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*U* General Explanations  
of the  
Administration's Revenue Proposals

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## **TAX CREDIT FOR DEPENDENT CHILDREN**

### **Current Law**

A tax exemption, in the form of a deduction, is allowed for each taxpayer and for each dependent of a taxpayer. A dependent includes a child of the taxpayer who is supported by the taxpayer and is under age 19 at the close of the calendar year or is a student under age 24. The deduction amount is \$2,500 for tax year 1995. This amount is indexed annually for inflation.

In addition to an exemption for each child, three other tax benefits may accrue to taxpayers with dependent or otherwise qualifying children:

- the credit for child and dependent care expenses,
- the exclusion for employer-provided child and dependent care benefits, and
- the earned income tax credit (EITC).

The EITC is a refundable tax credit based on the earnings of the taxpayer. The EITC is restricted to lower-income taxpayers and is phased out when earnings exceed specified levels. Although the EITC is available for taxpayers without dependents or otherwise qualifying children, the credit rate and income range of the credit are far greater when the taxpayer has one or more qualifying children. In addition, the rate and income range are higher for taxpayers with two or more qualifying children than for taxpayers with only one qualifying child.

### **Reasons for Change**

Tax relief for middle-class families has been and continues to be an important goal of this Administration. In 1993, the Administration faced a projection of ever-increasing deficits. Bringing the deficit under control and providing tax relief for low-income workers through an expansion of the EITC were the first priorities. Having achieved more favorable than projected results from the deficit reduction program introduced in 1993; the Administration can now turn to providing tax relief to middle-income families.

Tax relief to taxpayers with children is needed to adjust the relative tax burdens of smaller and larger families to reflect more accurately their relative abilities to pay taxes. Available resources should be targeted to those in greatest need and at greatest risk.

### **Proposal**

A nonrefundable tax credit would be allowed for each dependent child under age 13. It would be phased in, at \$300 per child for tax years 1996, 1997, and 1998, and \$500 per child for 1999 and thereafter. The credit would not reduce any alternative minimum tax

liability. The credit would be phased out for taxpayers with adjusted gross income between \$60,000 and \$75,000. Beginning in the year 2000, both the amount of the credit and the phase-out range would be indexed for the effects of inflation. The EITC would be applied after the dependent child credit.

Taxpayers claiming the dependent child credit would be required to provide valid taxpayer identification numbers for themselves, their spouses, and their children who qualify for the credit. The procedures that would apply for determining the validity of taxpayer identification numbers under a separate proposal regarding the EITC (discussed below) would apply for purposes of the dependent child credit. This proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

To ensure that the budget reaches balance in 2002, the child credit would be allowed to sunset on January 1, 2001, if the fiscal dividend for the year 2000 is not at least \$20 billion.

## **EDUCATION AND JOB TRAINING TAX DEDUCTION**

### **Current Law**

Taxpayers generally may not deduct the expenses of higher education and training. There are, however, special circumstances in which deductions for educational expenses are allowed, or in which the payment of educational expenses by others is excluded from income.

Educational expenses may be deductible, but, in the case of an employee, only if the taxpayer itemizes, and only to the extent that the expenses, along with other miscellaneous itemized deductions, exceed two percent of adjusted gross income (AGI). A deduction for educational purposes is allowed only if the education maintains or improves a skill required in the individual's employment or other trade or business, or is required by the individual's employer, or by law or regulation for the individual to retain his or her current job.

The interest from qualified U.S. savings bonds is excluded from a taxpayer's gross income to the extent the interest is used to pay qualified educational expenses. To be qualified, the savings bonds must be purchased after December 31, 1989 by a person who has attained age 24. Qualified educational expenses consist of tuition and fees for enrollment of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent at a public or non-profit institution of higher education, including two-year colleges and vocational schools. The interest exclusion is phased out for taxpayers with higher incomes.

### **Reasons for Change**

Deductions for educational expenses combine needed tax relief with preparation for new economic imperatives. The expenses of higher education place a significant burden on many middle-class families. Grants and subsidized loans are available to students from lower-income families; high-income families can afford the costs of higher education.

Well-educated workers are essential to an economy experiencing technological change and facing global competition. The Administration believes that reducing the after-tax cost of education for individuals and families encourages investment in education and training while lowering tax burdens for middle-income taxpayers.

### **Proposal**

A taxpayer would be allowed to deduct qualified educational expenses paid during the taxable year for the education or training of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent. The deduction would be allowed in determining AGI. Therefore, taxpayers could claim the deduction even if they do not itemize and even if they do not meet the two-percent of AGI floor on itemized deductions.

Qualified educational expenses would be defined as tuition and fees charged by educational institutions that are directly related to an eligible student's course of study (*e.g.*, registration fees, laboratory fees, and extra charges for particular courses). Charges and expenses associated with meals, lodging, books, student activities, athletics, health care, transportation, and similar personal, living or family expenses would not be included. The expenses of education involving sports, games, or hobbies would not be qualified educational expenses unless the education is required as part of a degree program or related to the student's current profession.

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

In 1996, 1997, and 1998, the maximum deduction would be \$5,000. In 1999 and thereafter, this maximum would increase to \$10,000. The deduction would be phased out ratably for taxpayers with modified AGI between \$70,000 and \$90,000 (\$100,000 and \$120,000 for joint returns). Modified AGI would include taxable Social Security benefits and amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). Beginning in 2000, the income phase-out range would be indexed for inflation.

Any amount taken into account as a qualified educational expense would be reduced by educational assistance or any other payment made on the student's behalf that is not required to be included in the gross income of either the student or the taxpayer claiming the deduction. Thus, qualified educational expenses would be reduced by scholarship or fellowship grants excludable from gross income under section 117 of the Internal Revenue Code (even if the grants are used to pay expenses other than qualified educational expenses) and any educational assistance received as veterans' benefits. However, no reduction would be required for a gift, bequest, devise or inheritance within the meaning of section 102(a).

An eligible student would be one who is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible institution. The student must pursue a course of study on at least a half-time basis unless the student is enrolled in a course that enables the student to improve or acquire job skills. The student may not be enrolled in an elementary or secondary school, and cannot be a nonresident alien.

An eligible institution generally would be an accredited postsecondary educational institution offering credit toward a bachelor's degree, associate's degree or other recognized postsecondary credential. It could also be a proprietary institution or postsecondary

vocational institution. The institution must have entered into an agreement with the Department of Education to participate in the student loan program.

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 this provision. An eligible student would not be eligible to claim a deduction under this provision if that student could be claimed as a dependent of another taxpayer.

The proposal would be effective for taxable years beginning after 1995. To ensure that the budget reaches balance in 2002, the educational expense deduction would be allowed to sunset on January 1, 2001, if the fiscal dividend for the year 2000 is not at least \$20 billion.

## EXPANDED INDIVIDUAL RETIREMENT ACCOUNTS

### Current Law

Under current law, an individual may make deductible contributions to an individual retirement account or individual retirement annuity (IRA) up to the lesser of \$2,000 or compensation (wages and self-employment income). (The dollar limit is \$2,250 if the individual's spouse has no compensation.) If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the \$2,000 limit on deductible contributions is phased out for couples filing a joint return with adjusted gross income (AGI) between \$40,000 and \$50,000, and for single taxpayers with AGI between \$25,000 and \$35,000. To the extent that an individual is not eligible for deductible IRA contributions, he or she may make nondeductible IRA contributions (up to the contribution limit).

The earnings on IRA account balances are not includable in gross income until they are withdrawn. Withdrawals from an IRA (other than withdrawals of nondeductible contributions) are includable in income, and must begin by age 70½. Amounts withdrawn before age 59½ are generally subject to an additional 10-percent tax. This 10-percent early withdrawal tax does not apply to distributions upon the death or disability of the taxpayer or to substantially equal periodic payments over the life (or life expectancy) of the IRA owner or over the joint lives (or life expectancies) of the IRA owner and his or her beneficiary. In general, an excess distribution tax of 15 percent applies to the extent that an individual receives an aggregate amount of retirement distributions in excess of \$155,000 in any year.

### Reasons for Change

The Administration believes that individuals should be encouraged to save, both in order to provide for long-term needs, such as retirement and education, and in order to sustain a sufficient level of private investment to continue the healthy growth of the economy. Targeted tax policies can provide an important incentive for savings. Under current law, however, savings incentives in the form of deductible IRAs are not available to all middle-income taxpayers. Furthermore, the present-law income thresholds for deductible IRAs and the maximum contribution amount are not indexed for inflation, so that fewer Americans are eligible to make a deductible IRA contribution each year, and the amount of the maximum contribution is declining in real terms over time. The Administration also believes that providing taxpayers with the option of making IRA contributions that are nondeductible but can be withdrawn tax free will provide an alternative savings vehicle that some middle-income taxpayers may find more suitable for their savings needs.

Individuals save for many purposes besides retirement. Broadening the tax incentives for non-retirement saving can help increase the nation's savings rate. IRAs that are flexible enough to meet a variety of essential savings needs, such as first-time home purchases, higher education expenditures, unemployment, and catastrophic medical and nursing home

expenses, should prove to be more attractive to many taxpayers than accounts that are limited to retirement savings.

## **Proposal**

### *Expand Deductible IRAs*

Under the proposal, the income thresholds and phase-out ranges for deductible IRAs would be doubled, in two stages. Beginning in 1996, eligibility would be phased out for couples filing joint returns with AGI between \$70,000 and \$90,000 and for single individuals with AGI between \$45,000 and \$65,000. Beginning in 1999, eligibility would be phased out for couples filing joint returns with AGI between \$80,000 and \$100,000 and for single individuals with AGI between \$50,000 and \$70,000. The income thresholds and the present-law annual contribution limit of \$2,000 would be indexed for inflation. As under current law, any individual who is not an active participant in an employer-sponsored plan and whose spouse is also not an active participant would be eligible for deductible IRAs regardless of income.

Under the proposal, the IRA contribution limit would be coordinated with the current-law limits on elective deferrals under qualified cash or deferred arrangements (section 401(k) plans), tax-sheltered annuities (section 403(b) annuities), and similar plans. The proposal also would provide that the current-law exclusion from the 10-percent early withdrawal tax for IRA withdrawals after an individual reaches age 59½ does not apply in the case of amounts attributable to contributions (excluding rollovers from tax-qualified plans or tax-sheltered annuities) made during the previous five years.

### *Special IRAs*

Each individual eligible for a traditional deductible IRA would have the option of contributing an amount up to the contribution limit either to a deductible IRA or to a new "Special IRA." Contributions to this Special IRA would not be tax deductible, but distributions of the contributions would be tax-free. If the contributions remained in the account for at least five years, distributions of the earnings on the contributions also would be tax-free. Withdrawals of earnings from Special IRAs during the five-year period after contribution would be subject to ordinary income tax. In addition, such withdrawals would be subject to the 10-percent early withdrawal tax unless used for one of the four purposes described below.

The proposal would permit individuals whose AGI for a taxable year does not exceed the upper end of the new income eligibility limits (\$100,000 for couples filing joint returns and \$70,000 for single individuals) to convert balances in deductible IRAs into Special IRAs without being subject to the early withdrawal tax. The amount converted from the deductible IRA to the Special IRA generally would be includable in the individual's income in the year of the conversion. However, if a conversion was made before January 1, 1998, the

converted amount included in the individual's income (and taken into account in applying the 15-percent excess distribution tax) would be spread evenly over four taxable years.

### *Distributions Not Subject to Early Withdrawal Tax*

Amounts withdrawn from deductible IRAs and Special IRAs within the five-year period after contribution would not be subject to the early withdrawal tax, if the taxpayer used the amounts to pay post-secondary education costs, to buy or build a first home, to cover living costs if unemployed, or to pay catastrophic medical expenses (including certain nursing home costs).

Education expenses. The early withdrawal tax would not apply to the extent the amount withdrawn is used to pay qualified higher education expenses of the taxpayer, the taxpayer's spouse, the taxpayer's dependent, or the taxpayer's child or grandchild (even if not a dependent). In general, a withdrawal for qualified higher education expenses would be subject to the same requirements as the deduction for qualified educational expenses (e.g., the expenses are tuition and fees that are charged by educational institutions and are directly related to an eligible student's course of study).

In addition, to further assist taxpayers who are saving to pay these qualified higher education expenses, deductible IRAs and Special IRAs would be expressly permitted to invest in qualified State prepaid tuition program instruments to the extent provided by the Secretary. In general, a qualified State prepaid tuition program instrument is one issued under a program established or maintained by a State, that can be converted into a percentage of tuition expenses for an individual if the funds are used to pay tuition expenses, or can be redeemed for an amount not less than the purchase price (less any reasonable administrative fees), if the funds are not used for education. To the extent a qualified instrument held by an IRA is converted into tuition and fees, the IRA owner will be treated as having received a distribution from the IRA to pay qualified higher education expenses. No inference is intended as to the tax treatment of prepaid tuition programs under current law or for other purposes of the Code.

First-time home purchasers. The early withdrawal tax would not apply to the extent the amount withdrawn is used to pay qualified acquisition, construction, or reconstruction costs with respect to a principal residence of a first-time home buyer who is the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild.

Unemployment. Withdrawals would not be subject to the early withdrawal tax if (1) the individual has separated from employment, (2) the individual has received unemployment compensation for 12 consecutive weeks, and (3) the withdrawal is made during the taxable year in which the unemployment compensation is received or the succeeding taxable year.

Medical care expenses and nursing home costs. The proposal would extend to IRAs the present-law exception to the early withdrawal tax for distributions from qualified plans

and tax-sheltered annuities for certain medical care expenses (deductible medical expenses that are subject to a floor of 7.5 percent of AGI) and would expand the exception for IRAs to allow withdrawal for medical care expenses (in excess of 7.5 percent of AGI) of the taxpayer's child, grandchild, parent or grandparent, whether or not that person otherwise qualifies as the taxpayer's dependent.

In addition, for purposes of the exclusion from the early withdrawal tax for distributions from IRAs, the definition of medical care would include expenses for qualified long-term care services for incapacitated individuals.

The proposal would be effective January 1, 1996. To ensure that the budget reaches balance in 2002, the proposal would be allowed to sunset on January 1, 2001, if the fiscal dividend for the year 2000 is not at least \$20 billion.

## **INCREASE IN SELF-EMPLOYED INDIVIDUALS' DEDUCTION FOR HEALTH INSURANCE COSTS**

### **Current Law**

Under present law, the tax treatment of health insurance expenses depends on whether the taxpayer is an employee and whether the taxpayer is covered under a health plan paid for by his or her employer. An employer's contribution to a plan providing accident or health coverage for the employee (and the employee's spouse and dependents) is excludable from an employee's income. The exclusion is generally available for owners of a business who are also employees.

In the case of self-employed individuals (i.e., sole proprietors or partners in a partnership), a deduction is allowed for 30 percent of the amount paid for health insurance for the self-employed individual and the individual's spouse and dependents. The 30-percent deduction is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse. The amount of the deduction may not exceed the taxpayer's earned income, although health insurance payments in excess of the deductible amount can be taken into account in determining whether the individual is entitled to an itemized deduction for medical expenses.

For purposes of these rules, more than 2-percent shareholders of S corporations are treated the same as self-employed individuals.

Other individuals who purchase their own health insurance (e.g., an individual whose employer does not provide health insurance) can deduct their insurance premiums only to the extent that the premiums, when combined with other unreimbursed medical expenses, exceed 7.5 percent of adjusted gross income.

### **Reasons for Change**

The deduction for health insurance costs of self-employed individuals should be increased to provide greater equity between employees and self-employed individuals and to encourage broader health care coverage.

### **Proposal**

The percentage of a self-employed individual's deduction would increase to 35 percent for 1996 and 1997, 40 percent for 1998, 45 percent for 1999, and 50 percent for 2000 and thereafter. This proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

To ensure that the budget reaches balance in 2002, the deductible percentage would

be allowed to revert to 30 percent after 2000 if the fiscal dividend for the year 2000 is not at least \$20 billion.

## **INCREASED EXPENSING FOR SMALL BUSINESSES**

### **Current Law**

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect under section 179 to deduct up to \$17,500 of the cost of qualifying property placed in service for the taxable year. In general, qualifying property is defined as depreciable tangible property that is purchased for use in the active conduct of a trade or business. The \$17,500 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

### **Reasons for Change**

Increasing the maximum investment that may be expensed for small businesses would provide an incentive for small businesses to increase their investment in capital assets. In addition, the proposal would simplify tax reporting for eligible small businesses.

### **Proposal**

The proposal would increase the amount allowed to be expensed under Code section 179 from \$17,500 to \$25,000. The increase would be phased in as follows:

Taxable year	Maximum expensing
1996	19,000
1997	20,000
1998	21,000
1999	22,000
2000	23,000
2001	24,000
2002 and thereafter	25,000

This proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

The provision is effective for property placed in service in taxable years beginning after December 31, 1995. To ensure that the budget reaches balance in 2002, the expensing level would be allowed to revert to \$17,500 for property placed in service in taxable years

beginning after December 31, 2000, if the fiscal dividend for the year 2000 is not at least \$20 billion.

## **EXPANSION OF ESTATE TAX EXTENSION PROVISIONS FOR CLOSELY HELD BUSINESSES**

### **Current Law**

Estate tax attributable to certain interests in closely held businesses may be paid in installments over up to 14 years (interest only for four years followed by up to ten annual installments of principal and interest). A special four-percent interest rate is provided for the tax deferred on the first \$1 million of value. The regular IRS rate on tax underpayments applies to values over \$1 million. An estate is eligible for the installment payment provision if the value of the business interest included in the estate equals at least 35 percent of the value of the adjusted gross estate. Eligible business interests include those operated as proprietorships, partnerships or corporations, but partnerships and corporations qualify only if they have 15 or fewer owners, or the estate owns 20 percent or more of the value of the entity.

In general, an executor can only take advantage of the installment payment provision if the entity is owned directly by the estate or operates a trade or business. Under a special rule added in 1984, an executor can elect to look through certain non-publicly traded holding companies to determine whether an estate includes an interest in an active business eligible for the installment treatment, but if the election is made, neither the five-year deferral nor the four percent interest rate applies.

A special estate tax lien applies to property on which the tax is deferred during the installment payment period. Interest paid on the deferred estate tax is allowed as a deduction against either the estate tax or the estate's income tax obligation. Claiming the estate tax deduction requires an annual filing of a supplemental estate tax return which is complicated due to iterative computations.

### **Reasons for Change**

The installment payment provisions need to be expanded in order to better address the liquidity problems of estates holding farms and closely held businesses. The \$1 million cap on the four percent interest rate has been in effect since 1976. An increase is necessary in order to adjust for inflation. Furthermore, the annual computations involved in claiming an estate tax deduction for interest paid are complex and result in numerous disputes.

The holding company rule should be expanded to include partnerships so that the choice of entity does not affect the availability of the installment payment plan. Furthermore, the estate should not be forced to forego the benefits of the five-year deferral and lower interest rate simply because of the structure of the business entity.

Some businesses find it difficult to obtain the credit needed for day-to-day operations

when business property is subject to an IRS tax lien.

### **Proposal**

The proposal would increase the cap on the special low interest rate so that it applies to the tax deferred on the first \$2.5 million of value of the closely held business. The 4 percent rate would be reduced to 2 percent, and the rate on values over \$2.5 million would be reduced to 45 percent of the usual IRS rate on tax underpayments. The interest paid on deferred estate tax would not be deductible for estate or income tax purposes.

The proposal also would expand the availability and benefits of the holding company exception to include partnerships that function as holding companies. In addition, an estate using the holding company exception (as modified by this proposal) would also be able to take advantage of the five-year deferral and the 2 percent interest rate, thus providing the same relief to closely held businesses whether owned directly or through holding companies. Finally, the non-readily-tradable stock requirement under the holding company rule would be clarified and expanded to include publicly traded partnerships.

The proposal would authorize the Secretary to accept security arrangements in lieu of the special estate tax lien.

The proposal would be effective for decedents dying after December 31, 1996. However, estates deferring estate tax under current law may make a one-time election to use lower interest rates and forego the interest deduction.

## THE NEST -- A SIMPLE RETIREMENT PLAN FOR SMALL BUSINESS

### Current Law

Under current law, an individual may make deductible contributions to an individual retirement account or individual retirement annuity (IRA) up to the lesser of \$2,000 or compensation (wages and self-employment income). (The dollar limit is \$2,250 if the individual's spouse has no compensation.) If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the \$2,000 limit on deductible contributions is phased out for couples filing a joint return with adjusted gross income (AGI) between \$40,000 and \$50,000, and for single taxpayers with AGI between \$25,000 and \$35,000. To the extent that an individual is not eligible for deductible IRA contributions, he or she may make nondeductible IRA contributions (up to the contribution limit).

The earnings on IRA account balances are not included in income until they are withdrawn. Withdrawals from an IRA (other than withdrawals of nondeductible contributions) are includible in income, and must begin by age 70 1/2. Amounts withdrawn before age 59 1/2 are generally subject to an additional 10 percent tax. The additional tax does not apply to distributions upon the death or disability of the taxpayer or to substantially equal periodic payments over the life (or life expectancy) of the IRA owner or over the joint lives (or life expectancies) of the IRA owner and his or her beneficiary.

Simplified employee pensions (SEPs) and, for employers with 25 or fewer employees, salary reduction SEPs (SARSEPs), are employer-sponsored plans under which employer contributions and, in the case of SARSEPs, employee-elected salary reduction contributions are made to IRAs established by employees. An employer that adopts a SEP must contribute to the SEP for every employee who has attained age 21, has worked for the employer during at least three of the immediately preceding five years, and is paid at least \$400 (for 1996, as adjusted for cost of living) by the employer for the year. Thus, for example, an employer would have to make a SEP contribution for an employee who worked for the employer one hour per year in the preceding three years and worked 40 hours (and earned \$400) in the current year, if the employer was making contributions for any other employee for the year. SEPs do not allow employees to make elective contributions through salary reduction.

SARSEPs allow employees to make elective contributions, but cannot provide for employer matching contributions. SARSEPs are available only to for-profit employers that had 25 or fewer employees at all times during the preceding year. In addition, special eligibility and nondiscrimination rules apply to SARSEPs. If at least 50 percent of the eligible employees do not choose to make elective contributions to a SARSEP in a year, then no employee can make elective contributions. An employer with 25 or fewer employees may fall below the 50 percent threshold (and out of SARSEP eligibility) from year to year.

SARSEPs are subject to the top-heavy rules. A SARSEP is considered top-heavy if

the aggregate accounts of key employees in the plan exceed 60 percent of the aggregate accounts of all employees in the plan. If a SARSEP is top-heavy and any key employee of the employer makes elective contributions of at least 3 percent of pay, then the employer must make minimum contributions of 3 percent of pay for all non-key employees -- even if those non-key employees also make elective contributions of 3 percent of pay.

### **Reasons for Change**

The tax-favored employer retirement plans currently available under the Internal Revenue Code have not been sufficiently successful in attracting small employers. In 1993, for example, only 24 percent of full-time workers in private firms with fewer than 100 employees were covered by employer retirement plans. In contrast, 73 percent of full-time workers in firms with 1,000 or more workers were covered.

The administrative cost and complexity associated with traditional qualified retirement plans often discourage small employers from sponsoring these plans. For employers with few employees, the cost of maintaining the plan may be large relative to the benefits provided to employees. As a result, pension coverage of employees of small employers is significantly lower than the pension coverage of employees of larger employers.

SEPs and SARSEPs, which were designed for small employers, are perceived by many employers as overly complicated and impractical. The nondiscrimination and eligibility rules applicable to SARSEPs make it difficult for an eligible employer to maintain a SARSEP on an ongoing basis. An eligible employer cannot encourage employees to make elective contributions through the incentive of offering to match employee contributions dollar-for-dollar or otherwise.

The inability to offer matching contributions makes it difficult for the employer to satisfy the SARSEP nondiscrimination test. Under this test, elective contributions for any highly compensated employee are limited to 125 percent of the average elective contributions for all nonhighly compensated employees for the year. Thus, highly compensated employees are limited to very low levels of elective contributions unless other employees make significant elective contributions -- which they are less likely to make without the incentive of a matching contribution. Concerns have also been raised that, where SEPs and SARSEPs are used, there may be significant noncompliance with the statutory requirements.

### **Proposal**

The proposal would allow employers with 100 or fewer employees to adopt a new simple retirement plan. The new plan would be known as the National Employee Savings Trust, or "NEST."

The NEST would operate through individual IRA accounts for employees, and would incorporate design-based nondiscrimination safe harbors similar to those the Administration is

proposing for 401(k) plans. Like other IRA accounts, investment in NEST accounts would be directed by each employee. By eliminating or greatly simplifying many of the rules that apply to other qualified retirement plans, including 401(k) plans, the NEST would remove major obstacles that deter many small employers from setting up retirement plans. The current SEP and SARSEP rules would not be eliminated or modified, but would remain in place.

### Funding Through IRAs

Use of IRAs as the funding vehicle. All employee and employer contributions to NESTs would be made to IRAs, and the IRA rules would govern except where otherwise specified.

Initial use of specific financial institution. In order to simplify plan administration for employers, an employer could require that all of its participating employees use a designated financial institution's IRAs as the recipient of NEST contributions -- but only if participants were notified in writing that a participant could move his or her account balance (in a trustee-to-trustee transfer) without charge to another IRA at any time. This notification could be incorporated into the annual disclosure to employees regarding the NEST (described below) or could be provided separately.

### Employer Eligibility

100-employee limit. Any employer, including a tax-exempt organization or governmental entity, would be eligible to make a NEST program available to its employees in a given year if the employer had no more than 100 employees in the prior year. For this purpose, employees would be counted only if they had at least \$5,000 of compensation (as reported on Form W-2) from the employer. The "employer" would be determined on a "controlled group" basis (i.e., aggregating 80 percent affiliates).

Two-year grace period. If an eligible employer established a NEST program and, subsequently, the number of employees grew to exceed 100 (based on the prior year's employment), the employer would continue to be eligible to provide a NEST for the current and subsequent year. After that two-year "grace period," the employer would cease to be eligible unless the employee count again dropped to 100 or fewer (based on the prior year's employment). If an eligible employer ceased to meet the 100-employee test because of an acquisition, disposition or similar transaction, the NEST program could continue only if no significant changes in coverage occurred.

### Employee Eligibility to Participate and Vesting

Two-year eligibility. Each employee who attained age 21 and completed two consecutive years of service with the employer generally would be eligible to participate in the NEST. A "year of service" would be defined as a calendar year during which an

employee's W-2 compensation from the employer was at least \$5,000. An employer could choose to allow all employees to participate earlier than upon attainment of age 21 and completion of two years of service. Nonresident aliens and employees covered under a collective bargaining agreement would not have to be eligible to participate in a NEST.

Participating employees who drop below the \$5,000 threshold or whose employment terminates mid-year. Once an employee became eligible, the employee would be entitled to make elective contributions and receive any employer matching contributions for a year without regard to the employee's compensation during the year. All eligible employees with at least \$5,000 of compensation from the employer for the year would receive a nonelective employer contribution for that year. However, no nonelective employer contributions would be required for eligible employees with less than \$5,000 of compensation for the year, unless the employer chose a lower compensation threshold for all eligible employees.

Portability/100 percent vesting. All contributions would be 100 percent vested immediately and would be fully portable, even during the two-year holding period (described below).

#### No Nondiscrimination Testing

Nondiscrimination tests not applicable. NESTs would not be subject to:

- the top-heavy rules;
- the nondiscrimination rules that apply to elective contributions under a 401(k) plan (the "ADP" test);
- the nondiscrimination rules that apply to matching contributions (the "ACP" test); or
- the nondiscrimination rules that apply to SEPs and SARSEPs. (Thus, for example there would be no 50 percent participation requirement, and no 125 percent test.)

HCE determinations irrelevant. Because NESTs would not be subject to any nondiscrimination tests, an employer that offers a NEST would not be required to determine which employees are "highly compensated employees."

#### Contributions

NESTs would receive nonelective employer contributions and, depending on the option selected by the employer, elective contributions and employer matching contributions.

Design-based safe harbors. In lieu of top-heavy and nondiscrimination rules, every

NEST would be required to choose annually to satisfy one of the following two design-based safe harbors (generally similar to the Administration's proposed 401(k) safe harbors):

- (1) The employer makes a nonelective contribution of at least 3 percent of compensation<sup>1</sup> for each eligible employee. The employer may choose to allow employee elective contributions in addition to the employer nonelective contributions (an employer who wants to combine nonelective contributions with matching contributions may use the second safe harbor.)
- (2) The employer makes a nonelective contribution of at least 1 percent of compensation for each eligible employee and allows employee elective contributions. The employer must provide a 100 percent matching contribution on the employee's elective contributions up to 3 percent of compensation and a matching contribution of at least 50 percent (and no greater than 100 percent) on the next 2 percent of employees' elective contributions. The employer may not provide any other matching formula, including a more generous formula. Although this safe harbor would require a 1 percent nonelective employer contribution, the top-heavy rules would not apply, as noted above. This means that those employers that otherwise would have been required to make a 3 percent top-heavy minimum contribution for each non-key employee would have to make only a 1 percent nonelective contribution. In addition, employers that offer a NEST would be relieved of the requirement to test the NEST for top-heavy status.

Employee elective contributions. The limit on an employee's annual elective contributions (i.e., salary reduction contributions) to a NEST would be \$5,000. (Elective contributions to 401(k) plans are currently limited to \$9,500.) The NEST limit would remain at \$5,000 until the section 402(g) limit exceeded \$10,000; then, the NEST limit would be indexed to (and remain at) one half of the section 402(g) limit for each year.

Nonelective employer contributions. A NEST could provide for discretionary nonelective employer contributions in excess of the safe harbor minimums (1 percent or 3 percent) from year to year. Any such nonelective employer contributions in excess of the 1 percent or 3 percent minimums would have to be an equal percentage of compensation for all eligible employees. Total nonelective contributions (both the safe harbor minimums and discretionary contributions) could not exceed 5 percent of compensation.

Section 404 deduction limit not applicable. The employer would be permitted to

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<sup>1</sup> The \$150,000 compensation limit that applies for purposes of the deduction and contribution limits for qualified plans, SEPs, and SARSEPs would apply for purposes of determining NEST contributions. However, for purposes of the NEST, a simplified definition of compensation would apply -- compensation would be determined *before* elective contributions were subtracted from compensation.

deduct the elective, matching, and nonelective contributions described above (within the contribution limits described) without regard to any separate percent-of-compensation limitation (i.e., there would be no limit comparable to that imposed by section 404(a)(3)).

### Timing of Contributions

Elective contributions. Employee elective contributions would be required to be deposited in employees' accounts by the time required under Title I of ERISA for elective contributions to a 401(k) plan.

Quarterly employer contributions. Employer matching contributions would be required to be deposited in employees' accounts (IRAs) no less frequently than quarterly. Employer nonelective contributions would also be required to be deposited no less frequently than quarterly -- but only for employees who as of the end of the quarter were paid at least \$5,000 (or any lower threshold adopted by the employer) for that calendar year. If an employee did not reach the threshold until the second, third, or fourth calendar quarter, the employer would be required, after the threshold had been reached, to make nonelective contributions for both the current and all preceding calendar quarters in the year. Contributions for any calendar quarter would be required to be deposited within 45 days after the end of that quarter.

### Distributions

Two-year holding period. NEST contributions (and attributable earnings) would be subject to a two-year holding period beginning on the first day of the calendar year for which the contribution was made. This two-year restriction on withdrawals would apply whether or not the participant had incurred a termination of employment.

Otherwise, distributions from NEST IRAs would be subject to the same rules as distributions from IRAs generally (as distinguished from 401(k) or other qualified plans) -- no other restrictions would be imposed. The additional 10 percent tax on premature distributions would apply to distributions before age 59 1/2. During the two-year holding period, contributions and earnings could be rolled over to another IRA -- but the original two-year holding period would continue to apply to the rolled-over amounts in the recipient IRA.

Rollovers. NESTs could originate and receive transfers from other IRAs (whether NESTs, SEPs, SARSEPs, or other IRAs). NESTs could also receive rollovers from qualified plans. All movement of NEST funds to other IRAs, whether or not during the two-year holding period, would be required to be carried out in the form of a trustee-to-trustee transfer. Any amounts rolled over or transferred to a NEST would not be subject to the two-year holding period unless they were amounts transferred from a NEST for which the two-year holding period had not yet elapsed.

## Miscellaneous

SEPs and other plans permitted. An employer that maintains a NEST could also maintain tax-qualified plans or SEPs, other than a plan that allows for elective contributions or matching contributions. For example, if the employer maintained a 401(k), salary reduction or matching 403(b), or SARSEP plan, and wished to establish a NEST, it would have to freeze (but not terminate) the 401(k), 403(b), or SARSEP plan.

If an employer did maintain another plan, compliance of the NEST with the NEST requirements would be determined without regard to the other plan. The other plan would have to take the NEST into account only for purposes of the section 404 deduction limits and the section 415 contribution and benefits limitations. For example, the top-heavy rules and nondiscrimination rules would apply to the other plan without regard to the NEST.

In the case of an employee who works for two employers, one of which sponsors a NEST and the other of which sponsors a 401(k), 403(b), or SARSEP plan, the section 402(g) elective deferral limit for that employee would be coordinated. Elective contributions to the NEST would have to be taken into account in determining whether the \$9,500 limit had been exceeded under the other plan, but any elective contributions made to the other plan would not be taken into account in determining whether the \$5,000 NEST limit had been exceeded.

Coordination with IRA deduction rules. NESTs would be treated as qualified plans for purposes of the IRA deduction phase-out rules. Thus, employees who participated in a NEST would be subject to the phase-out rules for making deductible IRA contributions if they had AGI in excess of the applicable thresholds.

IRS model form. The IRS would be directed to issue a model NEST document, but vendors and employers would have the option of using their own documents.

Application of ERISA fiduciary rules. The proposal would limit a plan sponsor's fiduciary liability. The sponsor would not be subject to fiduciary liability for the designation of the NEST trustee or issuer, or the manner in which the NEST is invested, after the earliest of (1) an affirmative employee election with respect to the initial investment of any contributions, (2) a transfer to another IRA, or (3) one year after the employee's NEST is established, provided that the employee had been properly notified that he or she has a right to transfer the NEST account balance without charge. The assets held in the NEST would cease to be plan assets when transferred to another IRA or otherwise distributed as benefits.

Reporting. An employer maintaining a NEST would not be subject to any reporting requirements (e.g., Form 5500 filing). However, the NEST trustee or issuer would be required to report NEST contributions on Form 5498, on which IRA contributions are reported.

Disclosure. Employees would be required to be notified annually in writing of their

rights under the plan, including, for example, the right to a matching contribution and information from the NEST trustee or issuer. Similarly, if an employer wanted to change its safe harbor formula, the employer would be required to notify eligible employees of the formula that would be used for a year no later than a reasonable time before the employer required employees to make their elections for the year.

Plan suspension. In order to provide flexibility to an employer that faced an unexpected financial hardship, employers would generally be permitted to suspend all NEST contributions (i.e., all elective, matching, and nonelective contributions) at any time during the year after notifying eligible employees in writing at least 30 days before the suspension. Only one suspension would be allowed during any year. The Secretary may prescribe rules to prevent abuse, such as the repeated suspension of a NEST in a manner that prevents seasonal workers from receiving benefits.

Calendar plan year. The calendar year would be the plan year for all NESTs and would have to be used in applying all NEST contribution limits, eligibility, and other NEST requirements.

This proposal would be effective for years beginning after December 31, 1996.

The proposal is similar to a simplified pension plan proposal contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## OTHER PENSION SIMPLIFICATION MEASURES

### A. 401(K) PLANS FOR TAX-EXEMPT ORGANIZATIONS

#### Current Law

Except for certain plans established before July 2, 1986, an organization exempt from income tax is not allowed to maintain a section 401(k) plan. The restriction on tax-exempts, including state and local governments, sponsoring a 401(k) plan does not apply to money purchase pension plans maintained by rural electrical cooperatives or cooperative telephone companies. While a section 401(k) plan can distribute amounts upon hardship or attainment of age 59 1/2, in accordance with the distribution restrictions generally applicable to pension plans, these rural cooperative plans generally cannot allow distributions prior to a participant's separation from service.

#### Reasons for Change

The limitation on maintaining a 401(k) plan prevents many tax-exempt organizations from offering their employees retirement benefits on a salary reduction basis. Although tax-sheltered annuity programs can provide similar benefits, many types of tax-exempt organizations are also precluded from offering those programs.

It is also appropriate to allow a 401(k) plan maintained by a rural cooperative to permit distributions to plan participants under the same circumstances as a 401(k) plan maintained by other employers.

#### Proposal

The proposal would allow organizations exempt from income tax (other than state or local governments) and Indian tribes to maintain a 401(k) plan. This proposal would be effective for plan years beginning after December 31, 1996.

The rules governing distributions from a 401(k) plan of a rural cooperative would be conformed to those that apply to other 401(k) plans by allowing distributions after attainment of age 59 1/2 and upon financial hardships. This proposal would be effective for distributions after date of enactment.

### B. REPEAL FIVE-YEAR AVERAGING FOR LUMP SUM DISTRIBUTIONS

#### Current Law

A distribution that satisfies the many requirements necessary to qualify as a "lump

sum distribution" is eligible for five-year forward averaging. Under this method, the tax that is owed on the lump sum distribution is separately calculated and added to the individual's other income tax for the year. The separate tax is approximately equal to five times the tax that would apply to one-fifth of the distribution, assuming the taxpayer had no other taxable income. Because the tax on the distribution is calculated separately from other income and because the distribution is taxed at the marginal rate that would apply to one-fifth of the distribution, a recipient who receives a large distribution in one taxable year may be able to benefit from a lower marginal tax rate by using five-year forward averaging.

Prior to the Tax Reform Act of 1986 (TRA 1986), lump sum distributions were eligible for 10-year averaging rather than five-year averaging. In addition, the portion of a lump sum distribution attributable to pre-1974 services could be treated as capital gain. These rules may be used currently only if the employee attained age 50 before January 1, 1986.

### **Reasons for Change**

Both the definition of a lump sum distribution and the calculation of tax under the five-year averaging method are complicated. In addition, the problem that five-year averaging addresses (i.e., avoiding the bunching of income in one year, resulting in an unusually high tax rate for that year) can be achieved by rolling over a lump sum distribution to an IRA without tax and taking periodic payments from the IRA over five years or more. In 1992, the availability of tax-free rollovers was expanded and the rules for rollovers were simplified significantly.

### **Proposal**

The five-year averaging rules would be repealed, effective for lump sum distributions after December 31, 1998. However, the provisions of TRA 1986 the rules that apply ten-year averaging and capital gain treatment for employees who attained age 50 before January 1, 1986 would be retained.

## **C. SIMPLIFY TAXATION OF ANNUITY DISTRIBUTIONS**

### **Current Law**

If an employee makes after-tax contributions to a qualified employer retirement plan or IRA, those contributions (i.e., the employee's "basis") are not taxed upon distribution. When the plan distributions are in the form of an annuity, a portion of each payment is considered nontaxable return of basis. This nontaxable portion is determined by multiplying the distribution by an exclusion ratio. The exclusion ratio generally is the employee's total after-tax contributions divided by the total expected payments under the plan over the term of the annuity.

## **Reasons for Change**

The determination of the total expected payments, which is based on the type of annuity being paid, often involves complicated calculations that are difficult for the average plan participant. Because of the difficulty an individual may face in calculating the exclusion ratio, and in applying other special tax rules that may be applicable, the IRS in 1988 provided a simplified alternative method for determining the nontaxable portion of an annuity payment. However, this alternative has effectively added to the existing complexity because taxpayers feel compelled to calculate the nontaxable portion of their payments under every possible method in order to ensure that they maximize the nontaxable portion.

## **Proposal**

A simplified method for determining the nontaxable portion of an annuity payment, similar to the current simplified alternative, would become the required method. Taxpayers would no longer be compelled to do calculations under multiple methods in order to determine the most advantageous approach.

Under the simplified method, the portion of an annuity payment that would be nontaxable is generally equal to the employee's total after-tax employee contributions, divided by the number of anticipated payments listed in a table (based on the employee's age as of the annuity starting date).

The proposal would be effective with respect to annuity starting dates on or after January 1, 1997.

## **D. COMMENCEMENT OF MINIMUM DISTRIBUTIONS BEFORE RETIREMENT**

### **Current Law**

Under current law, an employee who participates in a qualified employer retirement plan must begin taking distributions of his or her benefit by the April 1 following the year in which he or she reaches age 70 1/2. Generally, the so-called "minimum distribution" for any year is determined by dividing the employee's account balance or accrued benefit by the employee's life expectancy.

### **Reasons for Change**

If the employee is still working and accruing new benefits at age 70 1/2, the new benefits must be taken into account to determine the minimum amount required to be distributed for the same year. In effect, a portion of each year's new benefit accrual is required to be distributed in the same year. This pattern of contemporaneous contributions and required distributions causes considerable complication and confusion.

## Proposal

The requirement to distribute benefits before retirement would be eliminated, except for employees who own more than 5 percent of the employer that sponsors the plan. Instead, distributions would have to begin by the April 1 following the *later of* the year in which the employee reaches age 70 1/2 or the year in which the employee retires from service with the employer maintaining the plan. If payment of an employee's benefits were delayed past age 70 1/2 pursuant to this rule, the benefits ultimately paid at retirement would have to be actuarially increased to take into account the delay in payment. Without this increase, the delay in payment could cause the employee to "lose" the benefit payments that would otherwise have been paid between age 70 1/2 and retirement. The actuarial adjustment rule and the 5 percent owner rule would not apply to a governmental plan or a church plan.

The age-70 1/2 requirement would continue to apply to IRAs. Because an IRA is not maintained by an employer, the initial payment date for an IRA cannot be tied to retirement from the employer maintaining the plan. (Note that the proposal also includes a separate item that would change the age-70 1/2 rule to an age-70 rule.)

The proposal would be effective for years beginning after December 31, 1996.

## **E. SIMPLIFY DEFINITION OF HIGHLY COMPENSATED EMPLOYEE AND REPEAL THE FAMILY AGGREGATION RULES**

### Current Law

*Definition of highly compensated employee.* A qualified retirement plan must satisfy various nondiscrimination tests to ensure that it does not discriminate in favor of "highly compensated employees." In order to apply these tests, the employer must identify its "highly compensated employees." This term is currently defined by reference to a test with seven major parts. Under this definition, an employee is treated as a highly compensated employee for the current year, if, at any time during the current year or the preceding year, the employee:

- (1) owned more than 5 percent of the employer,
- (2) received more than \$100,000 (as indexed for 1996) in annual compensation from the employer,
- (3) received more than \$66,000 (as indexed for 1996) in annual compensation from the employer and was one of the top-paid 20 percent of employees during the same year, or

- (4) was an officer of the employer who received compensation greater than \$60,000 (as indexed for 1996).

These four rules are modified by three additional rules.

- (5) An employee described in any of the last three categories for the current year but not the preceding year is treated as a highly compensated employee for the current year only if he or she was among the 100 highest paid employees for that year.
- (6) No more than 50 employees or, if fewer, the greater of three employees or 10 percent of employees are treated as officers.
- (7) If no officer has compensation in excess of \$60,000 (for 1996) for a year, then the highest paid officer of the employer for the year is treated as a highly compensated employee.

*Family aggregation.* If an employee is a family member of either a more-than-5 percent owner of the employer or one of the employer's ten highest-paid highly compensated employees, then any compensation paid to the family member and any contribution or benefit under the plan on behalf of the family member is aggregated with the compensation paid and contributions or benefits on behalf of the highly compensated employee. Therefore, the highly compensated employee and all family members are treated as a single highly compensated employee. For purposes of this rule, an employee's "family member" is generally a spouse, parent, grandparent, child, or grandchild (or the spouse of a parent, grandparent, child, or grandchild).

A similar family aggregation rule applies with respect to the \$150,000 annual limit on the amount of compensation that may be taken into account under a qualified plan. (However, under these provisions, only the highly compensated employee's spouse and children and grandchildren under age 19 are aggregated.)

### **Reasons for Change**

The definition of highly compensated employee is not only complicated, it classifies many middle-income workers as "highly compensated employees" who are then prohibited from receiving higher levels of benefits.

The family aggregation rules greatly complicate the application of the nondiscrimination tests, particularly for family-owned or operated businesses, and may unfairly reduce retirement benefits for the family members who are not highly compensated employees.

## **Proposal**

*Definition of highly compensated employee.* The current seven-part test would be replaced by a simplified two-part test: an employee would be a "highly compensated employee" for the current year only if the employee owned more than 5 percent of the employer during the current or preceding year *or* had compensation from the employer of more than \$80,000 (indexed annually for changes in the cost of living after 1997) during the preceding year. This dollar threshold would mean that many middle-income Americans no longer would be subject to nondiscrimination restrictions.

*Family aggregation.* The family aggregation rules would be repealed.

The proposals would be effective for years beginning after December 31, 1996.

## **F. REPEAL OF MINIMUM PARTICIPATION RULE FOR DEFINED CONTRIBUTION PLANS**

### **Current Law**

Under current law, every qualified defined benefit plan or defined contribution plan is required to cover at least 50 employees or, in smaller companies, 40 percent of all employees of the employer. This rule was intended primarily to prevent an employer from establishing individual defined benefit plans for highly compensated employees in order to provide those employees with more favorable benefits than those provided to lower paid employees under a separate plan. The rule prevents an employer from favoring one small group of participants over another by, for example, covering them under two separate plans and funding one plan better than the other.

### **Reasons for Change**

As applied to defined contribution plans, the minimum participation rule adds complexity for employers without delivering commensurate benefits to the system, given that the nondiscrimination rules also prevent qualified retirement plans from unduly favoring the top-paid group of employees. The abuses intended to be addressed by the minimum participation requirement rarely arise in the context of defined contribution plans. Accordingly, this requirement adds unnecessary administrative burden and complexity with respect to these plans.

### **Proposal**

The minimum participation rule would be repealed for defined contribution plans. In addition, if an employer had only two employees, the rule for defined benefit plans would be modified to require any such plan to cover both employees.

The proposal would be effective for plan years beginning after December 31, 1996.

## **G. SIMPLIFIED NONDISCRIMINATION TESTING FOR 401(K) PLANS**

### **Current Law**

The actual deferral percentage (ADP) test generally applies to the elective contributions (typically 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 plan passes either of the following two tests: (1) the average percentage of elective contributions for highly compensated employees does not exceed 125 percent of the average percentage of elective contributions for nonhighly compensated employees, or (2) the average percentage of elective contributions for highly compensated employees does not exceed 200 percent of the average percentage of elective contributions for nonhighly compensated employees, and does not exceed the percentage for nonhighly compensated employees by more than two percentage points. The actual contribution percentage (ACP) test is almost identical to the ADP test, but generally applies to employer matching contributions and after-tax employee contributions under any qualified employer retirement plan.

Both the ADP test and the ACP test generally compare the average contributions for highly compensated employees for the year to the average contributions for nonhighly compensated employees for the same year.

When the ADP or ACP test is violated, correction is made by reducing the excess contributions of highly compensated employees beginning with employees who have deferred the greatest percentage of pay.

### **Reasons for Change**

The annual application of these tests, and correcting violations of these tests, can be complicated and costly. For example, because the current year average for the nonhighly compensated employees is not known until the end of the year, the tests commonly require either monitoring and adjustments of contributions over the course of the year or complicated correction procedures and information reporting after the end of the year.

The current correction method often does not affect the most highly paid of the highly compensated employees: their contributions, as a percentage of pay, are likely to be lower than the percentage contributions of lower-paid highly compensated employees, even if the dollar amount of their contributions is higher. For example, if an employee makes \$85,000 and contributes \$6,000 (7.05 percent of pay), his or her contribution would be reduced before that of a CEO who makes \$150,000 and contributes \$9,000 (6 percent of pay).

## Proposal

*Design-based safe harbors.* The proposal would provide two alternative "design-based" safe harbors. If a plan were properly designed, the employer would avoid all ADP and ACP testing. Under the first safe harbor, the employer would have to make nonelective contributions of at least 3 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 nonelective contribution of at least 1 percent of compensation for each eligible nonhighly compensated employee, 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.

A more generous matching contribution formula would also be considered to satisfy the matching contribution safe harbor, but only if the level of matching contributions did not increase as employee elective contributions increased and the matching contributions at every level of compensation were at least as great as they would have been under the safe harbor formula. However, for purposes of satisfying the matching contribution safe harbor with respect to the ACP test (but not the ADP test), matching contributions could not be made with respect to employee elective contributions in excess of 6 percent of compensation. The safe harbors could not be used to satisfy the ACP test with respect to after-tax employee contributions, which would be tested separately.

Under both safe harbors, the nonelective employer contributions and the matching employer contributions would be treated in a manner similar to "qualified nonelective contributions", including being nonforfeitable immediately and generally not distributable prior to the participant's death, disability, termination of employment, or attainment of age 59 1/2. In addition, each employee eligible to participate in the plan would have to be given notice of his or her rights and obligations under the plan within a reasonable period before the beginning of any year.

*Simplification for plans that chose not to use the design-based safe harbors.* The proposal would also simplify the nondiscrimination rules for plans that chose not to use the design-based safe harbors. First, the proposal would modify the ADP and ACP tests to provide that, unless an employer made an election to use current year data, the average contributions for highly compensated employees for the current year would be compared to the average contributions for nonhighly compensated employees for the *preceding* year. An election to use current year data could be revoked only as provided by the Secretary. For the first plan year of a 401(k) plan, the average percentage for nonhighly compensated employees would be deemed to be 3 percent or, at the employer's election or (except to the extent provided by the Secretary) in the case of a successor plan, the average percentage for that first plan year. Second, a simplified correction method would require excess contributions to be distributed first to those highly compensated employees who deferred the highest dollar amount (as opposed to the highest percentage of pay) for the year. Under this

approach, the lower-paid highly compensated employees would no longer tend to bear the brunt of the correction method.

The design-based safe harbors would be effective for years beginning after December 31, 1998. The proposal relating to prior-year data and the correction procedures would be effective for years beginning after December 31, 1996.

## **H. SIMPLIFICATION OF RULES RELATING TO MAXIMUM CONTRIBUTIONS AND BENEFITS**

### **Current Law**

Annual additions to a defined contribution plan for any participant are limited to the lesser of \$30,000 (for 1996) or 25 percent of compensation. Annual benefits payable under a defined benefit plan are limited to the lesser of \$120,000 (for 1996) or 100 percent of "three-year-high average compensation." (Reductions in the dollar or percentage limit for defined benefit plans may be required if the employee has fewer than 10 years of plan participation or service.)

An employee who participates in a qualified defined benefit plan and a qualified defined contribution plan of the same employer must also satisfy a combined plan limit. This limit is satisfied if the sum of the "defined benefit fraction" and the "defined contribution fraction" is no greater than 1.0.

The defined benefit fraction measures the portion of the maximum permitted defined benefit that the employee actually uses. The numerator is the projected normal retirement benefit, and the denominator is generally the lesser of 125 percent of the dollar limitation for the year *or* 140 percent of the employee's percent of pay limitation.

The defined contribution fraction measures the portion that the employee actually uses of the maximum permitted contributions to a defined contribution plan for the employee's entire career with the employer. The numerator is generally the total of the contributions and forfeitures allocated to the employee's account for each of the employee's years of service with the employer. The denominator is the sum of a calculated value for each of those years of service. The calculated value is the lesser of 125 percent of the dollar limitation for that year of service, *or* 35 percent of the participant's compensation. Because of the historical nature of this fraction, its computation is extremely cumbersome and requires the retention of various data for an employee's entire career.

The combined plan limit is not the only Code provision that safeguards against an individual accruing excessive retirement benefits on a tax-favored basis. There are maximum limits for both defined benefit and defined contribution plans. In addition, a 15 percent "excess distribution" penalty was enacted in 1986 to achieve many of the same goals as the

combined plan limit. A distribution is generally considered an "excess distribution" to the extent all distributions to an individual from all of the individual's qualified employer plans and IRAs exceed a specified dollar limit (\$155,000 in 1996) during a calendar year. The limit is multiplied by five (i.e., \$775,000 in 1996) for a lump sum distribution. Excess distributions made after death are subject to an additional estate tax of 15 percent. Other rules also protect against tax-favored excessive benefits.

For purposes of the various compensation limits, compensation generally does not include employer contributions (including elective deferrals) made to section 401(k) plans, section 403(b) annuities, section 125 cafeteria plans, and certain other employee benefit plans.

If benefits under a defined benefit plan begin before social security retirement age, the dollar limit must be actuarially reduced to compensate for the earlier commencement. The reduction to the dollar limit for commencement between age 62 and social security retirement age is based on the early commencement factors used for social security. Certain special rules apply to governmental plans. In addition, if benefits are paid in a form other than a straight life annuity (or a joint and survivor annuity), the benefits must be adjusted to an actuarially equivalent straight life annuity prior to comparison with the dollar limitation.

The interest rate that must be used for the actuarial reductions for any commencement prior to age 62, and for purposes of the benefit adjustment, depends on the form of the benefit that is being paid. If the benefit is being paid in an annuity distribution, the interest rate that must be used for both of these adjustments is the greater of 5 percent or the interest rate used for the parallel adjustments under the plan. However, if the benefit is being paid in a nonannuity form (e.g., a single sum distribution), the interest rate that must be used for both of these adjustments is the greater of the interest rate applicable under section 417(e)(3) or the interest rate used for the parallel adjustments under the plan.

### **Reasons for Change**

Because other provisions of the Code, such as the excise tax on excess distributions, go far toward ensuring that an individual cannot accrue excessive retirement benefits on a tax-favored basis, the complexity of the combined plan limit is not justified.

The exclusion of elective deferrals restricts the amount that employees can accrue under a qualified plan. Because the dollar limit is usually the operative limit for a highly compensated employee, and the percent-of-compensation limit is usually the operative limit for nonhighly compensated employees, the exclusion of elective contributions from the definition of compensation is not only complicated, but it primarily limits benefits for nonhighly compensated employees.

The qualified plan limitations are uniquely burdensome for governmental plans, which have long-established benefits structures and practices that may conflict with the limitations.

In addition, some state constitutions may significantly restrict the ability to make the changes needed to conform the plans to these limitations.

These limitations also present 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.

The requirement that the interest rate used for the early commencement actuarial adjustment vary depending on whether or not the benefit is payable in an annuity form adds complexity to the calculation of the maximum benefit limitations that is not justified.

### **Proposal**

*Combined limit.* The combined plan limit (Code section 415(e)) would be repealed. This proposal would be effective for years beginning after December 31, 1998.

*Definition of compensation.* Under the proposal, elective contributions would be considered compensation for purposes of the annual limits on contributions and benefits. This proposal would be effective for years beginning after December 31, 1996.

*Governmental and multiemployer plans.* The rules for governmental plans and multiemployer plans would be modified to eliminate the 100 percent-of-compensation limit (but not the \$120,000 limit) for such plans, and to exempt certain survivor and disability benefits from the adjustments for early commencement and for participation and service of less than 10 years. To the extent that governmental employers have previously made elections that would prevent them from utilizing these simplification provisions, the proposal would allow those employers to revoke their elections. These proposals would be effective for years beginning after December 31, 1996 for multiemployer plans and December 31, 1995 for governmental plans.

*Benefit limits for early retirees.* The actuarial assumptions to be used for adjusting the \$120,000 limit for commencement prior to age 62 would be based on the greater of 5 percent or the interest rate used for this purpose under the plan, without regard to the form of benefit that is being paid. This proposal would be effective as if it were included in the Retirement Protection Act of 1994.

## **I. PLANS MAINTAINED BY SELF-EMPLOYED INDIVIDUALS**

### **Current Law**

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), numerous special rules applied to qualified retirement plans that covered self-employed individuals. Almost all of these special rules were repealed by TEFRA. However, special aggregation rules that do not apply to other qualified retirement plans still apply to qualified plans that cover an "owner-employee" (i.e., a sole proprietor of an unincorporated trade or business or a more-than-10 percent partner of a partnership). These aggregation rules generally require affected plans to be treated as a single plan and affected employers to be treated as a single employer. For example, if an owner-employee controls more than one trade or business, then any qualified plans maintained with respect to those trades or businesses must be treated as a single plan and all employees of those trades or business must be treated as employed by a single employer.

### **Reasons for Change**

The special aggregation rules afford plan participants little, if any, protection because they are largely duplicative of the general aggregation rules that apply to all qualified employer plans, including plans that cover self-employed individuals.

### **Proposal**

The special aggregation rules for qualified plans that cover owner-employees would be repealed. As under current law, these plans would be subject to the general plan aggregation rules that apply to tax-qualified employer retirement plans.

This proposal would be effective for years beginning after December 31, 1996.

## **J. REPEAL OF SLOWER VESTING SCHEDULE FOR MULTIEMPLOYER PLANS**

### **Current Law**

Under the Code and the Employee Retirement Income Security Act of 1974, as amended, (ERISA) the accrued benefits of a collectively bargained employee under a multiemployer retirement plan are not currently required to become nonforfeitable (i.e., "vested") until the employee has completed 10 years of service. If the employee's employment terminates before then, all benefits can be lost. Accrued benefits of all other employees (i.e., employees under all non-multiemployer plans and any noncollectively bargained employees under a multiemployer plan) must vest after five years of service, or after seven years if partial vesting begins after three years.

## **Reasons for Change**

The 10-year vesting schedule for multiemployer plans adds to the complexity of the pension law by providing different vesting schedules for different types of plans and for different people covered by the same plan. In addition, conforming the multiemployer plan vesting rules to the vesting rules for other plans would ensure that workers covered by multiemployer plans would become entitled to pension benefits on the same basis as workers covered by other plans.

## **Proposal**

The special ten-year vesting rule applicable to multiemployer plans under the Code and ERISA would be repealed.

This proposal would be effective for plan years beginning on or after the earlier of (1) the later of January 1, 1997, or the date on which the last of the collective bargaining agreements pursuant to which the plan is maintained terminates, or (2) January 1, 1999, with respect to participants who have at least one hour of service after the effective date.

## **K. UNIFORM RETIREMENT AGE**

### **Current Law**

Several of the statutory requirements for qualified employer plans involve "normal retirement age." Under most of these provisions, normal retirement age can be no later than age 65. However, under certain other provisions, normal retirement is the social security retirement age (currently age 65, but scheduled to increase).

### **Reasons for Change**

Many retirement plans base benefits on social security age in order for the benefits to complement social security. Yet, under current law, the use of social security retirement age (which is not uniform among participants) may cause the plan to fail applicable nondiscrimination tests, since those tests generally require the use of a retirement age that is uniform among participants.

### **Proposal**

Under the proposal, the social security retirement age would be a uniform retirement age for purposes of the nondiscrimination rules. In addition, subsidized early retirement benefits and joint and survivor annuities would not be treated as not being available to employees on the same terms merely because they were based on an employee's social security retirement age.

This proposal would be effective for years beginning after December 31, 1996.

## **L. DISABLED EMPLOYEES**

### **Current Law**

An employer may elect to continue making deductible contributions to a defined contribution plan on behalf of permanently and totally disabled employees who are not highly compensated.

### **Reasons for Change**

Contributions for disabled employees should be encouraged. In addition, contributions should be allowed for highly compensated disabled employees, as well as for nonhighly compensated disabled employees, if the contributions are provided on a nondiscriminatory basis.

### **Proposal**

In order to simplify the rules for permanently and totally disabled workers and to encourage contributions for those disabled workers, an employer would not have to make an election in order to make contributions for disabled employees, and plans would generally be allowed to provide for contributions for disabled highly compensated employees, as well as for disabled nonhighly compensated employees.

This proposal would be effective for years beginning after December 31, 1996.

## **M. DEFERRED COMPENSATION PLANS OF GOVERNMENTS AND TAX-EXEMPT ORGANIZATIONS**

### **Current Law**

The amount of reasonable compensation that may be provided to an employee under a nonqualified deferred compensation arrangement maintained by a for-profit organization generally is not subject to any limitation. Many such employers maintain a nonqualified "excess benefit plan" that provides benefits for certain employees in excess of the limitations on annual contributions and benefits imposed by section 415 of the Code. The nonqualified deferred compensation is not taxable to the employee until it is paid or otherwise made available to the employee to draw upon at any time.

Section 457 sets forth the tax rules applicable to nonqualified deferred compensation provided by a state or local governments or tax-exempt organization. Under section 457, an

employee who elects to defer the receipt of compensation under an "eligible plan" is taxed on the amounts deferred when the amounts are paid or made available. If a plan for the deferral of compensation is not an "eligible plan," the deferred compensation is taxed to the participant in the first taxable year in which the compensation is not subject to a substantial risk of forfeiture, even if the compensation is not paid or otherwise made available to the participant until a later date.

A section 457 plan is not an eligible plan unless, among other requirements, annual deferrals for an employee are limited to the lesser of \$7,500 or 33 1/3 percent of compensation. In contrast to other dollar limitations applicable to employee benefit plans, the \$7,500 limit is not indexed for cost of living. In addition, amounts deferred under an eligible plan may not be made available to a participant before the earlier of the calendar year in which the participant attains age 70 1/2, the participant's separation from service, or an unforeseeable emergency. Benefits under an eligible plan are not considered made available if the participant may elect to receive a lump sum payable after separation from service and within 60 days of the election. However, this exception is available only if the total amount payable to the participant under the plan does not exceed \$3,500 and no additional amounts may be deferred under the plan with respect to the participant.

### **Reasons for Change**

In order to maintain the value of deferrals under an eligible section 457 plan, the dollar limits on deferrals should be indexed in a manner that is consistent with the way other plan dollar limits are indexed. In addition, the existing constructive receipt rules that apply to section 457 plans are unnecessarily restrictive.

An excess benefit plan provides to certain employees -- those whose contributions or benefits are reduced by the section 415 limits -- contributions or benefits that are already provided to other employees under a qualified plan. Even though an excess benefit plan does not provide management employees with disproportionately higher benefits than those provided to lower paid employees, the restrictions of section 457 still apply to such a plan if it is maintained by a state and local government or tax-exempt organization. These employers are therefore at a disadvantage in attempting to provide all employees with proportionate contributions or benefits.

### **Proposal**

The proposal would provide for increases in the \$7,500 limit, based on changes in the cost of living since 1994. The indexed value would be rounded down to the next lower multiple of \$500. The proposal would also permit the in-service distribution of a participant's account if that account did not exceed \$3,500, no amount was deferred under the plan with respect to the participant for two years, and there was no prior distribution under this cash-out rule. In addition, the proposal would allow an additional election to be made with respect to the time distributions must begin under the plan. The amount payable

to a participant under an eligible plan would not be treated as made available merely because the participant could elect to defer commencement of distributions under the plan after amounts could be distributed under the plan but before the actual commencement of benefits. Only one such additional election would be permitted. These proposals would be effective for taxable years beginning after December 31, 1996.

The proposal would exempt excess benefit plans of state and local governments and tax-exempt organizations from section 457. The exemption would not apply to an excess benefit plan that also provided benefits in excess of qualified plan limitations other than the section 415 limits. This proposal generally would be effective for years beginning after December 31, 1996. The provision permitting governments to provide excess benefit plans is effective at an earlier date.

#### **N. TRUST REQUIREMENT FOR DEFERRED COMPENSATION PLANS OF STATE AND LOCAL GOVERNMENTS**

##### **Current Law**

Section 457 sets forth the tax rules applicable to nonqualified deferred compensation provided by a state or local governments or tax-exempt organization. Under section 457, an employee who elects to defer the receipt of compensation under an "eligible plan" is taxed on the amounts deferred when the amounts are paid or made available. If a plan for the deferral of compensation is not an "eligible plan," the deferred compensation is taxed to the participant in the first taxable year in which the compensation is not subject to a substantial risk of forfeiture, even if the compensation is not paid or otherwise made available to the participant until a later date.

Amounts deferred under a section 457 plan, including all property purchased with such amounts and all income attributable to such amounts, must remain solely the property of the employer, subject only to the claims of the employer's general creditors, until made available to the participant or beneficiary. Thus, compensation deferred by employees under a section 457 plan is not protected from the employer's general creditors in the event of the employer's bankruptcy. By contrast, the assets of a qualified cash or deferred arrangement must be held in trust for the exclusive benefit of participants and beneficiaries.

##### **Reasons for Change**

Employers should be encouraged to provide benefits under a qualified retirement plan, but a governmental employer may want to offer a section 457 plan. However, employees of a State and local government could lose all or a portion of their retirement savings in the event that their employer chose to provide benefits through a section 457 plan, which must be an unfunded plan that is subject to the claims of the employer's creditors.

## **Proposal**

Under the proposal, all amounts deferred (including amounts deferred prior to the effective date of the change) under a section 457 plan maintained by a State or local government employer would be required to be held in trust (or in a custodial account or annuity contract) for the exclusive benefit of employees. Consequently, the requirement that amounts deferred under a section 457 plan be subject to the claims of the employer's creditors would be repealed with respect to section 457 plans of a governmental employer. The trust would be provided tax-exempt status and, as under current law, amounts would not be includible in income until paid or made available to the employee.

Other present-law requirements applicable to section 457 plans, including the annual limit on the maximum amount of deferral, would continue to apply. To the extent these requirements, including the trust requirement, were not satisfied, amounts deferred would be includible in the employee's income when there is no substantial risk of forfeiture.

The proposal would not alter the present-law rules applicable to section 457 plans of nongovernmental tax-exempt employers or the rules applicable to nonqualified plans of governmental or nongovernmental employers.

The proposal would be effective for assets and income held under a section 457 plan on the date of enactment, but amounts would not be required to be held in trust until the end of the first calendar quarter beginning after the end of the first regular session (treating a two-year legislative session as two separate one-year sessions) of the State legislature of the State in which the governmental entity maintaining the plan is located that begins after the date of enactment.

## **O. APPLICATION OF ELECTIVE DEFERRAL LIMIT TO 403(B) ANNUITIES**

### **Current Law**

Annual elective deferrals made by an employee under a section 403(b) annuity plan generally are limited to \$9,500. Elective deferrals in excess of this limit may be corrected by distributing the excess deferrals no later than April 15 of the year following the year of deferral. If the excess is not timely corrected, the excess deferrals are includible in the employee's income in the year of deferral and again in the year of distribution. In addition, a 403(b) annuity plan must provide that elective deferrals made under the plan may not exceed the annual limit. Plans that do not comply with this requirement may lose their tax-qualified status.

### **Reasons for Change**

Employees participating in a 403(b) annuity plan should not be adversely affected if

other employees violate the annual limit on elective contributions with respect to their individual contracts or custodial accounts.

### **Proposal**

Under the proposal, each 403(b) annuity contract, not the 403(b) plan, must provide that elective deferrals made under the contract may not exceed the annual limit.

This proposal would be effective for years beginning after December 31, 1996.

## **P. EXCISE TAX AND CIVIL PENALTY ON PROHIBITED TRANSACTIONS**

### **Current Law**

A "prohibited transaction" under section 4975 is generally any transaction between a plan and a person who is considered a "disqualified person" with respect to the plan. Unless exempt by statute or by an individual or class exemption, a prohibited transaction gives rise to an excise tax (imposed on the disqualified person) equal to 5 percent of the amount involved in the transaction. If the transaction is not corrected, an additional 100 percent excise tax may be imposed. ERISA includes a parallel civil penalty for any prohibited transactions involving a plan that is not subject to section 4975 of the Code.

### **Reasons for Change**

It is appropriate to raise the initial 5 percent amounts to discourage prohibited transactions.

### **Proposal**

The proposal would increase the initial excise tax and ERISA penalty from 5 percent to 10 percent, effective for transactions occurring after December 31, 1996.

## **Q. DEFINITION OF LEASED EMPLOYEE**

### **Current Law**

Individuals who are "leased employees" of a service recipient are considered to be employees of that recipient for qualified retirement plan and certain other purposes. A "leased employee" is any person who is not a common-law employee of the recipient and who provides services to the recipient if (1) the services are provided pursuant to an agreement between the recipient and the employer of the service provider, (2) the person has performed the services for the recipient on a substantially full-time basis for at least one

year, and (3) the services are of a type historically performed, in the business field of the recipient, by employees.

### **Reasons for Change**

The historically performed standard produces many unintended and inappropriate results. For example, under this standard, employees and partners of a law firm could be leased employees of a client of the firm if they work a sufficient number of hours for the client, assuming that it is not unusual for employers in the client's business to have in-house counsel.

### **Proposal**

The "historically performed" test would be replaced by a test that considers whether the services performed for the recipient are performed under significant direction or control by the recipient.

This proposal would generally be effective for years beginning after December 31, 1996, but would not apply to relationships that have been previously determined by an IRS ruling not to involve leased employees.

## **R. UNIFORM INFORMATION REPORTING PENALTIES**

### **Current Law**

The penalty structure for failure to provide information reports with respect to pension payments is currently separate and different from the penalty structure that applies to information reporting in other areas. The penalty for failure to file a Form 1099-R report of pension distributions is currently \$25 per day per return, up to a maximum of \$15,000 per year per return. The penalty for failure to file Form 5498 IRA report is currently a flat \$50 per return, with no maximum, regardless of the number of returns.

In contrast, the penalty for failure to file any other information return is generally \$50 per return up to \$250,000 per year, with lower penalties and maximums if the return is filed within specified times. (The penalty is \$15 per return filed late but within 30 days and \$30 per return filed late but on or before August 1.) Lower maximums also apply to persons with gross receipts of no more than \$5 million. The penalty for failure to furnish a payee statement is \$50 per payee statement up to \$100,000 per year. (Under a separate proposal, the general penalty amount would be increased to the greater of \$50 per return or five percent of the total amount required to be reported, unless the aggregate amount reported by the trustee for the calendar year is at least 97 percent of the amount required to be reported.) Separate penalties apply in the case of intentional disregard of the requirement to furnish a payee statement.

## **Reasons for Change**

Conforming the information reporting penalties that apply with respect to pension payments to the general information reporting penalty structure would simplify the overall penalty structure by providing uniformity and would provide more appropriate penalties with respect to pension payments.

## **Proposal**

The penalties for failure to provide information reports with respect to pension payments would be conformed to the general penalty structure. Thus, the penalty for failure to file Form 1099-R would generally be reduced (for any return that was late by more than two days). The penalty for failure to file Form 5498 would generally remain the same as under current law, but would no longer be unlimited. In addition, for both Form 1099-R and Form 5498, the penalties would be reduced if the forms were filed late but within specified times.

The proposal would apply to returns and statements for which the due date (determined without regard to extensions) is after December 31, 1996.

## **S. DEDUCTION AND ACTUARIAL VALUATION RULES FOR MULTIEMPLOYER PLANS**

### **Current Law**

An employer's annual deduction for contributions to a defined benefit plan is generally limited to the amount by which 150 percent of the plan's current liability (or, if less, 100 percent of the plan's accrued liability) exceeds the value of the plan's assets. The 150 percent-of-current-liability limit restricts the extent to which an employer can deduct contributions for benefits that have not yet accrued.

Defined benefit plans are required by the Code and ERISA to have an actuarial valuation no less frequently than annually.

### **Reasons for Change**

An employer has little, if any, incentive to make "excess" contributions to a multiemployer plan. The amount an employer contributes to a multiemployer plan is fixed 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 150 percent limit on deductible contributions 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.

Under the proposal, actuarial valuations would be required under the Code and ERISA no less frequently than every three years for multiemployer plans.

The proposal would be effective for years beginning after December 31, 1996.

## **T. ELIMINATION OF HALF-YEAR REQUIREMENTS**

### **Current Law**

In general, distributions from qualified employer plans and IRAs prior to age 59 1/2 are subject to a 10 percent penalty. In addition, under certain plans (such as section 401(k) plans), distributions before age 59 1/2 are generally prohibited. Minimum distributions from IRAs and qualified employer plans are required to begin after attainment of age 70 1/2. (Note that the proposal also includes a separate item that would eliminate the requirement that distributions from qualified employer plans begin by age 70 1/2 for employees, other than more-than-5 percent owners, who have not yet retired.)

### **Reasons for Change**

Requirements based on half years are not as simple to apply or communicate as requirements based on whole years, and may lead to confusion as to when distributions to IRA and qualified plan participants must commence and when distributions may be subject to penalty. The exact date on which an individual reaches age 59 1/2 or age 70 1/2 may not be readily apparent, whereas an individual's date of birth is obviously known to the individual and is typically included in plan and employer records.

### **Proposal**

To simplify these provisions, all references to age 59 1/2 would be changed to age 59, and all references to age 70 1/2 would be changed to age 70.

The proposal would be effective for years beginning after December 31, 1996.

## **U. PARTIAL TERMINATION RULES FOR MULTIEMPLOYER PLANS**

### **Current Law**

When a qualified retirement plan is terminated, all plan participants are required to become 100 percent vested in their accrued benefits to the extent those benefits are funded. In the case of certain "partial terminations" that are not actual plan terminations (e.g., a large reduction in the work force), all affected employees must become 100 percent vested in their benefits accrued to the date of the termination, to the extent the benefits are funded.

Whether a partial termination has occurred in a particular situation is generally based on the specific facts and circumstances of that situation, including the exclusion from the plan of a group of employees who have previously been covered by the plan, by reason of a plan amendment or severance by the employer. In addition, if a defined benefit plan stops or reduces future benefit accruals under the plan, a partial termination is deemed to occur if, as a result, a potential reversion of plan assets to the employer is created or increased.

### **Reasons for Change**

Over the years, court decisions have left unanswered many key questions as to how to apply the partial termination rules. Accordingly, applying the rules can often be difficult and uncertain, especially for multiemployer plans. For example, multiemployer plans experience frequent fluctuations in participation levels caused by the commencement and completion of projects that involve significant numbers of union members. Many of these terminated participants are soon rehired for another project that resumes their active coverage under the plan. In addition, it is common for participants leaving one multiemployer plan's coverage to maintain service credit under a reciprocal agreement if they move to the coverage of another plan sponsored by the same union. As a result, these participants do not suffer the interruption of their progress along the plan's vesting schedule that ordinarily occurs when an employee stops being covered by a plan. Given these factors, and the related proposal to require multiemployer plans to vest participants after five (instead of the current ten) years of service, the difficulties associated with applying the partial termination rules to multiemployer plans outweigh the benefits.

### **Proposal**

The requirement that affected participants become 100 percent vested in their accrued benefits (to the extent funded) upon the partial termination of a qualified employer retirement plan would be repealed with respect to multiemployer plans.

The proposal would be effective for partial terminations that begin on or after January 1, 1997.

## **V. VETERANS' REEMPLOYMENT RIGHTS**

### **Current Law**

Under the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"), which revised and restated the Federal law protecting veterans' reemployment rights, a returning veteran generally is entitled to the restoration of certain pension, profit sharing and similar benefits that would have accrued but for the employee's absence due to the military service. USERRA generally provides that service in the uniformed services is considered service with the employer for retirement plan benefit accrual purposes. USERRA also provides that the reemployed veteran is entitled to any accrued benefits that are contingent on the making of, or derived from, employee contributions or elective deferrals, but only to the extent the reemployed veteran makes payment to the plan with respect to such contributions or deferrals. No such payment may exceed the amount the reemployed veteran would have been permitted or required to contribute had the person remained continuously employed by the employer throughout the period of uniformed service. USERRA generally became effective with respect to reemployments initiated on or after December 12, 1994. However, retirement plans not in compliance with the relevant provisions of USERRA on the date of its enactment (October 13, 1994) have two years to come into compliance.

Under the Code, annual limits are provided on contributions and benefits under certain retirement plans. For example, the maximum amount of elective deferrals that can be made by an individual pursuant to a qualified cash or deferred arrangement in any taxable year is limited to \$9,500 in 1996. Certain other rules, such as rules relating to nondiscrimination, coverage, minimum participation, and top-heavy plans, might limit the amount that can be contributed to a plan on behalf of an employee. There is no special provision under present law that permits contributions or deferrals to exceed these limits for a reemployed veteran. Violations of these rules can result in plan disqualification. The Code also imposes certain limits on deductible contributions to retirement plans without any special provision for payments made on behalf of a reemployed veteran.

### **Reasons for Change**

Amendments are needed to conform the Code's qualified retirement plan rules with USERRA.

### **Proposal**

The proposal provides special rules in the case of certain contributions ("make-up contributions") with respect to a reemployed veteran that are made pursuant to USERRA, so as to conform the rules contained in the Code with the rights of reemployed veterans under USERRA. The proposal applies to make-up contributions made by an employer or employee to an individual account plan and to make-up contributions made by an employee to a defined benefit plan that provides for employee contributions.

Under the proposal, a make-up contribution is subject to the generally applicable plan contribution limits and the limit on deductible contributions for the year to which the contribution relates, not for the year in which the contribution is made. The proposal also provides that a plan under which a make-up contribution is made will not be treated as failing to meet the qualified plan nondiscrimination, coverage, minimum participation, or top-heavy rules on account of the contribution. In addition, the proposal provides that certain rules that apply to plan loans will not be violated merely because a plan suspends the repayment of a loan during a period of uniformed service.

The proposal would be effective as of December 12, 1994.

## **W. DATE FOR ADOPTION OF PLAN AMENDMENTS**

### **Current Law**

Plan amendments that are made to reflect amendments to the Internal Revenue Code must generally be made by the employer's income tax return due date for the employer's taxable year in which the change in the law occurs.

### **Reasons for Change**

Plan sponsors should be given adequate time to amend plan documents following the enactment of legislation that requires plans to be amended.

### **Proposal**

In order to ensure that plan sponsors have adequate time to amend plan documents for the pension simplification provisions, plan amendments required by these pension simplification provisions would not be required to be made before the end of the first plan year beginning on or after January 1, 1998, if the plan were operated in accordance with the applicable provision and the amendment were retroactive to the effective date of the applicable provision. Governmental employers would have a later date.

## **X. SUBSTANTIAL OWNER RULES RELATING TO PLAN TERMINATIONS**

### **Current Law**

ERISA contains very complicated rules for determining the benefits guaranteed by the Pension Benefit Guaranty Corporation (PBGC) for an individual who owns more than ten percent of a business (a "substantial owner") and who is a participant in the business's terminating plan. These rules were designed to prevent a substantial owner from establishing a plan, underfunding it, and terminating it in order to receive benefits from the PBGC.

Under the rules, the PBGC guarantee with respect to a participant who is not a substantial owner is generally phased in over five years from the date of the plan's adoption or amendment. However, for a substantial owner, the guarantee is generally phased in over 30 years from the date the substantial owner begins participation in the plan. The substantial owner's benefit under each amendment within the 30 years before plan termination is separately phased in. In addition, a substantial owner's guaranteed benefit cannot exceed twice the amount guaranteed under the original plan provisions.

### **Reasons for Change**

The substantial owner phase-in rules are complex and difficult to apply because of the need to obtain plan documents going back up to 30 years. The reduced guarantee for employees with less than a majority ownership interest penalizes employees who may have little, if any, control over plan benefit levels or funding decisions. It also unfairly penalizes substantial owners who granted themselves low benefits when they entered the plan.

### **Proposal**

The same five-year phase-in that currently applies to a participant who is not a substantial owner would apply to a substantial owner with less than a 50 percent ownership interest. For a substantial owner with a 50 percent or more ownership interest (a "majority owner"), the phase-in would depend on the number of years the plan has been in effect, rather than on the number of years the owner has been a participant. Specifically, the guaranteeable plan benefit for a majority owner would be 1/30 for each year the plan has been in effect. (Benefits under plan amendments would not be separately phased in.) Under this approach, the fraction would be the same for each majority owner, eliminating the need for separate computations based on documents that are up to 30 years old. However, a majority owner's guaranteed benefit would be limited so that it could not be more than the amount that would be guaranteed under the regular five-year phase-in applicable to other participants. In addition, the proposal would eliminate the restriction that limits a substantial owner's guaranteed benefit to twice the amount guaranteed under the original plan provisions and would simplify, in certain cases, the allocation of assets with respect to majority owners upon plan termination.

The proposal would be effective for plan terminations for which notices of intent to terminate are provided on or after the date of enactment.

## **Y. ERISA SUMMARY PLAN DESCRIPTION FILING REQUIREMENTS**

### **Current Law**

Under ERISA, administrators of employee pension and welfare benefit plans are required to furnish each participant and beneficiary with a summary plan description (SPD),

summaries of material modifications (SMMs) to the SPD and, at specified intervals, an updated SPD. These documents must also be filed with the Department of Labor (DOL). Filed SPDs, SMMs, and updated SPDs are required to be made available for public disclosure. These requirements are administered by the DOL's Pension and Welfare Benefits Administration (PWBA). The SPD is intended to provide participants and beneficiaries with important information concerning their plan, the benefits provided by the plan, and their rights and obligations under the plan. A penalty of \$100 per day may be imposed for failure to provide an SPD to a participant or beneficiary who has requested it. The \$100 per day penalty only applies if there is a failure to provide the information when requested by a participant.

### **Reasons for Change**

The primary purpose of having SPDs filed with the DOL is to have them available for participants and beneficiaries who are unable or reluctant to request them from their plan administrators. However, because SMMs are not required to be filed with the DOL until 210 days after the end of the plan year, there is little, if any, certainty that the SPD information on file with the DOL at any given point in time is up-to-date.

PWBA annually receives approximately 250,000 SPD and SMM filings. Although PWBA's cost for maintaining a filing, storage, and retrieval system for SPDs is relatively small, approximately \$52,000 annually, compliance with the SPD filing requirements costs plan administrators approximately \$2.5 million annually, with the annual imposition of an estimated 150,000 burden hours. On average, PWBA receives requests annually for about 2 percent of the filed SPDs. Many of the requests for SPDs come from researchers and others who are not plan participants and beneficiaries. While there is some limited benefit from the federal government receiving and storing SPDs, the costs to the public and private plan administrators outweigh the benefits. This conclusion is consistent with the findings of the National Performance Review.

### **Proposal**

The proposal would amend ERISA to eliminate the requirement that all SPDs be filed with the DOL, and would authorize the DOL to obtain SPDs and other relevant documents from plan administrators, e.g., for purposes of responding to individual SPD requests or monitoring compliance with the SPD requirements. If a plan administrator failed to furnish the documents requested by the DOL within 30 days, the administrator would be subject to a civil penalty of no more than \$100 per day (\$1,000 per request), unless the failure was reasonably beyond the administrator's control. The elimination of the SPD filing requirement would substantially reduce costs and burdens for public and private plan administrators, while this approach would preserve the ability of the DOL to assist participants who are unable or reluctant to request SPDs from their plan administrators.

This proposal would be effective for SPDs that otherwise would be required to be

filed with the DOL on or after the date of enactment.

## **Z. PBGC MISSING PARTICIPANT PROGRAM**

### **Current Law**

When a qualified retirement plan is terminated, there may be plan participants who cannot be located. If the plan is a defined benefit plan covered by the PBGC, the plan administrator must generally distribute plan assets by purchasing irrevocable commitments from an insurer to satisfy all benefit liabilities. If the plan is a defined contribution plan or other plan not covered by the PBGC, plan assets still must be distributed to participants before the plan is considered terminated.

Because of the problems that plan administrators and participants may face under these rules when plan participants cannot be located, the Retirement Protection Act of 1994 (RPA) provided special rules for the payment of benefits with respect to missing participants (including benefits for beneficiaries of deceased participants) under a terminating plan covered by the PBGC. The rules require the plan administrator to (1) transfer the missing participant's designated benefit to the PBGC or purchase an annuity from an insurer to satisfy the benefit liability, and (2) provide the PBGC with such information and certifications with respect to the benefits or annuity as the PBGC may specify.

### **Reasons for Change**

As currently enacted, these RPA rules apply only to defined benefit plans that are covered by PBGC. Yet other defined benefit plans, as well as defined contribution plans, face similar problems when they terminate and cannot locate missing participants.

### **Proposal**

The PBGC's program for missing participants would be expanded to apply to defined contribution plans (other than governmental and church plans) and to defined benefit plans of a small professional service employer, if such plans have missing participants when the plans terminate. These plans would be able to transfer the missing participants' benefits to the PBGC. If the benefit of a missing participant is not transferred to the PBGC or to another plan, the plan administrator would give the PBGC information with respect to the missing participant's benefit. This would provide plan administrators an entity (i.e., the PBGC) that would accept missing participants' benefits and would provide missing participants with a central repository for locating their benefits after a plan has been terminated.

This proposal would be effective with respect to distributions that occur after the PBGC has adopted final regulations implementing the provision.

These pension simplification proposals are similar to a package of pension simplification provisions contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **EXPAND EMPOWERMENT ZONES AND ENTERPRISE COMMUNITIES**

### **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 would be designated in a competitive application process. Of the nine empowerment zones, six were to be located in urban areas and three were to be located in rural areas. State and local governments would jointly nominate distressed areas and propose strategic plans to stimulate economic and social revitalization. By the June 30, 1994 application deadline, over 500 communities had submitted applications.

On December 21, 1994, the Secretaries of the Department of Housing and Urban Development and the Department of Agriculture designated the empowerment zones and enterprise communities authorized by Congress in OBRA '93.

Among other benefits, businesses located in empowerment zones are eligible for three federal tax incentives: an employment and training credit; an additional \$20,000 per year of section 179 expensing; and, a new category of tax-exempt private activity bonds. Businesses located in enterprise communities are eligible for the new category of tax-exempt bonds. OBRA '93 also provided that federal grants would be made to designated areas.

### **Reasons for Change**

The Administration believes that the number of authorized empowerment zones should be expanded, subject to budgetary constraints. Extending tax incentives to economically distressed areas will help stimulate revitalization of these areas.

### **Proposal\***

The proposal has three components. First, the designation of two additional urban empowerment zones would be authorized, to be made within 180 days of enactment. The effect of this component would be to extend the current empowerment zone tax incentives to two additional urban areas.

Second, technical changes would be made to the OBRA '93 tax-exempt private activity bond provisions and "enterprise zone business" definition. The purpose of these changes is to allow a broader range of businesses in to borrow the proceeds of the tax-exempt bonds and, in empowerment zones, to qualify for the additional section 179

\* This description of the proposal reflects certain modifications made since the printing of the OMB analytical materials relating to this proposal.

expensing. Unchanged are the requirements that at least 35 percent of the business's employees be zone residents and the bonds be applied against the State volume caps. These changes would be effective for bonds issued after the date of enactment and, with respect to expensing, for taxable years beginning on or after the date of enactment.

Third, the designation of 20 additional empowerment zones and 80 additional enterprise communities would be authorized. Among the 20 zones, 15 would be in urban areas and 5 would be in rural areas or Indian reservations. The 80 communities would be divided between 50 urban areas and 30 rural areas or Indian reservations.

The eligibility criteria for these new zones and communities would be expanded slightly. First, the square mileage limitations would be modified to allow the nominated areas to include an additional 2,000 acres for zones and 1,000 acres for communities. This additional acreage would not be subject to the poverty criteria and could be divided among up to three noncontiguous parcels. In addition, rather than applying the three-tiered poverty rate criteria applicable to the current zones and communities, the new zones and communities would be limited to census tracts that have poverty rates of 25 percent or more (in lieu of the poverty criteria, outmigration may be taken into account in designating a limited number of new rural communities). For this purpose, tracts with populations under 2,000 would be treated as if they had a 25 percent poverty rate if 75 percent or more of the tract was zoned for commercial or industrial use and the tract was contiguous to one or more other tracts that actually had a 25 percent or greater poverty rate.

The additional zones would have available a different combination of tax incentives than those available to existing zones. The current-law wage credit would not be available in the new zones. However, the additional section 179 expensing, as modified above, and the proposal to provide tax incentives for remediation of "brownfields" to zones and communities (described below) would be available in the new zones. In addition, the new zones would qualify for private-activity bonds (with the modifications proposed for the existing zones, described above), subject to separate per-zone caps that would be outside of the current-law State volume caps. Any new zones in rural areas or Indian reservations would be authorized to issue up to \$30 million of bonds, urban zones with populations under 100,000 would be subject to a bond cap of \$140 million, and urban zones with populations of 100,000 or more would be subject to a bond cap of \$240 million.

The additional communities would have available the same tax incentives that apply to the existing communities (including the private-activity bond modifications and "brownfields" tax incentives included in these proposals).

These new zones and communities would be required to be designated before 1998, and the designations would generally be effective for 10 years.

## **CURRENT DEDUCTION FOR CERTAIN ENVIRONMENTAL CLEANUP EXPENSES**

### **Current Law**

Generally, costs incurred for new buildings or for permanent improvements made to increase the value of any property (including amounts incurred to prolong the useful life of property or to adapt property to a new or different use) are not currently deductible, but must be capitalized. This general capitalization requirement covers both purchases and improvements to currently owned assets, but does not apply to repairs (which are generally deductible when incurred with respect to business and investment property).

In a ruling issued in 1994 (Revenue Ruling 94-38), the IRS concluded that certain costs incurred to clean up land and groundwater are currently deductible as business expenses. That ruling only addressed cleanup costs incurred by the same taxpayer that contaminated the land, rather than someone who acquired previously contaminated property. Also, the cleanup was not done in anticipation of putting the land to a new use. Additionally, the ruling concluded that the cost of monitoring equipment with a useful life beyond the year of acquisition had to be capitalized. While this ruling resolved some issues, it is still unsettled whether other remediation costs not addressed in that ruling are currently deductible or must be capitalized.

### **Reasons for Change**

Thousands of sites across the country have been neglected or underutilized because of concerns over potential legal liabilities for pollution and contamination. Many of these areas are located in distressed communities that would derive significant economic benefits if the sites were cleaned up and made available for use.

### **Proposal\***

Certain remediation costs would be currently deductible if incurred with respect to a qualified site. Generally, these expenses would be 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 would not qualify for this treatment except in the unusual circumstance where the demolition is required as part of ongoing remediation. This deduction will apply for alternative minimum tax purposes as well as for regular tax purposes.

\* This description of the proposal reflects certain modifications made since the printing of the OMB analytical materials relating to this proposal.

Qualified sites would be limited to those properties that satisfy use, geographic, and contamination requirements. The use requirement would be satisfied if the property is held by the taxpayer incurring the eligible expenses for use in a trade or business or for the production of income, or the property is of a kind properly included in the inventory of the taxpayer.

The geographic requirement would be satisfied if the property is located in (i) any census tract that has a poverty rate of 20 percent or more, (ii) any other census tract (a) that has a population under 2,000, (b) 75 percent or more of which is zoned for industrial or commercial use, and (c) that is contiguous to one or more census tracts with a poverty rate of 20 percent or more, (iii) an area designated as a federal Empowerment Zone or Enterprise Community, or (iv) an area subject to one of the 40 Environmental Protection Agency (EPA) Brownfields Pilots announced prior to February 1996. Both urban and rural sites may qualify. Superfund National Priority listed sites would be excluded.

The contamination requirement would be satisfied if hazardous substances are present or potentially present on the property. Typically, the property will be an abandoned or underused commercial or industrial property, the expansion or redevelopment of which is complicated by the presence or potential presence of the hazardous substance. Hazardous substances would be defined generally by reference to sections 101(14) and 102 of the Comprehensive Environmental Response Compensation and Liability Act (CERCLA), subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use.

To claim this deduction, the taxpayer must obtain a statement that the site satisfies the geographic and contamination requirements from a State environmental agency designated by the EPA for such purposes. It is anticipated that in States with voluntary cleanup or similar programs, this process will be handled by the State or local agency overseeing that program. With respect to other States, it is anticipated that EPA will provide the necessary statements until appropriate State agencies are designated to take over that task.

This deduction would be subject to recapture under current-law section 1245. Thus, any gain realized on disposition generally would be treated as ordinary income, rather than capital gain, up to the amount of deductions taken with respect to the property. This rule would be limited to deductions claimed under this provision. Environmental cleanup expenses that are deductible under current law would not be subject to this recapture regime.

The proposal would be effective for eligible expenses incurred after the date of enactment. To ensure that the budget reaches balance in 2002, the provision would be allowed to sunset on January 1, 2001, if the fiscal dividend for the year 2000 is not at least \$20 billion.

## **TAX RELIEF FOR CERTAIN ARMED FORCES PERSONNEL**

### **Current Law**

The Internal Revenue Code contains eight sections that provide special tax benefits for members of the Armed Forces serving in Presidentially designated "combat zones." A combat zone is any area which the President designates as an area in which the Armed Forces are or have engaged in combat. These provisions are (i) section 112, which excludes from income the compensation earned by enlisted personnel and warrant officers, and up to \$500 per month of the compensation earned by commissioned officers, during any month in which the individual is engaged in active service in a combat zone or in which the individual is hospitalized (for up to two years) as a result of service in a combat zone, (ii) section 7508(a), which extends a number of federal income tax deadlines while a member of the Armed Forces is serving in a combat zone, is hospitalized as a result of service in a combat zone, or in a missing status, and for at least 180 days thereafter, (iii) section 692, which exempts from federal income tax all income earned during any year in which a member of the Armed Forces serves in a combat zone if the individual dies as a result of such service (in addition, federal income taxes attributable to prior years that are unpaid as of the date of death are not subject to collection), (iv) section 2(a)(3), which allows the surviving spouse of an individual who dies while in missing status an additional period during which the surviving spouse tax rates are applicable, (v) section 2201(a), which provides partial estate tax relief to the estates of individuals who die as a result of service in a combat zone, (vi) section 3401(a), which provides an exemption from federal income tax withholding for all compensation for service in a combat zone, (vii) section 4253(d), which provides an exemption from telecommunications excise taxes for telephone calls by Armed Forces personnel that originate from combat zones, and (viii) section 6013(f), which allows the spouse of a member of the Armed Forces who is in missing status to file a joint return during the entire period in which the area is designated as a combat zone and for two years after the termination of that designation.

### **Reasons for Change**

While the nature of the Operation Joint Endeavor mission is not consistent with a designation of this area as a combat zone, the risk of harm and the arduous nature of that military operation justifies an extension of these special tax provisions to members of the U.S. Armed Forces serving in the operation.

### **Proposal**

The combat zone provisions of current law would be extended to Armed Forces personnel serving in the former republic of Yugoslavia for the period during which members of the Armed Forces are entitled to imminent danger pay for services performed in that area. In addition, support personnel who are performing services outside of the former republic of

Yugoslavia as part of Operation Joint Endeavor and who are deployed away from their permanent duty stations qualify for the extended period of time to file tax returns, pay taxes, etc. The monthly exclusion under section 112 is also increased from \$500 to approximately \$4,100 (determined by reference to the maximum rate of pay for enlisted personnel, including imminent danger pay where applicable). The proposal also includes a technical amendment to section 3401 that would conform income tax withholding rules to the compensation exclusion. The proposal generally would be effective November 21, 1995, except for the change to the withholding rules, which would be effective for payments after the date of enactment.

The proposal is identical to the provisions of HR 2778.

## **DISALLOW INTEREST DEDUCTION FOR CORPORATE-OWNED LIFE INSURANCE (COLI) POLICY LOANS**

### **Current Law**

No federal income tax generally is imposed on a policyholder with respect to the undistributed earnings under a life insurance contract (inside buildup), provided the life insurance contract meets certain requirements (section 7702). Further, an exclusion from Federal income tax is provided for death benefits received under a life insurance contract (section 101(a)). The policyholder may generally borrow with respect to a life insurance contract (other than a modified endowment contract) without affecting these exclusions.

The present law limits the allowance of a deduction for interest paid or accrued on any borrowings with respect to a life insurance, endowment or annuity contract. These limitations include specific disallowance provisions of section 264 and other statutory and judicial rules which may apply to preclude an interest deduction.

One of the section 264 rules disallows any deduction for interest paid or accrued on indebtedness with respect to one or more life insurance contracts covering the life of any individual who is (1) an officer or employee of, or (2) financially interested in, any trade or business carried on by the taxpayer to the extent that the aggregate amount of the indebtedness with respect to contracts covering the individual exceeds \$50,000. This \$50,000 limitation was added by the Tax Reform Act of 1986 and applies to contracts purchased after June 20, 1986.

### **Reasons for Change**

A company that sets up a COLI program typically purchases life insurance contracts on the lives of its employees, in many cases thousands or tens of thousands of employees, including former employees. The company, not the employee's family, receives all or most of the proceeds on the employee's death. The company typically borrows against the cash value of the life insurance contracts at an interest rate just above the rate at which inside buildup is credited under the contract. The interest that the company pays on policy loans is credited under the contract and increases the tax-free inside buildup. If the interest on the policy loans is in fact deductible under present law, the after-tax interest expense is less than the interest income being credited under the policy (the inside build-up). In addition, tax-free death benefits that the company receives on the death of insured employees subsidize the payment of premiums in future years.

Large COLI programs may be viewed as the economic equivalent of a tax-free savings account owned by the company into which it pays itself interest. The taxpayer is indirectly paying interest to itself through an increase in the value of the life insurance contract of which the taxpayer is the beneficiary. A general principle of accurate income

measurement provides that expenses such as interest are not deductible if they are costs of accretions of wealth that are not included in income. For example, interest incurred to purchase or carry tax-exempt bonds is not deductible under section 265 of the Code.

COLI programs represent an attempt to inappropriately use the tax rules to achieve a result that was never contemplated by Congress. When the \$50,000 limit was enacted in 1986, it was not anticipated that it would lead to the purchase of life insurance products covering hundreds and thousands of employees of a business organization in an attempt to maximize the tax arbitrage of deducting interest that is credited, tax-free, to the organizations that own the insurance contract.

A 1990 Treasury Report to Congress found that the increases in COLI programs since 1986 demonstrate that the Congressional intent was not accomplished and further that "borrowing against corporate owned life insurance does not provide family protection, subverts other Congressional limitations on tax-preferred retirement and health plans, and loses revenue." Department of Treasury, Report to The Congress on The Taxation of Life Insurance Company Products, 3 (March 1990).

### **Proposal**

Section 264 would be amended to provide that no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance, endowment or annuity contracts covering any individual who is (1) an officer or employee of, or (2) financially interested in, any trade or business carried on by the taxpayer, regardless of the aggregate amount of debt with respect to policies or contracts covering the individual.

The proposal is not intended to affect (and no inference is intended regarding) the tax treatment of any interest paid or accrued under present law (including whether interest paid or accrued during the phase-in is otherwise deductible); the IRS would not be precluded from challenging COLI plans under current law.

The provision would be effective generally with respect to interest paid or accrued after December 31, 1995. However, subject to the limitations described below, the provision would be phased in by allowing the taxpayer to deduct 50 percent of the otherwise deductible interest incurred during 1996 on debt incurred before September 18, 1995, with respect to a life insurance contract that was in effect on that date and that covers only the individual who was insured under the contract on that date. Only interest that would have been deductible but for this proposal is allowed under this phase-in. In addition, no deduction is allowed under this phase-in with respect to interest on borrowings by a taxpayer with respect to contracts on the lives of more than 20,000 insured individuals (for this purpose, all persons treated as a single employer are treated as one taxpayer). Finally, no deduction is allowed to the extent the rate of interest exceeds the lesser of (1) the borrowing rate specified in the contract as of September 18, 1995, or (2) the Moody's Corporate Bond Yield Average - Monthly Average Corporates for each month the interest is paid or accrued.

Any amount included in income during 1996 or 1997 that is received under a contract described in the proposal on the complete surrender, redemption, or maturity of the contract or in full discharge of the obligation under the contract that is in the nature of a refund of the consideration paid for the contract is includible ratably over the first four taxable years beginning with the taxable year the amount would otherwise have been includible.

The proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **DENY INTEREST DEDUCTION ON CERTAIN DEBT INSTRUMENTS**

### **Current Law**

Whether an instrument qualifies for tax purposes as debt or equity is determined under all the facts and circumstances based on principles developed in case law. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid. If an instrument qualifies as debt, the issuer may receive a deduction for accrued interest and the holder generally includes interest in income, subject to certain limitations.

Original issue discount ("OID") on a debt instrument is the excess of the stated redemption price at maturity over the issue price of the instrument. An issuer of a debt instrument with OID generally accrues and deducts the discount as interest over the life of the instrument even though interest may not be paid until the instrument matures. The holder of such a debt instrument also generally includes the OID in income on an accrual basis.

Section 385(c) provides rules for when an issuer's characterization of an interest in a corporation shall be binding on the issuer and the holders.

### **Reasons for Change**

The line between debt and equity is uncertain, and it has proven difficult to formulate general rules to classify an instrument as debt or equity for all purposes or to bifurcate an instrument into its debt and equity components. While the IRS has taken the position that some purportedly debt instruments with substantial equity features should be treated as equity, other instruments have not been specifically addressed. Taxpayers have exploited this lack of guidance by, among other things, issuing instruments that have substantial equity features (including many non-tax benefits of equity), but as to which they claim interest deductions. In many cases, these instruments have been issued in exchange for outstanding preferred stock.

### **Proposal**

Under the proposal no deduction would be allowed for interest or OID on an instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that (i) has a maximum weighted average maturity of more than 40 years, or (ii) is payable in stock of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including an instrument a substantial portion of which is mandatorily convertible or convertible at the issuer's option into the stock of the issuer or a related party. In addition, an instrument would be treated as payable in stock if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of stock of the issuer or related party. An instrument

would also be treated as payable in stock if it is part of an arrangement designed to result in the payment of the instrument with such stock, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised. The proposal would not affect typical convertible debt.

For purposes of determining the weighted average maturity of an instrument or the term of an instrument, any right to extend, renew, or relend would be treated as exercised, and any right to accelerate payment would be ignored.

The proposal would also clarify that for purposes of section 385(c), an issuer will be treated as having characterized an instrument as equity if the instrument (i) has a maximum term of more than 20 years, and (ii) is not shown as indebtedness on the separate balance sheet of the issuer. For this purpose, in the case of an instrument with a maximum term of more than 20 years issued to a related party (other than a corporation) that is eliminated in the consolidated balance sheet that includes the issuer and holder, the issuer will be treated as having characterized the instrument as equity if the holder or some other related party issues a related instrument that is not shown as indebtedness on the consolidated balance sheet. For this purpose, an instrument would not be treated as shown as indebtedness on a balance sheet because it is described as such in footnotes or other narrative disclosures. This proposal would apply only to corporations that file annual financial statements with the Securities and Exchange Commission (SEC), and the relevant balance sheet is the balance sheet filed with the SEC. In addition, this proposal would not apply to leveraged leases.

The proposal generally would not apply to demand loans, redeemable ground rents or any other indebtedness specified by regulation.

The proposal is not intended to affect the tax characterization of instruments described in this proposal as debt or equity under current law.

The proposal would be effective generally for instruments issued on or after December 7, 1995. The proposal would not, however, apply to instruments issued under a commitment that was binding as of December 6, 1995, and until the instrument is issued; instruments issued pursuant to any exchange offer outstanding on December 6, 1995; instruments that were priced for purposes of issuance on or before December 6, 1995; instruments issued pursuant to a registration statement filed with the SEC on or before December 7, 1995, (other than a statement that contemplates a delayed or continuous offering of instruments) to the extent the instruments are described in, and the aggregate amount of the instruments does not exceed the amount stated in, the registration statement; instruments issued pursuant to a registration statement that contemplates delayed or continuous offering filed with the SEC on or before December 7, 1995, to the extent the instruments are described in, and the aggregate amount of the instruments does not exceed the amount stated in, a prospectus supplement (including a preliminary prospectus

supplement) filed on or before December 7, 1995, or, if the preliminary prospectus does not state a maximum amount to be issued, the aggregate amount expected to be offered as established by contemporaneous, written evidence; instruments issued pursuant to a private placement under SEC rule 144A if on or before December 7, 1995, the issuer had made a public announcement of its intention to issue the instruments and an offering circular or memorandum (including a preliminary offering circular or memorandum) had been distributed to prospective investors, but only to the extent the instruments were described in, and the aggregate amount of the instruments does not exceed the amount stated in, the offering circular or memorandum; and any instruments issued before the 30th day after the enactment of this proposal as part of an issue that is substantially identical (other than yield) to an issue which was publicly announced as having been sold on December 7, 1995, but which was terminated on or after such date.

## **DEFER DEDUCTION FOR ACCRUED BUT UNPAID INTEREST ON CONVERTIBLE DEBT**

### **Current Law**

If a financial instrument qualifies as debt, the issuer of the instrument may receive a deduction for accrued interest and the holder generally includes interest in income. Original issue discount ("OID") is the excess of the stated redemption price at maturity over the issue price of a debt instrument. An issuer of a debt instrument with OID generally accrues and deducts the discount as interest over the life of the instrument even though interest may not be paid until the instrument matures. The holder of such a debt instrument also generally includes the OID in income on an accrual basis.

If a debt obligation is convertible into stock and provides no payment of, or adjustment for, accrued interest on conversion, no deduction is allowed for accrued but unpaid stated interest.

In contrast to the rules that apply to convertible debt instruments with stated interest, accrued but unpaid discount on a convertible debt instrument with OID generally is deductible, even if the instrument is converted before the issuer pays any OID.

### **Reasons for Change**

In many cases, the issuance of convertible debt with OID is viewed by market participants as a de facto purchase of equity. OID and accrued interest on convertible debt should be treated in the same manner.

### **Proposal**

The proposal would defer the deduction for OID and interest on convertible debt until payment. Conversion into the stock of the issuer or a related party (within the meaning of sections 267(b) and 707(b)) would not be treated as a payment of accrued OID. Payments in equity of the issuer or a related person, and payments in cash the amount of which is determined by reference to the value of such equity would also be disregarded for this purpose. For purposes of this proposal, convertible debt would include debt (i) exchangeable for the stock of a party related to the issuer, (ii) with cash-settlement conversion features, or (iii) issued with warrants (or similar instruments) as part of an investment unit in which the debt instrument may be used to satisfy the exercise price for the warrant. This proposal would not apply to any debt that would be convertible solely because a fixed payment of principal or interest is payable, at the election of the holder, in an amount of the issuer or related party's equity that has a value equal to the amount of the principal or interest. The proposal would not affect the treatment of holders.

The proposal would be effective generally for convertible debt issued on or after December 7, 1995. The proposal would not, however, apply to instruments issued under a commitment that was binding as of December 6, 1995, and until the instrument is issued; instruments issued pursuant to any exchange offer outstanding on December 6, 1995; instruments that were priced for purposes of issuance on or before December 6, 1995; instruments issued pursuant to a registration statement filed with the SEC on or before December 7, 1995, (other than a statement that contemplates a delayed or continuous offering of instruments) to the extent the instruments are described in, and the aggregate amount of the instruments does not exceed the amount stated in, the registration statement; instruments issued pursuant to a registration statement that contemplates delayed or continuous offering filed with the SEC on or before December 7, 1995, to the extent the instruments are described in, and the aggregate amount of the instruments does not exceed the amount stated in, a prospectus supplement (including a preliminary prospectus supplement) filed on or before December 7, 1995, or, if the preliminary prospectus does not state a maximum amount to be issued, the aggregate amount expected to be offered as established by contemporaneous, written evidence; instruments issued pursuant to a private placement under SEC rule 144A if on or before December 7, 1995, the issuer had made a public announcement of its intention to issue the instruments and an offering circular or memorandum (including a preliminary offering circular or memorandum) had been distributed to prospective investors, but only to the extent the instruments were described in, and the aggregate amount of the instruments does not exceed the amount stated in, the offering circular or memorandum; and any instruments issued before the 30th day after the enactment of this proposal as part of an issue that is substantially identical (other than yield) to an issue that was publicly announced as having been sold on December 7, 1995, but that was subsequently cancelled.

## **REDUCE DIVIDENDS-RECEIVED DEDUCTION TO 50 PERCENT**

### **Current Law**

If an instrument issued by a U.S. corporation is classified for tax purposes as equity, a corporate holder of that instrument generally is entitled to a deduction for dividends received on that instrument. This deduction is 70 percent of dividends received if the recipient owns less than 20 percent (by vote and value) of the stock of the payor. If the recipient owns more than 20 percent of the stock the deduction is increased to 80 percent. If the recipient owns more than 80 percent of the payor's stock, the deduction is further increased to 100 percent for qualifying dividends.

### **Reasons for Change**

The 70-percent dividends-received deduction is too generous for corporations that cannot be considered an alter ego of the distributing corporation because they do not have a sufficient ownership interest in that corporation.

### **Proposal**

Under the proposal, the dividends-received deduction available to corporations owning less than 20 percent (by vote and value) of the stock of a U.S. corporation would be reduced to 50 percent of the dividends received. The proposal would be effective for dividends paid or accrued more than 30 days after the date of enactment.

## **MODIFY HOLDING PERIOD FOR DIVIDENDS-RECEIVED DEDUCTION**

### **Current Law**

If an instrument issued by a U.S. corporation is classified for tax purposes as equity, a corporate holder of that instrument generally is entitled to a deduction for dividends received on that instrument. This deduction is 70 percent of dividends received if the recipient owns less than 20 percent (by vote and value) of the stock of the payor. If the recipient owns more than 20 percent of the stock the deduction is increased to 80 percent. If the recipient owns more than 80 percent of the payor's stock, the deduction is further increased to 100 percent for qualifying dividends.

The dividends-received deduction is allowed to a corporate shareholder only if the shareholder satisfies a 46-day holding period for the dividend-paying stock (or a 91-day period for certain dividends on preferred stock). The 46- or 91-day holding period generally does not include any time in which the shareholder is protected from the risk of loss otherwise inherent in the ownership of an equity interest.

### **Reasons for Change**

No deduction for a distribution on stock should be allowed when the owner of stock does not bear the risk of loss otherwise inherent in the ownership of an equity interest at a time proximate to the time the distribution is made.

### **Proposal**

The proposal would provide that a taxpayer is not entitled to a dividends-received deduction if the taxpayer's holding period for the dividend-paying stock is not satisfied over a period immediately before or immediately after the taxpayer becomes entitled to receive the dividend. The proposal would be effective for dividends paid or accrued more than 30 days after the date of enactment.

## **EXTEND PRO RATA DISALLOWANCE OF TAX-EXEMPT INTEREST EXPENSE TO ALL CORPORATIONS**

### **Current Law**

No income tax deduction is allowed for interest on debt used directly or indirectly to acquire or hold investments the income on which is tax-exempt. The determination of whether debt is used to acquire or hold tax-exempt investments differs depending on the holder of the instrument. For financial institutions and dealers in tax-exempt investments, debt generally is treated as financing all of the taxpayer's assets proportionately. For corporations, other than financial institutions and dealers, 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. One court has applied the tracing rule across members of the same consolidated group, but no statutory related-party rule specifically applies.

### **Reasons for Change**

The current rules applicable to corporations other than financial institutions and dealers in tax-exempt investments permit those corporations to reduce their tax liabilities inappropriately through double Federal tax benefits of interest expense deductions and tax-exempt interest income. The treatment of financial institutions and dealers therefore should be applicable to all corporations, without regard to the type of business activity the corporation conducts. This approach recognizes that money is fungible, and that, therefore, borrowing for one purpose frees the taxpayer's remaining assets for other purposes.

### **Proposal**

Under the proposal, all corporations would be treated the same as financial institutions are treated under current law (without regard to the small issuer exception of section 265(b)(3)). Thus, corporations investing in tax-exempt obligations would be disallowed deductions for a portion of their interest expense equal to the portion of their total assets that is comprised of tax-exempt investments. The rule would not apply to certain nonsaleable tax-exempt bonds acquired by a corporation in the ordinary course of business in payment for goods or services sold to a State or local government. Under the proposal, insurance companies would not be subject to the pro rata rule.

In addition, the proposal would apply section 265 to all related parties within the meaning of section 267(f) (with appropriate adjustments to reflect any inter-company arrangements.) For members of the same consolidated group, the pro rata rule would apply as if the group were a single entity, except that any member that is an insurance company would be excluded. For related parties that are not members of the same consolidated group,

the current tracing rules would apply treating all the related parties as a single entity for purposes of this tracing rule.

The proposal is not intended to affect the application of section 265 to related parties under current law.

The proposal would be effective for taxable years beginning after the date of enactment with respect to obligations acquired after December 7, 1995.

## REQUIRE AVERAGE COST BASIS FOR SECURITIES

### Current Law

Under current law, a taxpayer who sells stock or other securities is allowed to account for the transaction any one of a number of ways: by specifically identifying the stock or securities sold or by using an accounting system such as first-in-first-out or last-in-first-out. Holders of mutual funds are also permitted to account for sales using an average cost basis for their shares.

### Reasons for Change

Allowing taxpayers to account for gains or losses on the sale of fungible assets through specific identification is artificial and complex. For example, allowing taxpayers to specifically identify which shares of stock are treated as sold permits taxpayers to plan and control the amount of gain or loss they will recognize. Income is more clearly reflected if gain or loss is measured by the amount of gain or loss with respect to all substantially identical assets.

### Proposal

Taxpayers generally would be required to determine their basis in substantially identical securities using the average of all of their holdings in the securities. Thus, for example, if a taxpayer holds 100 shares of stock in Corporation A, 50 of which were purchased for \$50 and 50 of which were purchased for \$100, the taxpayer's total basis in each share will be \$75. For purposes of determining whether gain or loss on the sale of securities is short- or long-term, and any other time it is relevant, a taxpayer generally would be treated as selling or disposing of substantially identical securities on a first-in, first-out basis.

This method of determining basis and holding period would apply to securities as that term is defined by section 475(c)(2), other than subparagraph (F) thereof. Thus, average cost basis would be required for stock, debt instruments, options, certain futures contracts, and certain other derivative financial instruments (not including those based on commodities). The average cost basis rules generally would not apply to contractual financial products, such as over-the-counter options, notional principal contracts or forward contracts, because taxpayers are unlikely to have multiple fungible contractual financial products of these types that were purchased or entered into at different prices.

A special rule would allow the Treasury to treat securities that are substantially identical as not subject to the average cost basis rule if they have a special status under a provision of the Code. For example, the Treasury would be permitted to treat shares of the same stock as not substantially identical if some are contributed to a partnership with built-in

gain (and are therefore subject to section 704(c)) and others are purchased by the partnership (and, therefore, are not subject to section 704(c)). Securities not having an average cost basis under this regulatory authority would still be subject to the ordering rule for substantially identical securities (i.e., first-in, first-out) and would not be subject to specific identification.

This proposal would, by itself, eliminate taxpayers' ability to avoid immediate recognition of gain through short sales against the box transactions (even in the absence of the constructive sale proposal, described below.) This is because this proposal would govern the basis and holding period of all securities sold, and taxpayers would no longer be able to specifically identify borrowed securities as the ones delivered on a sale. For example, assume a taxpayer owns 20 shares of stock with an average cost basis of \$20, and borrows 10 shares of the stock immediately prior to selling 10 shares. The taxpayer would have a \$20 tax basis in each of the shares sold, and would determine the shares sold using the first-in first-out method. The 10 shares the taxpayer is obligated to deliver under the borrowing would have no effect on the taxpayer's calculation of its average basis.

The proposal would be effective 30 days after the date of enactment.

## **REQUIRE RECOGNITION OF GAIN ON CERTAIN APPRECIATED POSITIONS IN PERSONAL PROPERTY**

### **Current Law**

Under current law gain and loss are generally taken into account for tax purposes when realized. Gain or loss is usually realized with respect to a capital asset at the time the asset is sold, exchanged or otherwise disposed of. Special rules under the Code can defer recognition of loss until after realization, and occasionally can accelerate recognition of gain.

The recognition of gain or loss is postponed for open transactions. For example, in the case of a "short sale" (i.e., when a taxpayer sells borrowed property such as stock and closes the sale by returning identical property to the lender) no gain or loss on the transaction is recognized until the closing of the borrowing.

Transactions designed to reduce or eliminate risk of loss on financial assets generally do not cause realization. For example, taxpayers may lock in gain on securities by entering into a "short sale against the box," i.e., when the taxpayer owns securities that are the same as, or substantially identical to, the securities borrowed and sold short. Pursuant to rules that allow specific identification of securities delivered on a sale, the taxpayer can obtain open transaction treatment by identifying the borrowed securities as the securities delivered. When it is time to close out the borrowing, the taxpayer can choose to deliver either the securities held or newly purchased securities. The Code provides rules only to prevent taxpayers from using short sales against the box to accelerate loss or to convert short-term capital gain into long-term capital gain or long-term capital loss into short-term capital loss.

Taxpayers can also lock in gain on certain property by entering into straddles without recognizing gain for tax purposes. A straddle consists of offsetting positions with respect to personal property. A taxpayer can take losses on positions in straddles into account only to the extent the losses exceed the unrecognized gain in the other positions in the straddle. In addition, rules similar to the short sale rules prevent taxpayers from changing the tax character of gains and losses recognized on straddles.

The Code accelerates the recognition of gains and losses in certain cases. For example, taxpayers are required each year to mark to market certain regulated futures contracts, foreign currency contracts, non-equity options, and dealer equity options, and to take any capital gain or loss thereon into account as 40 percent short-term and 60 percent long-term. Securities dealers are also required to mark their securities to market.

### **Reasons for Change**

It is inappropriate for taxpayers to be able to dispose of the economic risks and rewards of owning appreciated property without realizing income for tax purposes. For

example, in a short sale against the box the taxpayer has no risk of loss and no opportunity for gain on the stock sold short, but for tax purposes is not treated as having disposed of the stock.

Recent innovations in the financial markets, such as swaps, have increased taxpayers' ability to tailor investments to lock-in gain without gain realization. It is possible now for a taxpayer with appreciated property to swap the returns on the property for the returns on almost any other property, without recognizing built-in gain for tax purposes. Thus, investors with sufficient capital or access to modern financial transactions seek to avoid recognizing gain indefinitely.

### **Proposal**

The proposal would require a taxpayer to recognize gain (but not loss) upon entering into a constructive sale of any appreciated position in either stock, a debt instrument, or a partnership interest. A taxpayer would be treated as making a constructive sale of an appreciated position when the taxpayer (or, in certain limited circumstances, a person related to the taxpayer) substantially eliminates risk of loss and opportunity for gain by entering into one or more positions with respect to the same or substantially identical property. For example, a taxpayer that holds appreciated stock and enters into a short position with respect to that stock or an equity swap with regard to the stock would recognize any gain on the stock. Similarly, a taxpayer that holds appreciated stock and grants a call option or enters into a put option on the stock would generally recognize gain on the stock if there is a substantial certainty that the option will be exercised. In addition, a taxpayer would recognize gain on an appreciated position in stock, debt or partnership interests if the taxpayer enters into a transaction that is marketed or sold as substantially eliminating the risk of loss and opportunity for gain, regardless of whether the transaction involves the same or substantially identical property.

The taxpayer would recognize gain in a constructive sale as if the position were sold and immediately repurchased. An appropriate adjustment (such as an increase in the basis of the position) would be made for gain recognized on the constructive sale, and a new holding period would begin as if the taxpayer had acquired the position on the date of the constructive sale.

If the taxpayer makes a constructive sale of less than all of his or her appreciated positions in a particular property, the proposal would trigger gain recognition in the order the positions were acquired or entered into. If the taxpayer actually disposed of a position previously constructively sold, the offsetting positions creating the constructive sale still held by the taxpayer would be treated as causing a new constructive sale of appreciated positions in substantially identical property, if any, the taxpayer holds at that time.

The proposal would not apply to any contract for the sale of any stock, debt instrument or partnership interest that is not a marketable security (as defined under the rules

that apply to installment sales) if the sale is reasonably expected to occur within one year of the date the contract is entered into. In addition, the proposal would not treat a transaction as a constructive sale if the taxpayer is required to mark to market the appreciated financial position under section 475 (mark to market for securities dealers) or section 1256 (mark to market for futures contracts, options and currency contracts).

The proposal would be effective for constructive sales entered into after the date of enactment. In addition, the proposal would apply to constructive sales entered into after January 12, 1996, and before the date of enactment if the transaction resulting in the constructive sale remains open 30 days after the date of enactment. The proposal would apply to those pre-enactment transactions as if the constructive sales occurred on the date that is 30 days after the date of enactment.

A special rule would be included for constructive sales entered into on or before the date of enactment by decedents dying after the date of enactment. If the constructive sale remains open on the day before the date of death and gain has not been recognized under this provision, the appreciated financial position would be treated as property constituting rights to receive income in respect of a decedent under section 691.

## **ELIMINATE THE EXTINGUISHMENT DOCTRINE**

### **Current Law**

Tax law distinguishes between a sale of a right or obligation to a third party and the extinguishment or retirement of the right or obligation. A sale to a third party can give rise to capital treatment whereas an extinguishment will be ordinary.

Extinguishment treatment has been eliminated statutorily for all debt instruments except those issued by natural persons and for most options and other positions in actively traded property. The application of extinguishment doctrine in other contexts is unclear.

### **Reasons for Change**

The distinction between sale and extinguishment allows taxpayers to choose whether they want capital or ordinary treatment for transactions in certain property. For example, if a taxpayer wants capital treatment for appreciation in the value of a non-actively traded contract, the taxpayer can sell the contract to a third party. If the taxpayer wants ordinary treatment, the taxpayer can arrange to have the contract extinguished. Thus, taxpayers can plan for ordinary losses and capital gains on a contract. This ability to select the treatment of the disposition is inappropriate.

### **Proposal**

Gain or loss attributable to the cancellation, lapse, expiration, or other termination of any right or obligation with respect to property that is or would be a capital asset in the hands of the taxpayer would be treated as gain or loss from the sale or exchange of a capital asset. In addition, the proposal would repeal the current exemption of instruments issued by a natural person from the general rule that any amounts received on retirement of a debt are treated as received in exchange for the debt.

The proposal is not intended to affect the treatment of any transaction under current law.

The proposal would be effective 30 days after the date of enactment.

## **REQUIRE REASONABLE PAYMENT ASSUMPTIONS FOR INTEREST ACCRUALS ON CERTAIN DEBT INSTRUMENTS**

### **Current Law**

An accrual method taxpayer generally must include interest in income as it accrues rather than when it is paid. Original issue discount ("OID") is includable in income on an accrual basis, even if the holder is a cash-method taxpayer.

If the principal amount of indebtedness may be paid by the borrower by a specified date without interest (as is the case with certain credit card balances), the accrual method of accounting does not require the lender to accrue interest until the specified date has passed. In addition, if a borrower can reduce the yield on a debt by exercising the option to prepay the debt, the accrual of OID is calculated assuming the issuer will exercise the option.

A special rule for determining interest accrual applies to instruments issued by real estate mortgage investment conduits (REMICs), mortgages held by REMICs and other debt instruments if payment on the instruments can be accelerated based on prepayments of obligations securing the instruments. Section 1272(a)(6) requires that for purposes of calculating the amount of OID accrued on these instruments, a reasonable prepayment assumption must be used and OID is calculated using the "catch-up" method. Because the timing of principal payments, and therefore the yield, on a mortgage acquired at a discount is uncertain, a special rule is necessary to provide for an approximation of the economic accrual of interest on the instrument. This provision requires taxpayers to accrue OID at a higher, but more accurate, rate than they would if they made no prepayment assumption.

### **Reasons for Change**

The prepayment, catch-up method applied to REMIC interests and mortgages held by REMICs should be extended to pools of debt instruments that have similarly uncertain payment schedules. For example, in the case of credit cards receivables an assumption about payment patterns must be used to accurately accrue interest income when the receivables are outstanding over the end of a taxable year. Applying the catch-up method with a prepayment assumption rule broadly to pools of receivables and other debt instruments would prevent taxpayers from accruing interest or OID at artificially low rates and would equalize the treatment of these instruments and REMIC interests and REMIC mortgages.

### **Proposal**

The proposal would require taxpayers to use the catch-up method with a reasonable prepayment assumption for purposes of determining the amount of interest or OID income that accrues on a pool of debt instruments. Changes in accounting required by the proposal

would be treated as a change in a method of accounting subject to section 481, with adjustments taken into account over a four-year period.

This proposal is not intended to apply to pools of receivables for which interest charges are incidental. For example, if a merchant permits customers to pay their bills within a reasonable period, and does not routinely receive interest from a substantial portion of its customers, the proposal would not apply. In addition, Treasury would be authorized to provide appropriate exemptions from this proposal, including, for example, for taxpayers that hold a limited amount of debt instruments.

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

## **REQUIRE GAIN RECOGNITION FOR CERTAIN EXTRAORDINARY DIVIDENDS**

### **Current Law**

A corporate shareholder is generally allowed to deduct a certain percentage of dividends received from another domestic corporation. A corporate shareholder who receives an "extraordinary" dividend is required to reduce the basis of the stock with respect to which the dividend was received by the non-taxed portion of the dividend (section 1059). Whether a dividend is "extraordinary" is determined by reference to, among other things, the size of the dividend in relation to the adjusted basis of the shareholder's stock. Also, a dividend resulting from a non prorata redemption or partial liquidation is an extraordinary dividend. If the reduction in basis of stock exceeds the basis in the stock with respect to which an extraordinary dividend is received, the excess is taxed as gain at the time of a sale or disposition of such stock.

In general, a distribution in redemption of stock is treated as a dividend, rather than as a sale of the 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 determination whether a redemption is essentially equivalent to a dividend includes reference to the constructive ownership rules of section 318, including the option attribution rules of section 318(a)(4). The rules relating to treatment of other property received in a reorganization contain a similar reference (section 356(a)(2)).

### **Reasons for Change**

Some corporate taxpayers are attempting to dispose of stock of other corporations in transactions structured as redemptions, where the redeemed corporate shareholder apparently expects to take the position that the transaction qualifies for the dividends-received deduction. Thus, the redeemed corporate shareholder attempts to exclude from income a substantial portion of the amount received. In some cases, it appears that the taxpayers' interpretations of the option attribution rules of section 318(a)(4) are important to the taxpayers' contentions that their interests in the distributing corporation are not meaningfully reduced.

Also, the present rules may be permitting inappropriate deferral of gain recognition when the portion of the distribution that is excluded due to the dividends-received deduction exceeds the basis of the stock with respect to which the extraordinary dividend is received.

### **Proposal**

The extraordinary dividend rules of section 1059 would be amended to provide that a corporate shareholder will recognize gain immediately with respect to any redemption treated as a dividend (in whole or in part) when the nontaxed portion of the dividend exceeds the

basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership. In addition, immediate gain recognition is required whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero. Reorganizations or other exchanges involving amounts that are treated as dividends under section 356(a)(2) of the Code are treated as redemptions for purposes of applying the rules relating to redemptions under section 1059(e).

The proposal would be effective for distributions after May 3, 1995 if the redemption is treated as a dividend due to options being counted as stock ownership unless the distribution is: (i) made pursuant to the terms of a written binding contract in effect on May 3, 1995, and at all times thereafter before such distribution, or (ii) made pursuant to the terms of a tender offer outstanding on May 3, 1995. For distributions which are treated as extraordinary dividends other than due to options being counted as stock ownership, this proposal applies to any of these distributions after September 13, 1995. The proposal is not intended to affect the treatment of transactions structured as redemptions under current law.

The proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **REPEAL PERCENTAGE DEPLETION FOR NON-FUEL MINERALS MINED ON 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 allowance for depletion for the year.

Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the property which is equal to the ratio of the units sold from that property during the taxable year, to the estimated total units remaining at the beginning of that year.

Under the percentage depletion method, a deduction is allowed in each taxable year for a statutory percentage of the taxpayer's gross income from the property. The 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 the cost of \$5.00 per acre or less.

### **Reasons for Change**

The percentage depletion provisions under present 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, however, is excessive 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 present law for non-fuel minerals mined on lands where the mining rights were originally acquired under the 1872 law. The proposal would be effective for taxable years beginning after the date of enactment.

## **MODIFY NET OPERATING LOSS CARRY-BACK AND CARRY-FORWARD RULES**

### **Current Law**

Net operating losses ("NOLs") generally can be used to offset taxable income from the prior three taxable years ("carry-backs") and the succeeding 15 taxable years ("carry-forwards").

### **Reasons for Change**

NOL carry-backs and carry-forwards may correct for income distortions that result when the end of a taxable year separates income from related losses. However, because of the increased complexity and administrative burden associated with carry-backs, the period of carry-back should be shortened. On the other hand, the carry-forward period under current law can be lengthened to allow taxpayers more time to utilize their NOLs without substantially increasing either complexity or administrative burdens.

### **Proposal**

The proposal would limit carry-backs of NOLs to one year and extend carry-forwards to 20 years. The proposal would be effective for taxable years beginning after the date of enactment.

## **TREAT CERTAIN PREFERRED STOCK AS "BOOT"**

### **Current Law**

In reorganization transactions within the meaning of section 368, no gain or loss is recognized except to the extent "other property" is received, that is, property other than certain stock, including preferred stock. Thus, preferred stock can be received tax-free in a reorganization, notwithstanding that many preferred stocks are functionally equivalent to debt securities. Upon the receipt of other property, gain but not loss can be recognized. A special rule permits debt securities to be received tax-free, but only to the extent debt securities of no lesser principal amount are surrendered in the exchange. Other than this debt-for-debt rule, similar rules generally apply to transactions described in section 351.

### **Reasons for Change**

Tax-free treatment in a reorganization or section 351 transaction is inappropriate for preferred stock that has an enhanced likelihood of recovery of principal or of maintaining a dividend or both, or that otherwise has certain non-stock characteristics.

### **Proposal**

The proposal would amend the relevant provisions (sections 351, 354, 355, 356 and 1036) to treat certain preferred stock as "other property" (boot), subject to certain exceptions. Thus, when a taxpayer exchanges property for this preferred stock in a transaction that qualifies under either section 351 or section 368, gain but not loss would be recognized.

The proposal would apply to preferred stock (i.e., stock which is limited and preferred as to dividends and does not participate, including through a conversion privilege, in corporate growth to any significant extent), where (i) the holder has the right to require the issuer or a related person (within the meaning of sections 267(b) and 707(b)) to redeem or purchase the stock, (ii) the issuer or a related person is required to redeem or purchase the stock, (iii) the issuer (or a related person) has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (iv) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices, regardless of whether such varying rate is provided as an express term of the stock (for example, in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (for example, in the case of auction rate stock). For this purpose, clauses (i), (ii) and (iii) apply if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase. In addition, a right or obligation would be disregarded if it may be exercised only upon the death, disability or mental incompetency of

the holder, or in the case of stock transferred in connection with the performance of services, upon the holder's retirement.

The following exchanges would be excluded from this gain recognition: (1) an exchange of preferred stock for comparable preferred stock of the same or lesser value; (2) an exchange of preferred stock for common stock; (3) an exchange of debt securities for preferred stock of the same or lesser value; and (4) exchanges of stock in certain recapitalizations of family-owned corporations. For this purpose, a family-owned corporation would be defined as any corporation if at least 50 percent of the total voting power and value of the stock of such corporation is owned by members of the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50 percent of the total voting power and value of the stock throughout the three-year period following the recapitalization. Members of the same family would be defined by reference to the definition in section 447(e). Thus, a family would include children, parents, brothers, sisters, and spouses, with limited attribution for directly and indirectly owned stock of the corporation. Shares held by a family member would be treated as not held by a family member to the extent a non-family member had a right, option or agreement to acquire the shares (directly or indirectly, for example, through redemptions by the issuer), or with respect to shares as to which a family member has reduced its risk of loss with respect to the share, for example, through an equity swap. Even though the provision excepts certain family recapitalizations, the special valuation rules of section 2701 for estate and gift tax consequences still apply.

An exchange of nonqualified preferred stock for nonqualified preferred stock in an acquiring corporation may qualify for tax-free treatment under section 354 but not section 351. In cases in which both sections 354 and 351 may apply to a transaction, section 354 will generally apply for purposes of this proposal. Thus, in that situation, the exchange would be tax free.

The Treasury Secretary would have regulatory authority to (i) apply installment-sale type rules to preferred stock that is subject to this proposal in appropriate cases, and (ii) prescribe treatment of preferred stock subject to this provision under other provisions of the Code (e.g., sections 304, 306, 318 and 368(c)).

The proposal would be effective for transactions after December 7, 1995, unless the stock: (1) is issued pursuant to a written agreement which was (subject to customary conditions) binding on such date and at all times thereafter before the stock was issued, (2) is issued pursuant to an exchange offer which was outstanding on such date, or (3) was priced for purposes of issuance on or before such date.

## **REPEAL SECTION 1374 FOR LARGE CORPORATIONS**

### **Current Law**

C corporations are generally subject to a two-tier tax. A corporation can avoid this two-tier tax by electing to be treated as an S corporation or by converting to a partnership. Converting to a partnership is a taxable event that generally requires the corporation to recognize any built-in gain on its assets and requires the shareholders of the corporation to recognize any built-in gain in their corporate stock. The conversion of a C corporation to an S corporation, however, is generally tax-free for both corporations and its shareholders, except that the S corporation must recognize the built-in gain on assets held at the time of conversion if the assets are sold within ten years under section 1374.

A corporation generally can also avoid the two-tier tax if it can qualify as a regulated investment company (RIC) or a real estate investment trust (REIT) (by deducting dividends paid to its shareholders). The conversion of a C corporation to a RIC or REIT, however, is treated as if the corporation had sold all of its assets at their fair market value and immediately liquidated, thereby requiring the corporation to recognize any built-in gain in its assets at the time of the conversion. Notice 88-19, 1988-1 C.B. 486. The IRS, however, permits the corporation to avoid the immediate recognition of its built-in gain if the corporation elects to be subject to rules similar to section 1374. *Id.*

### **Reasons for Change**

The tax treatment of the conversion of a C corporation to an S corporation generally should be consistent with the treatment of its conversion to a partnership. In particular, any appreciation in corporate assets that occurred during the time the corporation is a C corporation should be subject to the corporate-level tax.

### **Proposal**

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

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

The proposal would be effective for subchapter S elections that are first effective for a taxable year beginning after January 1, 1997. The proposal also would apply to acquisitions (e.g., the merger of a C corporation into an S corporation) after December 31, 1996. Thus, C corporations would continue to be permitted to elect S corporation status effective for taxable years beginning in 1996 or on January 1, 1997.

In addition, the Internal Revenue Service would revise Notice 88-19 to conform to the proposed amendment to section 1374, with an effective date similar to the statutory proposal. As a result, the conversion of a large C corporation to a RIC or a REIT after the revisions would result in immediate recognition by the C corporation of the net built-in gain in its assets.

## **REQUIRE GAIN RECOGNITION ON CERTAIN DISTRIBUTIONS OF CONTROLLED CORPORATION STOCK**

### **Current Law**

A corporation is generally required to recognize gain on the distribution of property (including stock of a subsidiary) as if such property had been sold for its fair market value. The shareholders generally treat the receipt of property as a taxable event as well. Section 355 provides an exception to this rule for certain distributions of stock in a controlled corporation, provided that various requirements are met, including certain restrictions relating to acquisitions and dispositions of stock of the distributing corporation ("distributing") or the controlled corporation ("controlled") prior and subsequent to a distribution.

### **Reasons for Change**

Corporate nonrecognition under section 355 should not apply to distributions that are effectively dispositions of a business.

### **Proposal**

The proposal would adopt additional restrictions under section 355 on acquisitions and dispositions of the stock of distributing and controlled. Specifically, section 355 tax-free treatment would not apply, and distributing (but not its shareholders) would recognize gain, on the distribution of the stock of controlled unless the direct and indirect shareholders of distributing, as a group, control both distributing and controlled at all times during the four year period commencing two years prior to the distribution. Control for this purpose means ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock and at least 50 percent of the total value of shares of all classes of stock.

In determining whether shareholders retain control in both corporations throughout the four-year time period, any acquisitions or dispositions of stock that are unrelated to the distribution will be disregarded. A transaction is unrelated to the distribution if it is not pursuant to a common plan or arrangement that includes the distribution. For example, public trading of the stock of either distributing or controlled is disregarded, even if that trading occurs in contemplation of the distribution. Similarly, an acquisition of distributing or controlled in a merger or otherwise that is not pursuant to a common plan or arrangement existing at the time of the distribution is not related to the distribution. For example, a hostile acquisition of distributing or controlled commencing after the distribution will be disregarded. On the other hand, a friendly acquisition will generally be considered related to the distribution if it is pursuant to an arrangement negotiated (in whole or in part) prior to the distribution, even if at the time of distribution it is subject to various conditions, such as the approval of shareholders or a regulatory body.

The proposal would be effective for distributions after March 19, 1996 unless the distribution is: (i) made pursuant to a written agreement which was (subject to customary conditions) binding on or before March 19, 1996, and at all times thereafter before the distribution; (ii) described in a ruling request submitted to the IRS on or before March 19, 1996; or (iii) described in a public announcement or SEC filing made on or before March 19, 1996.

## **REFORM THE TREATMENT OF CERTAIN CORPORATE STOCK TRANSFERS**

### **Current Law**

Under section 304, if one corporation purchases stock of a related corporation, the transaction is generally recharacterized as a redemption and may result in a dividend to the selling shareholder under section 302(d). A transaction is treated as a sale or a dividend depending on the change in the selling corporation's ownership of stock in the issuing corporation (applying the constructive ownership rules of sections 318(a) and 304(c)). Sales proceeds received by a corporate transferor that are treated as a dividend under section 304 may qualify for a dividends-received deduction ("DRD") under section 243 if all of the parties are domestic corporations. Section 304 does not apply to transfers of stock between members of a consolidated group.

Section 1059 applies to "extraordinary dividends," including certain redemption transactions treated as dividends qualifying for the DRD. If a redemption results in an extraordinary dividend, section 1059 generally requires the shareholder to reduce its basis in the stock of the redeeming corporation. Under a separate proposal (described above), section 1059 would be amended to provide that for certain redemptions only the basis of the shares redeemed would be taken into account for purposes of section 1059. Accordingly, gain would be realized to the extent that the nontaxed portion of the dividend (generally, the amount of the DRD) exceeds the shareholder's basis in the shares redeemed.

### **Reasons for Change**

Section 304 is directed primarily at preventing a controlling shareholder from claiming basis recovery and capital gain treatment on transactions that result in a withdrawal of earnings from corporate solution. These concerns are most relevant where the shareholder is an individual. Different concerns may be present if the shareholder is a corporation, due in part to the presence of the DRD. In fact, a corporation will often prefer a transaction to be characterized as a dividend, as opposed to a sale or exchange. Accordingly, a corporation may intentionally seek to apply section 304 to a transaction which is in substance a sale or exchange. For example, in certain related party sales the selling corporation may take the position that its basis in any shares of stock it may have retained need not be reduced by the amount of the DRD.

In international cases, a U.S. corporation owned by a foreign corporation may inappropriately claim foreign tax credits from a section 304 transaction. For example, if a foreign-controlled domestic corporation sells the stock of a subsidiary to a foreign sister corporation, the domestic corporation may take the position that it is entitled to credit foreign taxes that were paid by the foreign sister corporation. See Rev. Rul. 92-86, 1992-2 C.B. 199; Rev. Rul. 91-5, 1991-1 C.B. 114. However, if the foreign sister corporation had actually distributed its earnings and profits to the common foreign parent, no foreign tax

credits would have been available to the domestic corporation.

### **Proposal**

The proposal would clarify that a transaction described in section 304(a)(1) is treated as if (1) the seller transferred the stock of the issuing corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation then redeemed the shares it was treated as issuing. Thus, even though the characterization of the transaction as a sale or exchange or a dividend is made by reference to the stock of the issuing corporation, the acquiring corporation is treated for all purposes (including, for example, basis determinations and the application of section 1059) as redeeming the stock issued to the selling corporation. Furthermore, section 1059 would be amended so that, if the deemed redemption is treated as a dividend and the transferor claims a DRD, the dividend would be treated as an extraordinary dividend in which only the basis of the transferred shares would be taken into account for purposes of section 1059. Accordingly, gain would be realized to the extent that the nontaxed portion of the dividend exceeds the seller's basis in the shares transferred. These rules would apply without regard to the seller's holding period in the stock of the issuing corporation.

The proposal would also modify the results of international section 304 transactions. Under the proposal, the earnings and profits taken into account from a foreign acquiring corporation in a section 304 transaction would not exceed the amount of earnings and profits attributable to stock of the acquiring corporation owned directly or indirectly by a ten-percent U.S. shareholder who is either the transferor or a related person. In determining the amount of earnings and profits attributable to the U.S. shareholder's ownership, only the earnings and profits accrued during the period of such ownership would be taken into account. Thus, under the proposal, a section 304 transaction would generate foreign tax credits only to the extent that the foreign tax credits would have been available during the holding period if the acquiring corporation had actually distributed the sales proceeds to the common parent.

The proposal would be effective for transactions after March 19, 1996, unless the transaction is: (i) undertaken pursuant to a written agreement which was (subject to customary conditions) binding on that date and at all times thereafter; (ii) described in a ruling request submitted to the IRS on or before that date; or (iii) described in a public announcement or SEC filing made on or before that date. The proposal is not intended to affect the treatment of any transaction under current law.

## **DETER EXPATRIATION TAX AVOIDANCE**

### **Current Law**

Under current law, worldwide gains realized by U.S. citizens and resident aliens are subject to U.S. tax. However, if a U.S. citizen renounces or abandons citizenship or an alien ceases to be a resident, no tax is imposed on accrued but unrealized gains. Existing rules continue to tax former U.S. citizens on U.S. source income for ten years following expatriation if one of the principal purposes of the expatriation was to avoid U.S. income tax. A similar rule applies to expatriating aliens.

### **Reasons for Change**

Wealthy U.S. citizens and long-term residents sometimes abandon their U.S. citizenship or status as residents. Existing rules to prevent tax avoidance through expatriation have proven largely ineffective because they apply only to U.S. source income, and departing taxpayers can restructure their assets to resource their income. Enforcement of the existing rules is difficult because the Internal Revenue Service ("IRS") may have only limited access to information about a taxpayer's transactions after the taxpayer expatriates. New measures are needed to ensure that gains generally accruing during the time that a taxpayer was a citizen or long-term permanent resident should be subject to U.S. tax without regard to the tax motivation of the expatriation.

### **Proposal**

If a U.S. citizen or resident alien expatriates on or after February 6, 1995, that person would be treated as having sold his or her assets at fair market value immediately prior to expatriation. As a result of this deemed sale, gain or loss would be recognized and subject to tax. A U.S. citizen would be considered to expatriate if the citizen relinquishes U.S. citizenship. A resident alien individual would be taxed under this proposal if the alien has been subject to U.S. tax as a lawful permanent resident of the United States in at least eight of the prior fifteen taxable years and then abandons that status.

Exceptions to the tax on expatriation apply for U.S. real property interests (because they remain subject to U.S. taxing jurisdiction) and interests in qualified retirement plans. An expatriating individual also would be entitled to exclude \$600,000 of gain as determined under the proposal. A taxpayer may defer payment of the tax on expatriation until the asset is sold. Alternatively, a taxpayer may elect to continue to be taxed as a U.S. person. The taxpayer would be required to provide collateral satisfactory to the IRS.

## **REFORM THE TAX TREATMENT OF FOREIGN TRUSTS**

U.S. tax rules applicable to foreign trusts have not been revised for nearly two decades. New rules are needed to accommodate changes in the use and incidence of foreign trusts and to limit the avoidance and evasion of U.S. taxes. The foreign trust proposal would reform the taxation of trusts in several respects. This document summarizes the two most important changes.

### **A. INFORMATION REPORTING AND FOREIGN TRUSTS**

#### **Current Law**

Under current law, most foreign trusts established by U.S. persons are grantor trusts, the income of which is taxed to the grantor. U.S. persons who create or transfer property to foreign trusts are required to report transactions with the foreign trust.

#### **Reasons for Change**

The existing information reporting statute predates the significant expansion of the foreign grantor trust rules in 1976. In general, penalties for noncompliance are minimal. U.S. grantors of foreign trusts often do not report the income earned by foreign trusts and often do not comply with required information reporting. These foreign trusts are frequently established in tax haven jurisdictions with stringent secrecy rules. Attempts by the IRS to verify income earned by foreign trusts are often met with silence or a representation that foreign secrecy laws prevent the U.S. taxpayer from obtaining required information. Existing penalties have not proven adequate to encourage some U.S. taxpayers to comply with existing rules.

#### **Proposal**

The proposal would require trustees of foreign trusts created by U.S. persons to (1) appoint a U.S. agent who would provide the IRS with access to trust information, and (2) file an annual information return. If the trustees did not comply, creators of foreign trusts would be subject to substantial penalties. In addition, if required information is not provided, the appropriate tax treatment of any trust transactions or operations could be determined by the IRS. (This is similar to a rule that currently applies to certain foreign corporations.) The proposal would generally be effective for taxable years beginning after the date of enactment.

The proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **B. INBOUND FOREIGN GRANTOR TRUSTS**

### **Current Law**

The United States disregards certain "grantor" trusts for income tax purposes. The grantor of such a trust is taxed as if he owned the trust assets directly. Trusts generally are considered grantor trusts if (1) the grantor has a reversionary interest in trust income or corpus, (2) the grantor or a nonadverse party holds certain powers over the beneficial enjoyment of trust income or corpus, (3) certain administrative powers are exercisable for the grantor's benefit (*e.g.*, the grantor can reacquire trust assets by substituting assets of equivalent value), (4) the grantor or a nonadverse party has the power to revest trust assets in the grantor, or (5) trust income may be paid or accumulated for the benefit of the grantor or the grantor's spouse in the discretion of the grantor or a nonadverse party. A person other than the grantor is treated as owning trust assets if that person has the sole power to withdraw trust income or corpus.

The grantor trust rules are intended to prevent wealthy U.S. settlors from shifting taxable income to beneficiaries who are likely to be paying taxes at lower marginal tax rates. These grantor trust antiabuse rules therefore treat the settlor as the owner of the underlying trust assets even where he retains no beneficial interest in the trust.

In Revenue Ruling 69-70, 1969-1 C.B. 182, a foreign person funded a foreign grantor trust for U.S. beneficiaries. The ruling holds that since the foreign person is treated as the owner of the grantor trust, a U.S. beneficiary is not taxable on trust income distributed to him.

### **Reasons for Change**

Existing law inappropriately permits foreign taxpayers to affirmatively use the domestic antiabuse rules concerning grantor trusts. These rules permit U.S. beneficiaries, who enjoy the benefits of residing in the United States, to avoid their U.S. tax obligations. U.S. beneficiaries receiving distributions of income from a trust should be taxed in the United States in accordance with the terms of the trust instrument.

### **Proposal**

Under the proposal, a person generally would be treated as owning trust assets under the grantor trust rules only if the trust income is taxed to a U.S. person. Thus, U.S. beneficiaries of foreign trusts created by foreign persons would be taxed on distributions of trust income. The proposal would generally be effective on the date of enactment.

The proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **REFORMULATE PUERTO RICO AND POSSESSIONS TAX CREDIT (SECTION 936)**

### **Current Law**

Domestic corporations with business operations in U.S. possessions (including, for this purpose, Puerto Rico and the U.S. Virgin Islands) may elect under Code section 936 generally to eliminate the U.S. tax on certain income which is related to their possession-based operations. The section 936 credit may offset the U.S. tax on the following types of income: (1) foreign source 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, or (2) income from certain investments in the possessions or in certain Caribbean Basin countries ("qualified possession source investment income", or "QPSII"). The credit spares the electing corporation U.S. tax whether or not it pays income tax to the possession.

Limitations on the active-business element of the credit were enacted in 1993. Section 936 companies may elect either a reduced percentage of the profits-based credit as allowed under prior law (60 percent in 1994, phasing down to 40 percent beginning in 1998), or a limitation based on the company's economic activity in the possessions (measured by wages and other compensation, depreciation, and certain taxes paid).

### **Reasons for Change**

The Administration proposed to reformulate the credit in 1993 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 Administration continues to believe that any credit should provide an incentive for increased economic activity in the possessions rather than merely an incentive to attribute profits there.

### **Proposal**

To provide a more efficient tax incentive for the economic development of Puerto Rico and other U.S. possessions, and to continue the effort toward this goal that was begun in the 1993 Act, the proposal would modify current law to (1) phase-out the profits-based branch of the active-business portion of the credit over five years, beginning in 1997, and (2) allow excess amounts of economic-activity limitation to be carried forward for up to 5 years, effective for taxable years beginning after the date of enactment. The proposal would retain the economic-activity limitation on the active-business portion of the credit, as well as the passive-income portion of the credit for taxes otherwise payable on QPSII, as under present law.

## **EXPAND SUBPART F PROVISIONS REGARDING INCOME FROM NOTIONAL PRINCIPAL CONTRACTS AND STOCK LENDING TRANSACTIONS**

### **Current Law**

Subpart F income includes, in various subcategories, income from notional principal contracts referenced to foreign currency, commodities, or interest rates, or to indices based thereon. It also includes income with respect to the lending of debt securities. Subpart F income does not include income from equity swaps or other types of notional principal contracts or income from transfers of equities subject to section 1058. Subpart F provides piecemeal exceptions for dealers in foreign currency, commodities, inventory, or certain other property. However, it does not provide an exception for dealers in financial instruments referenced to commodities.

### **Reasons for Change**

Subpart F income should include income from all types of notional principal contracts and from stock-lending transactions, subject to a limited dealer exception. Such income is indistinguishable on policy grounds from other types of highly mobile income already targeted by subpart F.

### **Proposal**

The proposal would amend section 954 to create a new category of subpart F income--income from notional principal contracts--and to include in subpart F income the income with respect to the transfer of equities subject to section 1058. This would have the effect of including in subpart F income the net income from equity swaps and certain categories of notional principal contracts that are not reached by current law, as well as income from stock lending transactions.

Any income, gain, deduction, or loss from a notional principal contract entered into to hedge an item of income in a category of foreign personal holding company income would be included in that category.

In addition, section 954 would be amended to provide an ordinary-course-of-business exception for regular dealers in forwards, options, notional principal contracts, and similar financial instruments (including instruments referenced to commodities).

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

## **REFORM TREATMENT OF CAPTIVE "INSURANCE" ARRANGEMENTS**

### **Current Law**

Insurance premiums incurred in connection with a taxpayer's trade or business generally are deductible. In contrast, amounts set aside by a taxpayer to fund future losses are not deductible.

The Code does not define the term "insurance." Case law has long defined the term to require "risk shifting" and "risk distribution." However, this definition has not been applied consistently to arrangements that are structured to minimize the amount of insurance risk that is shifted or distributed.

In the case of a corporation that provides insurance to its shareholders, known as a "captive" insurance company, one recent court decision has held that the risk-shifting and risk-distribution requirements may be satisfied if the captive's unrelated business accounts for at least 30 percent of its total business. However, standards applied by the courts have varied considerably from case to case.

A taxpayer qualifies as an insurance company for tax purposes if its primary and predominant business activity is the issuance of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Section 953(c) contains special provisions regarding the inclusion of "related person insurance income" of foreign companies in their U.S. shareholders' subpart F income. In addition, an excise tax is imposed on certain premiums paid to a foreign insurer or reinsurer on insurance policies that cover U.S. risks, unless the excise tax is waived by a tax treaty.

### **Reasons for Change**

The uncertainty under current law as to when transactions with captives are considered insurance for federal income and excise tax purposes has encouraged aggressive planning and resulted in excessive controversy. The IRS also has experienced difficulty enforcing section 953(c), in part due to difficulty in obtaining information about foreign captives' operations.

### **Proposal**

The proposal would treat certain "insurance" transactions between domestic and foreign captive insurance companies and their large shareholders as other than insurance for certain purposes. In applying the primary and predominant business activity test to determine whether the captive is an insurance company for tax purposes, premiums or similar amounts paid by large shareholders would not be considered insurance premiums. Thus, a captive would not qualify as an insurance company if more than 50 percent of its net

written premiums were derived from insuring or reinsuring risks of its large shareholders. In determining whether a captive was an insurance company, net written premiums could be determined based on a multi-year rolling average, which would exclude premiums written in taxable years beginning on or before the date of enactment. If a captive engaged in both an insurance business and a financing or other noninsurance business, the captive might not qualify as an insurance company even if less than 50 percent of its net written premiums were derived from insuring or reinsuring risks of its large shareholders.

If a captive qualified as an insurance company under the primary and predominant business activity test, premiums paid to the captive by its shareholders (including its large shareholders) for bona fide insurance would be deductible to the extent that such amounts would be deductible under current law, provided that the shareholder claiming a deduction complied with reporting and recordkeeping requirements to be prescribed. Similarly, the captive would compute its taxable income or the U.S. shareholders would compute their subpart F inclusions under the rules of subchapter L and section 953, as applicable.

If a foreign or domestic captive failed to qualify as an insurance company under the primary and predominant business activity test, premiums paid directly or indirectly to such captive by its large shareholders would not be deductible and would be excluded from the captive's gross income. However, premiums paid by small shareholders or unrelated policyholders would continue to be deductible and would continue to be included in the captive's gross income. In addition, the captive would not be subject to subchapter L. The subpart F inclusions for a foreign captive that failed to qualify as an insurance company generally would be computed as under current law, except that the captive would not be entitled to claim reserve deductions for any of its policies or to use any other subchapter L rules. A captive that failed to qualify as an insurance company also would not be eligible for a tax exemption under section 501(c)(15).

For captives that failed to qualify as insurance companies, claims paid to a large shareholder of a domestic captive would be deductible by the captive and includible in the large shareholder's income to the extent such claims exceeded the "premiums" paid by such large shareholder on the "insurance" policy. Claims payments to large shareholders of foreign captives would be taxable to such shareholders and deductible by the captive to the extent they exceeded the shareholders' "premium" payments. Large shareholders who incurred losses that gave rise to such payments would deduct those losses under sections 162 or 165, subject to the current law all events test and economic performance rules.

For purposes of this proposal, large shareholders would include any 10 percent shareholders of the captive and any person that would be a related person with respect to the shareholder under rules similar to those of section 953(c)(6). For this purpose, the attribution rules of section 958(a) and the constructive ownership rules of section 958(b) would apply, except for section 958(b)(4). Policyholders of mutual captives would be treated as shareholders for this purpose. In addition, Treasury would be authorized to promulgate regulations that defined related parties to include otherwise unrelated parties. For example,

persons that purchased insurance from the captive of a client could be considered related to the client that owned stock in the captive.

If an unrelated insurance company issued an insurance policy to a taxpayer, and some or all of the taxpayer's risks were ceded to a corporation in which the taxpayer was a large shareholder, the premium paid by the taxpayer to the unrelated insurance company (the "fronting company") would be bifurcated between a premium payment to the fronting company and a deemed payment to the captive, which would be subject to the rules contained in this proposal. These same principles would apply if a large shareholder's risks were ceded and/or retroceded to one or more unrelated insurance companies, and ultimately retroceded to the captive. Similarly, the premium payment to a captive that reinsured or retroceded some of its shareholder's risks to an unrelated insurance company would be bifurcated between a payment to the captive, which would be subject to the rules contained in this proposal, and a deemed payment to the reinsurer.

The insurance excise tax would not apply to amounts paid by a large shareholder to its foreign captive that failed to qualify as an insurance company, provided that certain procedural requirements were met.

The proposal would not apply to reinsurance transactions between affiliated insurance companies, if the insured risks were not related party risks with respect to the ceding or the assuming insurance companies.

The proposal is not intended to affect the treatment of putative insurance arrangements with captives under current law.

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

## REFORM FOREIGN TAX CREDIT RULES

### A. REPEAL FINANCIAL INSTITUTION TRANSITION RULE TO INTEREST ALLOCATION RULES

#### Current Law

For foreign tax credit purposes, taxpayers generally are required to allocate and apportion interest expense between U.S. and foreign source income based on the proportion of the taxpayer's total assets in each location. Such allocation and apportionment is required to be made for affiliated groups (as defined in sec. 864(e)(5)) as a whole rather than on a subsidiary-by-subsidiary basis. However, certain types of financial institutions that are members of an affiliated group are treated as members of a separate affiliated group for purposes of the allocation and apportionment of interest expense (sec. 864(e)(5)(B)). Section 1215(c) of the Tax Reform Act of 1986 (P L 99-514, 100 Stat 2548) includes a targeted rule which treats a certain corporation as a financial institution for this purpose.

#### Reasons for Change

The 1986 provision grants a single company a special exception to the basic fungibility principle underlying the interest allocation rules. This type of relief is inappropriate.

#### Proposal

The proposal would repeal the targeted exception provided by section 1215(c)(5) of the Tax Reform Act of 1986. The proposal would be effective for taxable years beginning after the date of enactment.

The proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

### B. MODIFY FOREIGN TAX CREDIT CARRYOVER RULES

#### Current Law

U.S. persons, including domestic corporations and U.S. citizens and residents, are subject to U.S. tax on their worldwide income. Income from sources outside the United States may also be taxed by the country in which such income originates. To avoid double taxation of the same income, the United States permits taxpayers to credit income taxes paid to a foreign government against U.S. tax on foreign source income. Through the foreign tax credit limitations, the Code prevents the use of foreign tax credits to reduce U.S. tax on U.S.

source income. These limitations, in effect, preserve the primary right of the United States to tax U.S. source income.

Under the foreign tax credit mechanism, current foreign income taxes in excess of the relevant current-year foreign tax credit limitation are not creditable against current U.S. tax liabilities. However, such excess foreign tax credits generally may be carried back for two years and carried forward for five years, and used as a credit to the extent there is excess foreign tax credit limitation (i.e., an excess of the foreign tax credit limitation over creditable foreign taxes) in any of those years. The unused credit is applied first against any excess limitation of the second preceding year, then against any excess limitation of the first preceding year, and is then carried forward to the first, second, and succeeding carryover years until it is fully used or until the expiration of the five-year period.

### **Reasons for Change**

Experience over the years has shown that carrybacks are associated with increased complexity and administrative burdens as compared to carryforwards. Therefore, to reduce such complexity and burdens, the carryback period for foreign tax credits should be shortened. On the other hand, the carryforward period under current law can be lengthened in order to allow taxpayers more time to utilize their foreign tax credits without increasing either complexity or administrative burdens.

### **Proposal**

The proposal would limit foreign tax credit carrybacks to one year and extend foreign tax credit carryforwards to seven years. The proposal would be effective for foreign taxes paid or accrued or deemed paid or accrued in taxable years beginning after December 31, 1996.

## **REFORM TREATMENT OF FOREIGN OIL AND GAS INCOME AND DUAL-CAPACITY TAXPAYERS**

### **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.

Foreign oil and gas extraction income (FOGEI) generally is not included in subpart F income, but foreign oil related income (FORI) generally is so included. 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 fail 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 would treat foreign oil and gas income (including both FOGEI and FORI) as subpart F income. It 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.

## **REQUIRE THRIFTS TO ACCOUNT FOR BAD DEBTS IN THE SAME MANNER AS BANKS**

### **Current Law**

A thrift institution that holds at least 60 percent of its portfolio in home mortgages (and certain similar loans), cash, and government obligations is permitted to maintain a reserve for bad debts under section 593 of the Internal Revenue Code. Under section 593, a thrift institution generally may calculate the annual addition to its bad debt reserve under either the "percentage of taxable income" method or the "experience" method. Under the percentage of taxable income method, a thrift may deduct 8 percent of its taxable income (determined without regard to the deduction and with certain other adjustments) as an addition to its bad debt reserve. Under the experience method, a thrift may deduct the greater of (1) the percentage of its loans outstanding equal to its average bad debt experience (i.e., bad debt losses as a percentage of loans outstanding) in the current and five preceding years, or (2) the amount necessary to restore its reserve to its balance at the close of the last taxable year beginning before 1988 (adjusted downward to reflect any post-1987 decline in loans outstanding).

The reserve methods of section 593 are more generous than the rules applicable to commercial banks. Under section 585 of the Code, small banks are permitted to use the experience method, but not the percentage of taxable income method. If the adjusted basis of a bank's assets exceeds \$500 million, section 585 does not apply and only the specific charge-off method can be used to compute the bad debt deduction.

Under current law, a thrift that is no longer permitted to compute its reserve under section 593, either because it changes its charter to become a bank or because it fails the 60-percent test described above, must account for bad debts as if it were a bank. In addition, it must recapture, through a section 481(a) adjustment, the amount by which the reserve computed under section 593 exceeds the reserve (if any) computed under section 585. In general, the amount recaptured is included in income ratably over a 6-year period. A former thrift that becomes a large bank, however, may use the rules that apply when a small bank becomes a large bank to recapture an amount equal to its reserve computed under the experience method.

### **Reasons for Change**

As a result of the increasing convergence of the banking and thrift industries, the special rules applicable to thrifts, such as the subsidy provided through the reduction in effective marginal tax rates for thrifts using the percentage-of-taxable-income method, are no longer warranted. Some relief from recapture is appropriate, however, because deferred tax liabilities have not been recorded with respect to pre-1988 additions to thrift bad debt reserves. To require recapture with respect to these amounts, even on a deferred basis,

would have a significant effect on the capital of some thrifts. In addition, it is appropriate to provide some incentive for thrifts to continue in the mortgage lending business.

### **Proposal**

The bad debt reserve methods of section 593 would be repealed. (Other provisions that apply only to thrift institutions to which section 593 currently applies (e.g., sections 595 and 596) would also be repealed.) Small thrifts (those with no more than \$500 million of adjusted basis in their assets) would be permitted to use either the experience method of section 585 or the specific charge-off method. Large thrifts would be required to use the specific charge-off method. The percentage-of-taxable-income method of computing bad debt reserves would no longer be available.

Any change in the method a thrift uses to compute reserves for bad debts would be treated as a change in method of accounting and the section 481(a) adjustment with respect to the change generally would be taken into account ratably (recaptured) over a 6-year period beginning with the year of change. However, the balance of the bad debt reserve as of the close of the last taxable year beginning before 1988 adjusted, except to the extent attributable to the supplemental reserve, to reflect any subsequent reduction in the amount of loans outstanding (the pre-1988 balance) would not be recaptured. In the case of a thrift that becomes a small bank, the opening balance of its bad debt reserve for its first taxable year beginning after the date of enactment would be the greater of its pre-1988 balance or its reserve computed under the experience method at the close of its last taxable year beginning on or before the date of enactment. The pre-1988 balance included in the former thrift's bad debt reserve under this rule would not be recaptured (or taken into account in applying the cut-off method) if the former thrift later becomes a large bank.

Section 593(e) of current law (requiring recapture in the case of certain excess distributions to shareholders) would be modified to apply to the entire pre-1988 balance. In addition, the pre-1988 balance would be recaptured if the taxpayer ceases to be a bank (for this purpose, the taxpayer ceases to be a bank (and any amount recaptured is treated as income from an unrelated trade or business) if it becomes a credit union).

Recapture of reserves in excess of the pre-1988 balance would be suspended for the first taxable year beginning after the date of enactment and for the succeeding taxable year if the taxpayer meets a residential loan requirement. The residential loan requirement is met for a taxable year if the principal amount of residential loans made by the taxpayer during the year is not less than the average of the principal amount of such loans during the six most recent taxable years beginning on or before the date of enactment. At the election of the taxpayer, the average may be computed by disregarding the high and low years in the six-year period. A residential loan is any loan described in section 7701(a)(19)(C)(v) (generally, loans secured by residential real property, real property used by churches, and mobile homes), but only to the extent the loan is made to acquire, construct, or improve the property. The test would be applied on a controlled group basis.

The pre-1988 balance would be treated as a tax attribute to which section 381 applies. In addition, regulations would provide rules for the application of the statutory provisions in the case of acquisitions, mergers, spin-offs, and other reorganizations. The proposal would be effective for taxable years beginning after the date of enactment.

The proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **REFORM DEPRECIATION UNDER THE INCOME FORECAST METHOD**

### **Current Law**

Pursuant to several administrative pronouncements, the IRS has ruled that the cost of motion picture films, video tapes, sound recordings, and other similar property may be depreciated under the "income forecast" method, pursuant to which depreciation for any taxable year is determined by dividing the income realized for that year by the total estimated income from the property. The IRS has also ruled that the estimated income to be included in the denominator does not include income from television exhibition in the case of motion pictures released for theatrical exhibition, or income from syndication in the case of a television series or movie. In addition, estimated income does not include revenue from the exploitation of film characters. Such property is not eligible for depreciation under the modified accelerated cost recovery system.

### **Reasons for Change**

While the income forecast method may be an appropriate method for matching income and expenses in certain cases, the exclusion of income from certain sources results in an inappropriate acceleration of depreciation deductions. In addition, the use of estimates in the income forecast method necessarily results in a mismatch between income and depreciation deductions when the estimate of future income is either too high or too low. A look-back method, *i.e.*, a procedure to compensate for errors in estimates in prior taxable years, would eliminate any benefit that taxpayers may obtain from understating the estimated income from property, thereby overstating their depreciation deductions.

### **Proposal**

Several changes to the income forecast method of determining depreciation deductions would be made. All estimated income from the use of the property or the sale of merchandise would be taken into account in the denominator, other than income expected to be generated more than ten taxable years after the year in which the property was placed in service. For purposes of this rule, income realized by the taxpayer from related party transactions would be ignored, but income realized by the related party from the ultimate transaction with unrelated third parties would be taken into account. The basis for depreciation for any taxable year may only include amounts that satisfy the economic performance requirements of section 461(h) as of the end of the year (including the recurring item exception). The adjusted basis remaining at the beginning of the tenth taxable year after the year in which the property is placed in service may be recovered in full in that year. Finally, a look-back method would be imposed and applied in a manner similar to the long-term contract provisions of section 460 (together with de minimis exceptions). The changes would apply to property placed in service after September 13, 1995, unless subject to a written agreement which was binding as of that date and at all times thereafter.

This proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **PHASE OUT PREFERENTIAL TAX DEFERRAL FOR CERTAIN LARGE FARM CORPORATIONS REQUIRED TO USE ACCRUAL ACCOUNTING**

### **Current Law**

The Revenue Act of 1987 required certain closely held farm corporations (and partnerships with corporate partners) to change to the accrual method of accounting if their gross receipts exceed \$25 million in any taxable year beginning after 1985. However, in lieu of making a section 481(a) adjustment for the year of change, such taxpayers were permitted by section 447(i) to establish a "suspense account" for the lesser of the section 481(a) adjustment for the year of change or the adjustment that would have been applicable for the preceding taxable year. This suspense account is not required to be taken into account unless the corporation ceases to meet the closely held test or except to the extent that the gross receipts of the entity are reduced in any taxable year below the amount applicable to the last year prior to the year of change. As a result, the suspense account provision represents a potentially indefinite deferral of the section 481(a) adjustment.

### **Reasons for Change**

Section 447(i) is a substantial and inappropriate departure from the policy underlying section 481(a) and the administrative practices of the Service, in which the cumulative adjustments resulting from accounting method changes are taken into account generally over periods not exceeding six years.

### **Proposal**

The proposal would provide that no suspense accounts may be established under section 447(i). Any taxpayer required to change to the accrual method after the effective date would be required to take its section 481(a) adjustment into account generally over a ten-year period. Any existing suspense accounts must be restored to income ratably over a ten-year period (or sooner to the extent provided by existing law). This provision would be effective for taxable years ending after September 13, 1995, except that the 10-year period for restoring existing suspense accounts would begin with the first taxable year that begins after September 13, 1995.

This proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **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 and 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 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.

### **Proposal**

The proposal would repeal the LCM and subnormal goods methods. Appropriate wash-sale rules would also be included. The proposal would be treated as a change in the method of accounting for inventories, and any resulting section 481(a) adjustment 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.

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

## **REPEAL COMPONENTS OF COST 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. Under the regulations, a variety of dollar-value LIFO methods may be used, including double extension, link-chain and other index methods, in order to determine whether an increment has occurred and the cost of that increment. Certain taxpayers are permitted to use simplified LIFO methods based on externally developed price indexes. Some LIFO taxpayers that use a dollar-value, double-extension method make their computations with respect to the three components of cost (materials, labor and overhead) of their finished goods and work-in-process inventories (the "COC" method) rather than the aggregate cost of the physical items comprising these inventories (the "total product cost" method).

### **Reasons for Change**

The COC method, in many cases, does not adequately account for technological efficiencies in which skilled labor is substituted for less-skilled labor or where overhead costs (such as factory automation) replace direct labor costs. The costs of inventories determined by using the total product cost method generally are not affected by such factors.

### **Proposal**

The proposal would repeal the COC method on a prospective, or cut-off, basis. Thus, no section 481(a) adjustments would be necessary.

The proposal is not intended to affect the determination of whether the COC method is an appropriate method and the IRS would not be precluded from challenging its use in taxable years that began on or before the date of enactment.

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

## **MODIFY BASIS ADJUSTMENT RULES IN CERTAIN INVOLUNTARY CONVERSIONS**

### **Current Law**

Section 1033 provides generally that gain realized from certain involuntary conversions is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified period of time. The replacement property may be acquired directly or, alternatively, indirectly by acquiring control of a corporation that owns replacement property. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of money received or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion. The IRS has taken the position that, if the replacement property is stock in a corporation, the basis adjustment rules do not affect depreciation deductions claimed by the corporation with respect to the assets it owns.

### **Reasons for Change**

Where the replacement property in an involuntary conversion is stock in a corporation, it is necessary to adjust the basis in the assets of the corporation in order to properly reflect the purpose of the involuntary conversion rollover rules to allow deferral of gain recognition (but not avoidance of that gain).

### **Proposal**

Under the proposal, where a taxpayer acquires a controlling interest in the stock of a corporation as replacement property after an involuntary conversion, the corporation will generally be required to reduce its adjusted bases in its assets by the same amount as the taxpayer is required to reduce its basis in the acquired stock. The corporation's adjusted bases in its assets would not be reduced, in the aggregate, below the taxpayer's basis in its stock. In addition, the basis of any individual asset would not be reduced below zero. The basis reduction would be applied first to property that is similar or related in service or use to the converted property, then to other depreciable property, and finally to any other property.

The proposal would be effective for involuntary conversions occurring after September 13, 1995.

This proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **EXPAND REQUIREMENT THAT INVOLUNTARILY CONVERTED PROPERTY BE REPLACED WITH PROPERTY ACQUIRED FROM AN UNRELATED PERSON**

### **Current Law**

Under section 1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified period of time. C corporations (and partnerships with one or more corporate partners that own more than 50 percent of the capital or profits interest in the partnership) generally are not entitled to defer gain under section 1033 if the replacement property (including stock) is purchased from a related person. For this purpose, whether persons are related is determined by reference to sections 267(b) and 707(b)(1). This limitation does not apply to the extent the related person acquired the replacement property from an unrelated third party during the replacement period (generally, the end of the second full taxable year after the taxable year in which gain is first realized as a result of the conversion).

### **Reasons for Change**

The concerns regarding the acquisition of replacement property from a related party generally apply to non-corporate taxpayers as well as to corporate taxpayers.

### **Proposal**

The proposal would extend the rule denying gain deferral to any other taxpayer, including an individual, that acquires replacement property from a related person (within the meaning of sections 267(b) and 707(b)(1)) unless the taxpayer has aggregate realized gain of \$100,000 or less during the year as a result of involuntary conversions. In the case of a partnership or S corporation, the annual \$100,000 limitation would apply to the entity and each partner or shareholder. The proposal would be effective for involuntary conversions occurring after September 13, 1995.

The proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **FURTHER RESTRICT LIKE-KIND EXCHANGES INVOLVING PERSONAL PROPERTY**

### **Current Law**

An exchange of property, like a sale, is generally a taxable transaction. However, under section 1031 of the Internal Revenue Code, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind" which is to be held for productive use in a trade or business or for investment. In general, any kind of real estate is treated as of a like kind with other real property. By contrast, different kinds of personal property are not treated as of a like kind. Regulations under section 1031 provide that property that is of a "like class" is treated as being of a like kind. Certain types of personal property, such as inventory, stocks and bonds, and partnership interests, are not eligible for nonrecognition treatment under section 1031. In addition, in 1989 Congress amended section 1031 to provide that real property located in the United States and real property located outside the United States are not of a like kind.

In order to preserve the gain not recognized in a like-kind exchange, the basis of the property acquired is equal to the basis of the property transferred, decreased in the amount of any money received by the taxpayer and increased in the amount of gain (or decreased in the amount of loss) recognized by the taxpayer on the exchange.

### **Reasons for Change**

The limitations on exchanges of personal property should more closely conform to the limitations on exchanges of real property.

### **Proposal**

Under the proposal, personal property used predominantly within the United States and personal property used predominantly outside the United States would be treated as not of a like kind. Generally, the predominant use of the property relinquished in the exchange would be determined according to its use during the 2-year period ending on the date of relinquishment and the predominant use of the property acquired in the exchange would be determined according to its use during the 2-year period beginning on the date of acquisition. In addition, certain property that is used outside the United States but is not subject to the current-law alternative depreciation system applicable to property used predominantly outside the United States would be treated as used predominantly in the United States for purposes of this proposal.

In general, this proposal would be effective for transfers after December 6, 1995, in taxable years ending after such date. However, the proposal would not apply to any transfer made pursuant to a written binding contract in effect on December 6, 1995, and at all times

thereafter before the transfer. For purposes of this rule, a written contract may be treated as binding even if it provides for a sale in lieu of an exchange, or the replacement property to be received was not identified before December 7, 1995.

## **DENY ROLLOVER OR EXCLUSION OF GAIN ON SALE OF PRINCIPAL RESIDENCE WHICH IS ATTRIBUTABLE TO DEPRECIATION DEDUCTIONS**

### **Current Law**

Generally, under section 1034 no gain is recognized on the sale or exchange of a principal residence to the extent that the amount of sales price of the old residence is reinvested in a new residence within a specified period. This period generally begins two years before the sale of the old residence and ends two years after that sale.

In addition, section 121 generally provides that a taxpayer may exclude from gross income up to \$125,000 of gain from the sale or exchange of a principal residence if the taxpayer (i) has attained age 55 before the sale, and (ii) has used the residence as a principal residence for three or more years of the five years preceding the sale. This election is allowed only once in a lifetime unless all previous elections are revoked. For these purposes, sales on or before July 26, 1978, are not counted against the once-in-a-lifetime limit.

In the case of a mixed use of a residence (i.e., part principal residence, part rental property or home office), the section 121 exclusion is limited to that portion of the residence that is used by the individual as his principal residence for at least 3 of the 5 years preceding the sale. Similarly, the portion of gain attributable to business or rental use during the year of sale is not eligible for deferral under section 1034.

Depreciation deductions allowable with respect to an individual's residence reduce the individual's basis the residence.

### **Reasons for Change**

Depreciation is allowed with respect to a portion of a residence when that portion is used for business or production of income purposes. Thus, the portion of any gain realized on the sale of a residence that is attributable to allowable depreciation should not be eligible for deferral under section 1034 or the exclusion provided by section 121, as those provisions are intended to mollify certain tax implications of the personal use of a residence. Thus, the amount of realized gain attributable to depreciation should be subject to immediate recognition.

### **Proposal**

Gain would be recognized on the sale of a principal residence to the extent of any depreciation allowable with respect to the residence for periods after December 31, 1996. In addition, the amount of otherwise allowable one-time exclusion would be reduced to the extent of depreciation allowable with respect to the principal residence for periods after

December 31, 1996.

The proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **REQUIRE REGISTRATION OF CERTAIN CONFIDENTIAL CORPORATE TAX SHELTERS**

### **Current Law**

A tax-shelter organizer must register the shelter with the IRS if the tax shelter meets the following two requirements. First, any investment in the tax shelter must be (1) pursuant to an offering that is required to be registered under a Federal or state law regulating securities, (2) pursuant to an offering that is exempt from registration under such laws but with respect to which a notice must be filed with a Federal or state agency regulating the offering or sale of securities, or (3) a substantial investment. Second, any person must be able reasonably to infer from the representations made or to be made in connection with the offering for sale of interests in the investment that the ratio of deductions and 350 percent of credits to the investment for any investor (the "tax shelter ratio") may be greater than two to one as of the close of any of the first five years ending after the date on which the investment is offered for sale.

### **Reasons for Change**

Many corporate tax shelters are not registered with the IRS. Requiring registration of corporate tax shelters would result in the IRS receiving useful information at an early date regarding various forms of tax shelter transactions engaged in by corporate participants. This will allow the IRS to make better informed judgments regarding the audit of corporate tax returns and to monitor whether legislation or administrative action is necessary regarding the type of transactions being registered.

### **Proposal**

The proposal would require registration with the IRS of any investment, plan, arrangement or transaction (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant, (2) that is offered to any potential participant under conditions of confidentiality (for example confidentiality agreements entered with or for the benefit of the promoter), and (3) for which the tax shelter promoter (or promoters) may receive total fees in excess of \$100,000. Registration materials will be protected taxpayer information, and there will be substantial penalties for non-compliance. The proposal would be effective for any tax shelter offered to potential participants after the date the Secretary of the Treasury prescribes guidance regarding the filing requirements.

This proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **REQUIRE REPORTING OF PAYMENTS TO CORPORATIONS RENDERING SERVICES TO FEDERAL AGENCIES**

### **Current Law**

All persons engaged in a trade or business and making payments of \$600 or more to another person in remuneration for services generally must report those payments to the IRS and to the recipient. No reporting is required if the recipient is a corporation.

### **Reasons for Change**

The lack of reporting of payments made to corporations permits significant amounts of income to escape the tax system. Corporations that do business with the Federal Government should appropriately report as income their payments from the Federal Government.

### **Proposal**

The proposal would generally require reporting of payments of \$600 or more made to corporations for services rendered to Federal executive agencies. However, the Treasury Secretary would be authorized to prescribe regulations to except reporting in appropriate circumstances. 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.

## **INCREASE PENALTIES FOR FAILURE TO FILE CORRECT INFORMATION RETURNS**

### **Current Law**

Any person required to report payments of \$600 or more for services that fails to report those amounts timely or reports amounts incorrectly 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 or amounts, 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. The increased penalty would not apply if the aggregate amount actually reported by the taxpayer on all returns filed for that calendar 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.

## **EXTEND DISCLOSURE OF RETURN INFORMATION FOR ADMINISTRATION OF CERTAIN VETERANS' PROGRAMS**

### **Current Law**

The Department of Veterans Affairs (DVA) is permitted to obtain gross income information from the Social Security Administration and the IRS for the purpose of means-testing veterans' benefits. This authority expires on September 30, 1998.

### **Reasons for Change**

The Department of Veterans Affairs (DVA) effectively uses this information for the purpose of means-testing veterans' benefits.

### **Proposal**

The proposal would extend the authority to disclose return information to the DVA through September 30, 2002.

The proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **EXTEND IRS USER FEES**

### **Current Law**

The IRS generally charges fees for private rulings, such as a letter ruling, determination letter, opinion letter, or similar administrative determination. This authority is scheduled to expire on September 30, 2000.

### **Reasons for Change**

Rather than requiring the costs of special rulings to be paid by all taxpayers, through the general appropriations process, it is appropriate for the IRS to recover some of those costs through user fees from the specific taxpayers to whom the rulings are provided.

### **Proposal**

The proposal would extend the IRS's authority to impose user fees for private rulings through September 30, 2002.

The proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 and in HR 2778 as passed by Congress.

## **APPLY FAILURE-TO-PAY PENALTY TO SUBSTITUTE RETURNS**

### **Current Law**

The failure to pay penalty, which is a percentage of the tax due, generally runs from the due date of a return until the tax is paid. If, however, a taxpayer fails to file a return, and the Commissioner prepares a substitute return for the taxpayer, then the tax on which the penalty is measured is considered a deficiency and the penalty begins to run only ten days after the IRS sends the taxpayer notice and demand for payment of the tax.

### **Reasons for Change**

Taxpayers for whom the Commissioner prepares substitute returns should not be treated better than taxpayers who pay late but nevertheless file their own returns.

### **Proposal**

The proposal would require that the failure to pay penalty apply to taxpayers for whom the Commissioner prepares substitute returns in the same manner as it applies to delinquent taxpayers, *i.e.*, that it commence running from the due date of the return. The proposal would be effective for returns the due date for which (without regard to extensions) is after the date of enactment of the proposal.

The proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **EXTEND WITHHOLDING TO 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 date of enactment.

The proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **REQUIRE TAX REPORTING FOR PAYMENTS TO ATTORNEYS**

### **Current Law**

Tax information reporting is required for persons engaged in a trade or business making payments in the course of the trade or business of rent, salaries, wages, or other fixed or determinable income. Treasury regulations require a payor to report payments of attorney's fees if the payments are made in the course of a trade or business. If, however, a payment to an attorney is a gross amount and it cannot be determined what portion is the attorney's fee (as is the case with payments of lump-sum judgments or settlements made payable to a lawyer and plaintiff jointly), no reporting is required. In general, a payor is not required to report payments made to corporations.

### **Reasons for Change**

Payments of judgments and settlements made by insurance companies to attorneys and their clients jointly can yield large legal fees that are not now reported by any payor and are often under-reported by the recipients.

### **Proposal**

The proposal would require any person making a payment in the course of a trade or business to a lawyer (as sole or joint payee) to report the payment to the IRS. A payment to a law firm would be a payment to a lawyer for this purpose. When the portion that constitutes fees cannot be determined, the amount paid would be reported as gross proceeds. These reporting requirements would not apply to the extent provided in regulations if their application would result in double reporting (e.g., if the payor knows a payment does not include attorneys fees because the payor has made, and reports, a separate payment of fees to the attorney). In addition, the exception from reporting for payments made to corporations would not apply to payments of legal fees under the proposal. A lawyer receiving a payment would be required to provide his or her taxpayer identification number to the payor or be subject to applicable penalties and backup withholding. The proposal would be effective for payments made after December 31, 1996.

The proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **REPEAL ADVANCE REFUNDS OF DIESEL FUEL TAX FOR DIESEL CARS AND TRUCKS**

### **Current Law**

A Federal excise tax is imposed on highway motor fuels at a rate of 18.3 cents per gallon in the case of gasoline and 24.3 cents per gallon in the case of diesel fuel. The first purchaser of a diesel-powered highway vehicle with a gross vehicle weight of not more than 10,000 pounds is entitled to a payment in the nature of an advance refund of the difference between the diesel fuel excise tax and the gasoline excise tax. The amount of the payment is \$102 in the case of automobiles and \$198 in the case of a light truck or van.

### **Reasons for Change**

The tax code provides a refund to the purchasers of diesel-powered automobiles, light trucks, and vans because those vehicles contribute no more to highway maintenance costs than similar gasoline-powered vehicles but their owners pay a higher share of those costs unless the higher tax on diesel fuel they purchase is partially offset. However, changes in driving patterns and vehicles currently being marketed have resulted in fewer diesel-powered automobiles, vans, and light trucks today than was the case when the advance refund was enacted. In addition, each individual refund is very small and results in processing and other administrative costs disproportionate to its size. Thus, repeal of the advance refund is justifiable because it will reduce administrative costs and simplify the tax code.

### **Proposal**

The provision allowing payments to purchasers of diesel-powered automobiles and light trucks would be repealed for vehicles purchased after the date of enactment.

The proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **PERMIT DISCLOSURE OF FORM 8300 INFORMATION**

### **Current Law**

Any person who receives more than \$10,000 in cash in one transaction (or two or more related transactions) in the course of a trade or business generally must file an information return (Form 8300) giving the name and identifying information of the payor and the amount received. The IRS was temporarily permitted to disclose this information to other Federal agencies for Federal law enforcement purposes, but this authority expired in 1992.

### **Reasons for Change**

Information filed on Form 8300 is very similar to information filed on Currency Transaction Reports. Tax information should be accessible to the same agencies as Currency Transaction Reports for similar non-tax administration purposes.

### **Proposal**

The proposal would: (1) permanently extend the IRS's authority to disclose Form 8300 information; (2) expand that authority to permit disclosures not only to Federal agencies for Federal law enforcement purposes, but also to state, local, and foreign agencies for civil, criminal, and regulatory purposes (other than tax administration); and (3) make such disclosures subject to other information safeguards in the Code.

The proposal would be effective after the date of enactment.

## **EXTEND AUTHORITY FOR UNDERCOVER OPERATIONS**

### **Current Law**

An exemption in the Anti-Drug Abuse Act of 1988 permitted the IRS to use the income earned in undercover operations to pay additional expenses incurred in such operations. This authority was subject to detailed reporting requirements. The exemption, which originally expired December 31, 1989, was previously extended through December 31, 1991, but the IRS has not had the authority to use funds from undercover operations since that date.

### **Reasons for Change**

Other law enforcement agencies have similar authority, and it is appropriate for the IRS to have the same ability to fund ongoing operations.

### **Proposal**

The proposal would reinstate the IRS's authority to use funds from undercover operations from the date of enactment through January 1, 2001, subject to enhanced oversight and reporting obligations.

## **PROVIDE INTERMEDIATE SANCTIONS ON AMOUNTS OF PRIVATE EXCESS BENEFITS**

### **Current Law**

#### **Private Inurement**

In order to be recognized as a tax-exempt organization described in section 501(c)(3), a charity must not allow any of its net earnings to inure to the benefit of any private shareholder or individual. Several other types of organizations, such as labor and agricultural organizations described in section 501(c)(5) and trade associations described in section 501(c)(6), are also subject to this prohibition against "private inurement." However, the private inurement restriction does not apply to social welfare organizations described in section 501(c)(4).

#### **Sanctions for private inurement and other violations of exemption standards**

Section 509 divides section 501(c)(3) organizations into two categories, public charities and private foundations. Public charities are generally organizations with a broad base of public support. Private foundations are generally organizations with a limited number of contributors.

If a public charity engages in activities resulting in any amount of private inurement, it will have violated the requirements for tax-exempt status. In such cases, the only sanction that is specifically authorized under the Code is revocation of the organization's tax-exempt status. By contrast, private foundations are subject to penalty excise taxes under section 4945 on any expenditures they make that do not serve charitable purposes. In addition, certain disqualified persons who have close relationships with private foundations as well as the foundation's managers are subject to penalty excise taxes under section 4941 if they participate in "self-dealing" transactions with the private foundation.

Sanctions in addition to revocation of tax-exempt status are also available when either public charities or private foundations violate requirements of section 501(c)(3) other than the private inurement prohibition. For example, if a public charity or a private foundation makes a political expenditure, violating the section 501(c)(3) prohibition against political activities, it will be subject to a penalty excise tax under section 4955. Similarly, if a public charity makes excessive lobbying expenditures, violating the section 501(c)(3) prohibition against substantial activities seeking to influence legislation, it will be subject to a penalty excise tax under section 4911 or section 4912.

## Filing and Public Disclosure Rules

Tax-exempt organizations (other than churches and certain small organizations) are required to file an annual information return (Form 990) with the Internal Revenue Service ("IRS") setting forth information about the organization's income, expenses, disbursements, personnel and activities. Private foundations are required to allow public inspection at the foundation's principal office of their current annual information return. Other tax-exempt organizations, including public charities, are required to allow public inspection at the organization's principal office (and certain regional or district offices) of their annual information returns for the three most recent taxable years (section 6104(e)). The Code also requires that tax-exempt organizations allow public inspection of the organization's application to the IRS for recognition of tax-exempt status, the IRS determination letter, and certain related documents. In addition, upon written request to the IRS, members of the general public are permitted to inspect annual information returns of tax-exempt organizations and applications for recognition of tax-exempt status (and related documents) at the National Office of the IRS. When viewing these document at the IRS National Office, notes and photographs may be taken and copies made for a fee. (Treas. Reg. §§ 301.6104(a)-6 and 301.6104(g)-1).

Section 6652(c)(1)(A) provides that a tax-exempt organization that fails to file a complete and accurate Form 990 is subject to a penalty of \$10 for each day during which such failure continues (with a maximum penalty with respect to any one return of the lesser of \$5,000 or five percent of the organization's gross receipts for the year). Section 6652(c)(1)(C) provides that tax-exempt organizations that fail to make certain annual returns and applications for exemption available for public inspection are subject to a penalty of \$10 for each day the failure continues (with a maximum penalty with respect to any one return not to exceed \$5,000 and without limitation with respect to applications). In addition, section 6685 provides a penalty for willfully failing to make an annual return or application available for public inspection of \$1,000 per return or application.

Organizations that have tax-exempt status but that are not eligible to receive tax deductible charitable contributions are required expressly to state in certain fundraising solicitations that contributions or gifts to the organization are not deductible as charitable contributions for Federal income tax purposes (section 6113). Penalties may be imposed on such organizations for failure to comply with this requirement (section 6710).

## Reasons for Change

Sanctions on section 501(c)(3) organizations other than revocation of tax-exempt status are needed to improve enforcement of the private inurement prohibition. In particular, a sanction is needed that reaches the private parties to whom benefits are inuring, much as section 4941 does with respect to private foundation disqualified persons. In addition, to prevent organizations from using exemption under section 501(c)(4) as a way to avoid the private inurement prohibition, the private inurement prohibition and new intermediate

sanctions need to be extended to organizations described in section 501(c)(4).

## **Proposal**

### **Extend private inurement prohibition to social welfare organizations**

The proposal would amend section 501(c)(4) to provide explicitly that a social welfare organization or other organization described in that section would be eligible for tax-exempt status only if no part of its net earnings inures to the benefit of any private shareholder or individual.

This proposal generally would be effective on September 14, 1995. However, under a special transition rule, the provision would not apply to inurement occurring up to one year after the date of enactment of the statutory change, if such inurement results from a written contract that was binding on September 13, 1995, and at all times thereafter before such inurement occurred, and the terms of which have not materially changed.

### **Intermediate sanctions for excess benefit transactions**

The proposal would impose penalty excise taxes as an intermediate sanction in cases where an organization exempt from tax under section 501(c)(3) or 501(c)(4) (other than private foundations) engages in an "excess benefit transaction." In such cases, intermediate sanctions could be imposed on certain disqualified persons (i.e. insiders) who improperly benefit from an excess benefit transaction and on organization managers who participate in such a transaction knowing that it is improper.

In general, the intermediate sanction is expected to be the sole sanction imposed in those cases in which the excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization. In practice, revocation of tax-exempt status with or without the imposition of excise taxes would occur only when the organization no longer operates as a charitable organization.

An "excess benefit transaction" would be defined as (1) any transaction in which an economic benefit is provided to or for the use of any disqualified person if the value of the economic benefit provided directly by the organization (or indirectly through a controlled entity) to such person exceeds the value of consideration (including performance of services) received by the organization for providing such benefit, and (2) to the extent provided in regulations, any transaction in which the amount of any economic benefit provided to, or for the use of, any disqualified person is determined in whole or in part by the revenues of the organization, provided that the transaction constitutes prohibited inurement under present-law section 501(c)(3) or under section 501(c)(4), as amended. Thus, "excess benefit transactions" subject to excise taxes would include transactions in which a disqualified person engages in a non-fair-market-value transaction with an organization or receives unreasonable

compensation, as well as financial arrangements (to the extent provided in Treasury regulations) under which a disqualified person receives payment based on the organization's income in a transaction that violates the present-law private inurement prohibition.

Existing standards (see section 162) would apply in determining reasonableness of compensation and fair market value. In accordance with these standards, an individual need not necessarily accept reduced compensation merely because he or she renders services to a tax-exempt, as opposed to a taxable, organization. Cf. Treas. Reg. sec. 53.4941(d)-3(c)(1). In applying such standards, it is intended that the parties to a transaction would be entitled to rely on a rebuttable presumption of reasonableness with respect to a compensation arrangement with a disqualified person if such arrangement was approved by an independent board (or an independent committee authorized by the board) that (1) was composed entirely of individuals unrelated to and not subject to the control of the disqualified person(s) involved in the arrangement,<sup>1</sup> (2) obtained and relied upon appropriate data as to comparability (e.g. compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions, the location of the organization, including the availability of similar specialties in the geographic area, independent compensation surveys by nationally recognized independent firms, or actual written offers from similar institutions competing for the services of the disqualified person), and (3) adequately documented the basis for its determination (e.g. the record includes an evaluation of the individual whose compensation was being established and the basis for determining that the individual's compensation was reasonable in light of that evaluation and data).<sup>2</sup> A similar rebuttable presumption would arise with respect to the reasonableness of the valuation of the property sold or otherwise transferred (or purchased) by an organization to (or from) a disqualified person if the sale or transfer (or purchase) is approved by an independent board that uses appropriate comparability data and adequately documents its determination. It is expected that any guidance addressing the reasonableness standard would incorporate this presumption.

The proposal would specifically provide that the payment of personal expenses and benefits to or for the benefit of disqualified persons, and non-fair-market-value transactions benefiting such persons would be treated as compensation only if it is clear at the time of the

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<sup>1</sup> An individual would not be considered independent if, for example, his or her compensation were subject to review by the disqualified person whose compensation he or she was evaluating.

<sup>2</sup> The fact that a state or local legislative or agency body may have authorized or approved of a particular compensation package paid to a disqualified person would not be determinative of the reasonableness of compensation paid for purposes of the excise tax penalties provided for by the proposal. Similarly such authorization or approval would not be determinative of whether a revenue sharing arrangement violates the private inurement proscription.

payment that the organization intended and made the payment as compensation for services. In determining whether such payments or transactions are, in fact, compensation, the relevant factors would include whether the appropriate decision-making body approved the transfer as compensation in accordance with established procedures and whether the organization and the recipient reported the transfer (except in the case of nontaxable fringe benefits) as compensation on the relevant forms (i.e. the organization's Form 990, the Form W-2 or Form 1099 provided by the organization to the recipient, the recipient's Form 1040, and other required returns).

Any reimbursements by the organization of excise tax liability would be treated as an excess benefit unless they are included in the disqualified person's compensation during the year the reimbursement is made. The total compensation package, including the amount of any reimbursement, would be subject to the reasonableness requirement. Similarly, the payment by an applicable tax-exempt organization of premiums for an insurance policy providing liability insurance to a disqualified person for excess benefit taxes would be an excess benefit transaction unless such premiums are treated as part of the compensation paid to such disqualified person.

"Disqualified person" would mean any individual who is in a position to exercise substantial influence over the affairs of the organization, whether by virtue of being an organization manager or otherwise.<sup>3</sup> In addition, "disqualified persons" include certain family members and 35-percent owned entities of a disqualified person, as well as any person who was a disqualified person at any time during the five-year period prior to the transaction at issue. A person having the title of "officer, director, or trustee" would not automatically have the status of a disqualified person, nor would all highly valued professionals, such as members of a hospital's medical staff, be deemed to have substantial influence over the organizations for which they work.

A disqualified person who benefits from an excess benefit transaction would be subject to a first-tier penalty tax equal to 25 percent of the amount of the excess benefit (i.e. the amount by which a transaction differs from fair market value or the amount of compensation exceeding reasonable compensation). Organization managers who participate in an excess benefit transaction knowing that it is an improper transaction would be subject to a first-tier penalty tax of ten percent of the amount of the excess benefit (up to a maximum

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<sup>3</sup> Under the proposal, a person could be in a position to exercise substantial influence over a tax-exempt organization despite the fact that such person is not an employee of (and receives no compensation directly from) a tax-exempt organization, but is formally an employee of (and is directly compensated by) a subsidiary -- even a taxable subsidiary -- controlled by the parent tax-exempt organization.

penalty of \$10,000).<sup>4</sup>

Additional second-tier taxes could be imposed on a disqualified person if there were no correction of the excess benefit transaction within a specific time period. In such cases, the disqualified person would be subject to a penalty tax equal to 200 percent of the amount of excess benefit. The definition and timing of satisfactory correction would track those used for the private foundation self-dealing excise tax.

The intermediate sanctions for "excess benefit transactions" could be imposed by the IRS in lieu of (or in addition to) revocation of an organization's tax-exempt status. If more than one disqualified person or manager is liable for a penalty excise tax, then all such persons would be jointly and severally liable for such tax. As under current law, a three-year statute of limitations would apply, except in the case of fraud (section 6501). Under the proposal, the IRS would have authority to abate the excise tax penalty (under present-law section 4962) if it is established that the violation was due to reasonable cause and not due to willful neglect and the transaction at issue was corrected within the specified period.

To prevent avoidance of the penalty excise taxes in cases of private inurement of assets of a previously tax-exempt organization, the proposal would provide that an organization will be treated as an applicable tax-exempt organization subject to the excise taxes on excess benefit transactions if, at any time during the ten-year period preceding the transaction, it was a tax-exempt organization described in section 501(c)(3) or 501(c)(4), or a successor to such an organization.

This proposal generally would apply to excess benefit transactions occurring on or after September 14, 1995. The provision would not apply, however, to any benefits arising out of a transaction pursuant to a written contract which was binding on September 13, 1995 and at all times thereafter before such benefits arose, and the terms of which have not materially changed. In addition, parties to transactions entered into after September 13, 1995 and within one year of the date of enactment of this proposal, would be entitled to rely on the rebuttable presumption of reasonableness if, within a reasonable period (e.g. 90 days) after entering into the compensation package, the parties satisfy the three criteria that give rise to the presumption. After this period, the rebuttable presumption should arise only if the three criteria are satisfied prior to payment of the compensation (or, to the extent provided by the Secretary of the Treasury, within a reasonable period thereafter).

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<sup>4</sup> In determining who is an organization manager, it is intended that principles similar to those set forth in regulations issued under sections 4946 and 4955 with respect to final authority or responsibility for an expenditure be applied. (See Treas. Reg. secs. 53.4946-1(f)(1)(ii), 53.4946-1(f)(2), 53.4955-1(b)(2)(ii)(B) and 53.4955-1(b)(2)(iii)).

### Additional filing and public disclosure rules

Reporting with respect to disqualified persons, excise tax penalties and excess benefit transactions. Tax-exempt organizations would be required to disclose on their Forms 990 such information with respect to disqualified persons as the Secretary of the Treasury may prescribe. In addition, exempt organizations would be required to disclose on their returns information with respect to excess benefit transactions and any other excise tax penalties paid during the year under present-law sections 4911, 4912, and 4955, including the amount of the excise tax penalties paid with respect to such transactions, the nature of the activity, and the parties involved. The penalties applicable to failure to file a timely, complete and accurate return would apply for failure to comply with these requirements. In addition, it would be intended that the IRS implement its plan to require additional Form 990 reporting regarding (1) changes to the governing board or the certified accounting firm, (2) such information as the Secretary of the Treasury may require with respect to professional fundraising fees and (3) aggregate payments by related entities in excess of \$100,000 to highly paid employees.

Organizations required to provide copies of returns. Organizations described in sections 501(c) or (d) (other than private foundations) would be required to provide copies of their three most recent annual returns and any application for tax-exempt status they have filed to any individual requesting these documents. The organization may charge a reasonable fee to cover reproduction and mailing costs. If the request is made in person, it must be filled immediately. If it is made in writing, it must be filled within 30 days. Organizations that willfully fail to make these documents available would be subject to a penalty of \$5,000 with respect to each return or application requested. An organization would be relieved of the requirement that it supply these documents if it made the documents widely available in accordance with standards established by the Secretary or if the Secretary determined, upon application, that the organization was subject to a harassment campaign.

Penalties for failure to file timely or complete return. The section 6652(c)(1)(A) penalty imposed on a tax-exempt organization that either fails to file a Form 990 in a timely manner or fails to include all required information on a Form 990 would be increased from the present-law level of \$10 for each day the failure continues (with a maximum penalty with respect to any one return of the lesser of \$5,000 or five percent of the organization's gross receipts) to \$20 for each day the failure continues (with a maximum penalty with respect to any one return of the lesser of \$10,000 or five percent of the organization's gross receipts). Under the proposal, organizations with annual gross receipts exceeding \$1 million would be subject to a penalty under section 6652(c)(1)(A) of \$100 for each day the failure continues (with a maximum penalty with respect to any one return of \$50,000). As under present law, no penalty would be imposed under section 6652(c)(1)(A) if it were shown that the failure to file a complete return was due to reasonable cause (sec. 6652(c)(3)).

Effective dates. The filing and disclosure provisions governing tax-exempt organizations generally would be effective ninety days after the date of enactment. However,

the provisions regarding the reporting on annual returns of excise tax penalties and excess benefit transactions would be effective for returns with respect to taxable years beginning on or after January 1, 1996, and the requirement that organizations provide copies of their returns would be effective for requests made no earlier than 60 days after regulations had been promulgated providing standards for how returns could be made widely available.

The proposal is substantially similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **REIMPOSE SUPERFUND CORPORATE ENVIRONMENTAL INCOME TAX**

### **Current Law**

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 tax net operating loss deduction and the deduction for the corporate environmental 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, 1995, and before January 1, 2007.

## **REIMPOSE OIL SPILL LIABILITY TRUST FUND EXCISE 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 Treasury Department'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 the date of enactment and before October 1, 2006. In addition, the full funding limitation would be increased from \$1 billion to \$2.5 billion. The proposal would be effective on the date of enactment.

The proposal is similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

## **TAX KEROSENE IN THE SAME MANNER AS DIESEL FUEL**

### **Current Law**

A 24.3-cents-per-gallon excise tax is imposed on diesel fuel upon removal from a registered terminal facility unless the fuel is indelibly dyed and is destined for a nontaxable use. Treasury regulations provide that kerosene is not treated as diesel fuel for this purpose. Thus, undyed kerosene is not subject to the diesel fuel excise tax when it is removed from a terminal.

Kerosene is a petroleum distillate that is frequently blended with diesel fuel during cold weather in order to prevent formation of wax crystals in fuel lines. In some parts of the country, diesel fuel/kerosene blends containing 30-percent kerosene are common. When kerosene is blended with previously taxed diesel fuel for highway use, the untaxed portion of the mixture is taxable when the mixture is removed or sold by the blender. If kerosene is mixed with dyed diesel fuel for a nontaxable use, the dye concentration of the mixture must be adjusted to ensure that it meets regulatory requirements for untaxed, dyed diesel fuel.

Kerosene is also used as jet fuel in aircraft engines. Kerosene used as aviation fuel is currently taxed at a rate of 4.3 cents per gallon. Aviation fuel is taxed when it is sold or used by a producer, which is defined to include registered refiners, compounders, blenders, wholesale distributors, and dealers selling aviation fuel solely to other producers. However, sales between these persons are not taxed. Thus, tax is generally imposed when the fuel is sold to a retail dealer or used by a commercial airline that is registered as a producer.

Clear, low-sulfur kerosene (1-K) may also be used in space heaters, and is often available for this purpose at service station pumps. Kerosene used in space heaters is not subject to a Federal excise tax. Kerosene is also not subject to tax when it is added to diesel fuel that is used as heating oil. Although kerosene is commonly blended with heating oil before removal from the terminal, it may be necessary during periods of extreme or unseasonable cold to add pure kerosene directly to furnace supply tanks. Other nontaxable uses of kerosene include feedstock use in the petrochemical industry.

### **Reasons for Change**

Some wholesale distributors of diesel fuel have suggested that their competitors have not been paying the tax on kerosene that they blend with diesel fuel for highway use. As a result, the government is losing tax revenues and complying taxpayers are at a competitive disadvantage. However, any change to the current system should accommodate uses for which clear kerosene is necessary to comply with Federal or State rules or product safety certifications, and should not impose increased burdens on those who use kerosene in space heaters. The change should also accommodate cases in which unexpectedly severe weather conditions make it necessary to add clear kerosene to heating oil after removal from the

terminal and should not impose unnecessary burdens on feedstock uses of kerosene.

### **Proposal**

Kerosene would be subject to the same rules as diesel fuel. Thus, kerosene would be taxed when it is removed from a registered terminal unless it is indelibly dyed and destined for a nontaxable use. However, aviation-grade kerosene that is removed from the terminal by a registered producer of aviation fuel would not be subject to the dyeing requirement and would be taxed under the current law rules applicable to aviation fuel. Feedstock kerosene that a registered industrial user receives by pipeline or vessel would also be exempt from the dyeing requirement. Other feedstock kerosene would be exempt from the dyeing requirement to the extent and under conditions (including satisfaction of registration and certification requirements) prescribed by regulation. To accommodate State safety regulations that require the use of clear (1-K) kerosene in certain space heaters, a new refund procedure would be provided under which registered ultimate vendors could claim refunds of the tax paid on kerosene sold for that use. In addition, the Commissioner would be given discretion to refund to a registered ultimate vendor the tax paid on kerosene that is blended with heating oil for use during periods of extreme or unseasonable cold.

The changes would be effective on July 1, 1997, with appropriate floor stocks taxes imposed on kerosene held on that date.

## **PERMANENTLY EXTEND THE LUXURY PASSENGER AUTOMOBILE TAX**

### **Current Law**

An excise tax is imposed on the first retail sale of luxury automobiles. The tax is equal to 10 percent of the amount by which the retail sales price exceeds an inflation-adjusted \$30,000 base. The inflation-adjusted base currently is \$34,000. The tax is scheduled to expire on December 31, 1999.

### **Reasons for Change**

In the Omnibus Budget Reconciliation Act of 1990, Congress and the prior Administration agreed that a tax on luxury automobiles was an appropriate deficit reduction measure. Concerns have been expressed, however, that the scheduled expiration of the tax will substantially depress sales of automobiles subject to the tax for several months prior to its expiration.

### **Proposal**

The luxury tax on automobiles would be extended permanently.

## **EXTEND THE FUTA SURCHARGE AND REQUIRE MONTHLY DEPOSITS**

### **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. This 6.2 percent rate includes a temporary surtax of 0.2 percent. 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.

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8 percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The surtax has been extended several times, the most recently through 1998, to build up reserves in the Federal trust accounts and thus to help avoid future funding problems in these accounts.

### **Reasons for Change**

Extending the surtax will support the continued solvency of the Federal unemployment trust funds and maintain the ability of the unemployment system to adjust to any economic downturns.

Accelerating collections may reduce losses to the Federal unemployment trust funds caused by employer delinquencies and provide a regular inflow of money to State funds to offset the regular payment of benefits. Limiting the application of acceleration to larger employers would avoid imposing additional requirements on small businesses.

### **Proposal**

The proposal would extend the 0.2 percent surtax through December 31, 2006.

The proposal would also 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 permitted to adopt a similar mechanism for paying State unemployment taxes. This proposal would be effective for months beginning after December 31, 2001.

## MODIFICATIONS TO EARNED INCOME TAX CREDIT

### Current Law

#### *Structure of and eligibility for the credit generally*

Certain eligible low-income workers are entitled to claim a refundable earned income tax credit (EITC) on their income tax return. The amount of the credit an eligible individual may claim depends upon whether the individual has one, more than one, or no qualifying children and is determined by multiplying the credit rate by the taxpayer's earned income (up to a maximum earned income amount). The maximum amount of the credit is the product of the credit rate and this earned income amount. For taxpayers with earned income (or adjusted gross income (AGI), if greater) in excess of the beginning of a phase-out range of income, the maximum credit is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range of income. For taxpayers with earned income (or AGI, if greater) in excess of the phaseout range of income, no credit is allowed.

The parameters of the credit depend upon the number of qualifying children the individual claims. For 1996, the parameters are as follows:

	Two or more qualifying children	One qualifying child	No qualifying children
Credit rate	40.00%	34.00%	7.65%
Earnings at which maximum credit is reached	\$8,890	\$6,330	\$4,220
Maximum credit	\$3,556	\$2,152	\$323
Phaseout begins	\$11,610	\$11,610	\$5,280
Phaseout rate	21.06%	15.98%	7.65%
Phaseout ends	\$28,495	\$25,078	\$9,500

For years after 1996, the credit rate and phaseout rates do not change. The earned income amount and the beginning of the phaseout range of income are indexed for inflation, and because the end of the phaseout range depends on those amounts (as well as the credit and phaseout rates), the end of the phaseout range will also increase if there is inflation.

For taxable years beginning after December 31, 1995, an individual is not eligible for the EITC if the aggregate amount of "disqualified income" of the taxpayer for the taxable year exceeds \$2,350. Disqualified income is the sum of interest income (both taxable and tax-exempt), dividends, and positive net rent and royalty income.

In order to claim the EITC, an individual must either have a qualifying child or be older than 24 and younger than 65 and not be a dependent. A qualifying child must meet a relationship test, an age test, an identification test, and a residence test. To satisfy the identification test, individuals must include on their tax return the name and age of each qualifying child claimed. For 1996 returns filed in 1997, individuals must provide a taxpayer identification number (TIN) for all qualifying children born on or before November 30, 1996. For returns filed with respect to tax year 1997 and subsequent years, individuals must provide TINs for all qualifying children, regardless of age. An individual's TIN is generally that individual's social security number (SSN).

#### *Assessment procedures relating to mathematical and clerical errors*

The IRS may summarily assess additional tax due as a result of a mathematical or clerical error without sending the taxpayer a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate the assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. The request for abatement of the assessment is the only procedure a taxpayer may use prior to paying the assessed amount in order to contest an assessment arising out of a mathematical or clerical error. Once the assessed amount is paid or otherwise satisfied, however, the taxpayer may file a claim for refund if he or she believes the assessment was made in error.

#### *Advance EITC*

An eligible individual with a qualifying child may elect to receive a portion of the EITC on an advance basis simply by furnishing an advance payment certificate (IRS Form W-5) to his or her employer. For such an employee, the employer makes an advance payment of the EITC at the time wages are paid. The amount of advance payment allowable for the year is limited to 60 percent of the maximum credit available to an individual with one qualifying child. Advance payments by an employer during any payroll period are not treated as a payment of compensation, but rather are treated as made out of the employer's share of FICA taxes and amounts required to be withheld by the employer for income and the employee's share of FICA taxes. The balance of any EITC still due the individual is claimed on the individual's tax return.

## **Reasons for Change**

Since 1993 the Administration and Congress have taken a number of steps to improve the administration of the EITC. Further steps are desirable to ensure that only the intended beneficiaries receive the EITC.

Most EITC recipients do not have significant resources and must rely on earnings to meet their day-to-day living expenses. Taxpayers with significant capital gains or passive income, in contrast, are able to draw upon the resources that produce these kinds of income to meet family needs. Taxpayers should also be limited in their ability to claim the EITC because their adjusted gross income is reduced by certain kinds of losses.

In addition, the Administration believes the EITC should not be available to individuals who are not authorized to work in the United States. In this regard, only taxpayers with valid TINs should receive the EITC and certain other tax benefits.

Finally, receiving the EITC through advance payments may help recipients' cash flow and reinforce the message that "work pays," particularly among those who are trying to take the step from welfare to work. In the past, few EITC recipients have chosen to receive any portion of their EITC on an advance basis. The reasons for the low utilization rate are not fully known. The IRS has undertaken an intensive effort to educate both employers and eligible employees about the advance payment option, but participation still remains relatively low. The Administration is interested in learning whether participation would improve if State agencies were given the authority to provide advance payments on a limited basis.

## **Proposal**

Individuals would not be eligible for the EITC if they do not include their TIN (and, if married, their spouse's TIN) on their tax return. For this purpose, as well as for purposes of the present-law identification requirement for a qualifying child, the required TIN would be an SSN issued to an individual by the Social Security Administration other than a number issued under section 205(c)(2)(B)(i)(II) (or that portion of section 205(c)(2)(B)(i)(III) relating to section 205(c)(2)(B)(i)(II)) of the Social Security Act (regarding the issuance of a number to an individual applying for or receiving federally funded benefits).

If an individual fails to provide a correct TIN, the omission would be treated as a mathematical or clerical error. Similarly, if an individual who claims the credit with respect to net earnings from self-employment fails to pay the proper amount of self-employment tax on those net earnings, the failure would be treated as a mathematical or clerical error for purposes of the amount of EITC allowed. Finally, taxpayers would be required to provide a correct TIN for any dependent claimed on the return, and the failure to do so would be treated as a mathematical or clerical error. In such a case, the IRS would be authorized to deny the dependency exemption (subject to the taxpayer's ability to file a request for an abatement of the resulting assessment). The denial would also have indirect consequences

for other tax benefits conditioned on being able to claim a dependency exemption (e.g., head of household filing status and the dependent care credit).

The definition of disqualified income would be expanded to include net passive income that is not self-employment income and net capital gain (only to the extent such net amounts are positive). In addition, the disqualified income threshold would be lowered to \$2,200 in 1996 and indexed for inflation thereafter (subject to a \$50 round-down rule).

The definition of AGI for purposes of applying the phaseout rules would be modified by disregarding net capital losses, net losses from nonbusiness rents and royalties, net losses from trusts and estates, and 50 percent of the business losses from sole proprietorships (both farming and nonfarming) and from partnerships and S corporations.

Lastly, a demonstration program would be authorized pursuant to which an eligible individual would be able to receive the EITC on an advance basis from a designated State agency instead of receiving it on an advance basis from his or her employer. States interested in participating in the program would submit proposals to the Secretary of the Treasury who, in consultation with the Secretary of Health and Human Services, would select projects in up to 4 States. Advance EITC payments would be made for 3 years under the demonstration programs.

EITC recipients participating in the programs would receive up to 75 percent of the maximum credit available to an EITC claimant with the corresponding number of qualifying children. The advance payments, which would be made no less frequently than quarterly, would not be treated as compensation and would not be includible in the recipient's income. The State agency would be allowed to make such payments out of amounts withheld by the State from its employees' pay for income and employee FICA taxes as well as out of its own employer FICA liability.

The proposals submitted by States would include an explanation of how the advance EITC payments would be administered by the appropriate State agency and of how the payments would be coordinated with other benefits. A detailed explanation would also be required of how eligibility for the credit would be determined and verified. States would have to agree to provide to the IRS and participating recipients by January 31 annual information reports showing the participant's name, TIN, and the amount of advance payments made during the previous year. States would also be required to submit to the IRS by December 1 the name and TIN of each participant. States would be responsible for a portion of the erroneous advance EITC payments made as part of the demonstration program.

Generally these proposed changes to the EITC would be applicable for taxable years beginning after December 31, 1995. The provisions treating certain omissions as mathematical or clerical errors would be effective for returns the due date for which (without regard to extensions) is more than 30 days after the date of enactment of the proposal. The

demonstration project provisions would be effective for taxable years beginning after December 31, 1996.

## **REIMPOSE AIRPORT AND AIRWAY TRUST FUND EXCISE TAXES**

### **Current Law**

Before January 1, 1996, the Airport and Airway Trust Fund was supported by taxes on air passenger transportation, domestic air freight transportation, and noncommercial aviation fuel. The tax on domestic air passenger transportation was 10 percent of the amount paid for the transportation, the tax on international departures was \$6 per person, the tax on domestic air freight transportation was 6.25 percent of the amount paid for the transportation, and the tax on noncommercial aviation fuel, to the extent dedicated to the Trust Fund, was 17.5 cents per gallon (15 cents per gallon in the case of gasoline). The taxes on air passenger and air freight transportation, the dedicated tax on noncommercial jet fuel, and a 1-cent-per-gallon dedicated tax on noncommercial aviation gasoline expired on December 31, 1995. The authority to transfer tax revenues to the Trust Fund also expired on December 31, 1995.

### **Reason for Change**

To provide for necessary Federal airport and airway expenditures, the aviation excise taxes should be reinstated and revenues from the reinstated taxes should be transferred to the Airport and Airway Trust Fund.

### **Proposal**

The aviation excise taxes would be reinstated for the period after the date of enactment and before October 1, 2006. (The Administration understands that these taxes may be replaced by a fee-based structure before the proposed expiration date.) The reinstated taxes on air passenger and air freight transportation would not apply to amounts paid on or before the date of enactment. The authority to transfer revenues to the Airport and Airway Trust Fund would be reinstated for the period after December 31, 1995, and before October 1, 2006.

## **REIMPOSE LEAKING UNDERGROUND STORAGE TANK TRUST FUND TAX**

### **Current Law**

Before January 1, 1996, a tax of 0.1 cent per gallon was imposed on gasoline, diesel fuel, special motor fuels, aviation fuel, and fuels used on inland waterways. Revenues from the tax were dedicated to the Leaking Underground Storage Tank (LUST) Trust Fund.

### **Reason for Change**

The LUST Trust Fund taxes should be reinstated to ensure the availability of funds to pay clean-up costs associated with leaks from underground storage tanks.

### **Proposal**

The LUST Trust Fund tax would be reinstated for the period after the date of enactment and before October 1, 2006.

## **REIMPOSE 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.

### **Reason 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, 2006.





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