | 31 | 58 | 107 | 155 | 212 | 281 | 367 | 469 | 579 | 694 | 563 | 2953 |
| Other International | | | | | | | | | | | | |
| Expand ECI Rules to include certain foreign source income | 22 | 38 | 39 | 41 | 42 | 44 | 45 | 47 | 48 | 50 | 182 | 416 |
| Limit basis step-up for imported pensions | 28 | 33 | 34 | 36 | 38 | 40 | 42 | 44 | 46 | 48 | 169 | 389 |
| Replace sales-source rules | 320 | 570 | 600 | 630 | 660 | 690 | 725 | 800 | 840 | 880 | 2780 | 6715 |
| Modify rules relating to foreign oil and gas extraction income | 5 | 69 | 112 | 118 | 124 | 130 | 136 | 143 | 150 | 158 | 428 | 1145 |
| Recapture overall foreign losses when CFC stock is disposed | 2 | * | * | * | * | * | * | * | * | * | 2 | 2 |
| Modify foreign office material participation exception applicable to inventory sales attributable to nonresident's U.S. office | 8 | 10 | 11 | 11 | 11 | 12 | 12 | 13 | 13 | 14 | 51 | 115 |
| **Total Raisers** | **6088** | **9218** | **9676** | **10694** | **11704** | **9288** | **9274** | **9597** | **9983** | **10342** | **47380** | **95864** |
| **Net Package** | **-48** | **-4166** | **-10057** | **-16574** | **-23453** | **-36564** | **-38556** | **-37885** | **-42055** | **-45119** | **-54298** | **-254477** |

| 2/7/2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2001-2005 | 2001-2010 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Other provisions that affect receipts | | | | | | | | | | | | |
| Reinstate superfund environmental income tax | 725 | 432 | 438 | 434 | 437 | 470 | 494 | 496 | 495 | 508 | 2466 | 4929 |
| Reinstate superfund excise taxes | 859 | 762 | 772 | 785 | 797 | 810 | 824 | 838 | 850 | 864 | 3975 | 8161 |
| Increase excise tax on tobacco products and levy a youth smoking assessment | 4530 | 3738 | 3532 | 10140 | 9700 | 9789 | 9410 | 9233 | 3138 | 3103 | 31640 | 66313 |
| Recover state bank expenses | 78 | 82 | 86 | 90 | 95 | 99 | 104 | 109 | 113 | 119 | 431 | 975 |
| Transfer Federal Reserve surplus to the Treasury | 3752 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 3752 | 3752 |
| Restore premiums to UMWA benefit fund | 11 | 10 | 10 | 9 | 9 | 8 | 8 | 7 | 7 | 7 | 49 | 86 |
| Extend abandoned mine reclamation fees | 0 | 0 | 0 | 0 | 218 | 220 | 221 | 222 | 223 | 224 | 218 | 1328 |
| Replace harbor maintenance tax | -549 | -602 | -647 | -681 | -718 | -767 | -823 | -880 | -934 | -988 | -3197 | -7589 |
| Revise Army Corp of Engineers regulatory program fees | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 25 | 50 |
| Roll back Federal employee retirement contributions | -427 | -619 | -160 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | -1206 | -1206 |
| Provide government-wide buy-out authority | -9 | -18 | -9 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | -36 | -36 |
| **Subtotal, Other provisions that affect receipts** | **9699** | **5189** | **5527** | **12304** | **12065** | **11804** | **11040** | **10415** | **3897** | **3842** | **44784** | **85782** |

Department of the Treasury
Office of Tax Analysis

Note: Certain estimates above are for proposals included in the FY 2001 Budget affecting receipts, but not described in these General Explanations.

1/ Amounts for certain proposals, as noted below, include outlay effects. Estimated FY 2000 Budgetary effects have been added to FY 2001 estimates.
2/ Estimates include outlay effects of refundable credits. Increased outlays are presented as negative receipts effects.
3/ Modifications affecting the estimate were made to this proposal subsequent to the printing of the FY 2001 Budget documents.