General Explanations of the Administration's Revenue Proposals

Department of the Treasury
February 1998

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EXPANDING THE CHILD AND DEPENDENT CARE TAX CREDIT

Current Law

A taxpayer may be eligible for a nonrefundable tax credit if he or she pays for the care of a qualifying individual in order to work. Qualifying individuals include children under the age of 13 and disabled dependents or spouses. The credit is equal to a percentage of the taxpayer's employment-related expenditures for child or dependent care. A taxpayer must provide over half the costs of maintaining the household in which the taxpayer and the qualifying dependent reside.

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

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

Reasons for Change

Many working parents cannot find affordable and safe child care. In the FY 1999 budget, the Administration is proposing a comprehensive initiative to address the child care needs of both low- and moderate-income working families. Low-income families will receive additional assistance through an expansion of the Child Care and Development Block Grant. The needs of moderate-income families can be best served through an expansion of the child and dependent care tax credit, which was last increased in 1982.

Proposal

The maximum child and dependent care tax credit rate would be increased from 30 percent to 50 percent. Taxpayers would be eligible for the 50 percent credit rate if their adjusted gross income is $30,000 or less. For taxpayers with adjusted gross incomes between $30,000 and $59,000, the credit rate would be reduced by one percentage point for each additional $1,000, or fraction thereof, of adjusted gross income in excess of $30,000. Taxpayers with adjusted gross incomes over $59,000 would be eligible for a 20 percent credit rate.

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

The provision would be effective for tax years beginning after December 31, 1998. Beginning in the year 2000, the starting point for the phase-down range would be indexed for inflation. The maximum amounts of qualifying child and dependent care expenses that could be claimed for the credit would also be indexed, beginning in 2000.

EMPLOYER CREDIT FOR EXPENSES OF SUPPORTING EMPLOYEE CHILD CARE

Current Law

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

Reasons for Change

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

Proposal

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

(1) to acquire, construct, rehabilitate or expand property that is to be used as part of a taxpayer's qualified child care facility;

(2) for the operation of a taxpayer's qualified child care facility, including the costs of training and continuing education for employees of the child care facility; or

(3) under a contract with a qualified child care facility to provide child care services to employees of the taxpayer.

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

operations. If a new facility failed to meet this requirement, the credit would be subject to recapture.

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

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

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

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

PROVIDE TAX CREDIT FOR ENERGY-EFFICIENT BUILDING EQUIPMENT

Current Law

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

Reasons for Change

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

Proposal

A credit would be provided for the purchase of certain types of highly efficient building equipment: fuel cells, electric heat pump water heaters, advanced natural gas and residential size electric heat pumps, and advanced central air conditioners. The credit would equal 20 percent of the purchase price, subject to a cap. The credit would be nonrefundable. For businesses, it would be subject to the limitations on the general business credit and would reduce the basis of the equipment. The credit would generally be available for final purchases from unrelated third parties between January 1, 1999 and December 31, 2003 for use within the United States. (Because of the current state of technology, the credit for fuel cells would be available for purchases between January 1, 2000 and December 31, 2004.)

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

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

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

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

Natural gas heat pumps use either a gas-absorption cycle or a gas-driven engine to power the vapor compression cycle to extract heat from one source and deliver it to another. Qualifying natural gas heat pumps would be those with a coefficient of performance for heating of at least 1.25 and for cooling of at least 0.70.

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

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

PROVIDE TAX CREDIT FOR PURCHASE OF NEW ENERGY EFFICIENT HOMES

Current Law

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

Reasons for Change

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

Proposal

A tax credit of up to $2,000 would be available to purchasers of highly energy efficient new homes. To claim the credit, the taxpayer must use the new home as the taxpayer's principal residence, and the new home must use at least 50 percent less energy for heating, cooling and hot water than the Model Energy Code standard for single family residences. The tax credit would be one percent of the purchase price of the home up to a maximum credit of $2,000 for eligible homes purchased in the five-year period beginning January 1, 1999 and ending December 31, 2003. The credit would be available for an additional two years, i.e., for homes purchased January 1, 2004 through December 31, 2005, with a maximum credit of $1,000.

PROVIDE TAX CREDIT FOR HIGH-FUEL-ECONOMY VEHICLES

Current Law

No generally available income tax credit for purchases of fuel-efficient vehicles is provided currently. A 10 percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000. A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current, the original use of which commences with the taxpayer, and that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2002. The credit begins to phase down in 2002 and phases out in 2005.

Certain costs of qualified clean-fuel vehicle property may be deducted when such property is placed in service. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction. The deduction phases down in the years 2002 through 2004.

Reasons for Change

The transportation sector now accounts for one-third of greenhouse gas emissions in the United States. Cars, sport utility vehicles, light trucks and minivans alone account for 20 percent of our greenhouse gas emissions.

The proposed credits will encourage the early introduction and purchase of highly fuel-efficient vehicles and will help to move ultra fuel efficient vehicles with three times the fuel efficiency of today's vehicles from the laboratory to the highway. These vehicles can significantly reduce emissions of carbon dioxide, the most prevalent greenhouse gas.

Proposal

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

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

(2) Credit for vehicles with twice the base fuel economy. This credit would be $3,000 for each vehicle that has twice the base fuel economy for its class. The $3,000 credit would be available for purchases of qualifying vehicles after December 31, 1999 and

before January 1, 2004. The credit amount would phase down to $2,000 in 2004, $1,000 in 2005, and would phase out in 2006.

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

EQUALIZE TREATMENT OF PARKING AND TRANSIT BENEFITS

Current Law

Under current law, qualified transportation fringe benefits provided by an employer are excluded from income. Qualified transportation fringe benefits include parking, transit passes, and vanpool benefits. For taxable years beginning after December 31, 1997, parking is excludable from gross income even when provided in lieu of other compensation payable to an employee. Transit passes and vanpool benefits, however, are only excludable if provided in addition to, and not in lieu of, any compensation otherwise payable to an employee.

Under current law, up to $155 (in 1993 dollars) per month of employer-provided parking benefits is excludable from income; in 1998 the limit is $175 per month. Up to $60 (in 1993 dollars) per month of employer-provided transit and vanpool benefits is excludable from income; in 1998 the limit is $65 per month.

Reasons for Change

The tax treatment of transit and vanpool benefits should be equalized with the tax treatment of parking benefits. This equalization would eliminate the tax disincentives for providing transit and vanpool benefits relative to parking benefits.

Proposal

Under the proposal, employers would be allowed to offer their employees transit and vanpool benefits in lieu of compensation, beginning January 1, 1999. The proposal would enact the same change for transit and vanpool benefits that the Taxpayer Relief Act of 1997 enacted for parking benefits.

The proposal also would raise the monthly limit on employer-provided transit and vanpool benefits excludable from income to $155 (in 1993 dollars) per month, i.e., the limit on parking benefits. As under current law, the amount of the benefits would be indexed for inflation.

PROVIDE INVESTMENT TAX CREDIT FOR COMBINED HEAT AND POWER (CHP) SYSTEMS

Current Law

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

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

Reasons for Change

Combined heat and power systems utilize thermal energy that is otherwise wasted in the process of producing electricity by more conventional methods. CHP systems achieve greater energy efficiency, lessen the consumption of primary fossil fuels, lower total energy costs, and reduce carbon emissions. An investment tax credit for CHP assets is expected to encourage and accelerate investment in such systems. The increased demand for CHP equipment should, in turn, reduce manufacturing costs and spur technological innovation in improved CHP systems.

Proposal

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

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

The credit would be subject to the limitations on the general business credits. The depreciable basis of qualified property for which the credit is taken would be reduced by the amount of the credit. Regulated public utilities claiming the credit would be required to use a normalization method of accounting with respect to the credit. Taxpayers using the credit for CHP systems would not be entitled to any other tax credit for the same equipment. The credit would apply to investments in CHP systems placed in service after December 31, 1998, but before January 1, 2004.

PROVIDE TAX CREDIT FOR REPLACEMENT OF CERTAIN CIRCUIT BREAKER EQUIPMENT

Current Law

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

Reasons for Change

Some power circuit breakers used in the transmission and distribution of electric power use sulfur hexaflouride (SF6). Certain older circuit breakers that use a dual pressure technology are especially prone to leak SF6 gas. Of all greenhouse gases, SF6 is among the most potent because it has an expected atmospheric lifetime of over three thousand years, and a global warming potential 23,900 times that of carbon dioxide, the most abundant greenhouse gas.

Proposal

A tax credit would be available for the installation of new power circuit breaker equipment to replace certain older power circuit breakers. The tax credit would be 10 percent of qualified investment. To be eligible for the credit, the replaced power circuit breakers must be dual pressure circuit breakers that contain SF6, have a capacity of at least 115kV, and have been installed by December 31, 1985. The replaced circuit breaker equipment must be destroyed so as to prevent its further use. The credit would be subject to the limitations on the general business credits. The depreciable basis of qualified property for which the credit is taken would be reduced by the amount of the credit claimed. The new equipment must be placed in service in the five year period beginning January 1, 1999 and ending December 31, 2003.

PROVIDE TAX CREDIT FOR CERTAIN PERFLUOROCOMPOUND (PFC) AND HYDROFLUOROCARBON (HFC) RECYCLING EQUIPMENT

Current Law

No tax credits are provided currently for the purchase of perfluorocompound (PFC) and hydrofluorocarbon (HFC) recycling equipment. Semiconductor manufacturers who install equipment to recover or recycle PFC and HFC gases used in the production of semiconductors may depreciate the cost of that equipment over 6 years.

Reasons for Change

Of all greenhouse gases, PFCs and certain HFCs are among the most potent because of their extreme stability in the atmosphere and strong absorption of radiation. PFCs commonly have expected atmospheric lifetimes of thousands of years, and a global warming potential thousands of times greater than that of carbon dioxide, which is the most abundant greenhouse gas. PFCs and certain HFCs are used extensively in the semiconductor manufacturing industry. Because of the anticipated rapid growth of the semiconductor industry, annual emissions of PFCs would grow from 0.2 million metric tons of carbon equivalent (MMTCE) in 1990 to as much as 26 MMTCE by 2010 if no control measures were undertaken. Anticipated voluntary measures by the semiconductor industry to reduce emissions are expected to limit annual emissions to 13 MMTCE by 2010. Installation of additional equipment to recover and recycle PFC and HFC gases could eliminate most of the remaining emissions. While new methods of manufacturing semiconductors are expected ultimately to eliminate PFC and HFC emissions, emissions from existing plants would continue until the plants were eventually replaced or recycling equipment is installed.

Proposal

A tax credit would be available for the installation of PFC and HFC recovery/recycling equipment in semiconductor manufacturing plants. The tax credit would be 10 percent of qualified investment. The credit would be subject to the limitations on the general business credits. The depreciable basis of qualified property for which the credit is taken would be reduced by the amount of the credit claimed. Equipment would qualify for the credit only if it recovers at least 99 percent of PFCs and HFCs, and the equipment is placed in service in the five-year period beginning January 1, 1999 and ending December 31, 2003.

PROVIDE TAX CREDIT FOR ROOFTOP SOLAR EQUIPMENT

Current Law

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

Reasons for Change

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

Proposal

Under this proposal, a tax credit would be available for purchasers of rooftop photovoltaic systems and solar water heating systems located on or adjacent to the building for uses other than heating swimming pools. The credit would be equal to 15 percent of qualified investment up to a maximum of $1,000 for solar water heating systems and $2,000 for rooftop photovoltaic systems. This credit would be nonrefundable. For businesses, this credit would be subject to the limitations of the general business credit. The depreciable basis of the qualified property would be reduced by the amount of the credit claimed. The credit would apply only to equipment placed in service in the five year period after December 31, 1998 and before January 1, 2004 for solar water heating systems and for the seven year period beginning after December 31, 1998 and before January 1, 2006 for rooftop photovoltaic systems. Taxpayers would have to choose between the proposed credit and the present tax credit for each investment.

EXTEND WIND AND BIOMASS TAX CREDIT

Current Law

Current law provides taxpayers a 1.5 cent per kilowatt hour tax credit, for electricity produced from wind or "closed-loop" biomass. The electricity must be sold to an unrelated third party and the credit is limited to the first 10 years of production. The credit applies only to facilities placed in service before July 1, 1999, after which it expires. The credit amount is indexed for inflation after 1992.

Reasons for Change

The tax credit helps make such electricity produced from wind and closed-loop biomass competitive with other forms of electricity. Electricity from these sources produces no greenhouse gases.

Proposal

The proposal would extend the current credit for five years, to facilities placed in service before July 1, 2004.

EXPANDED ACCESS TO PAYROLL DEDUCTION FOR RETIREMENT SAVINGS

Current Law

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

Reasons for Change

Payroll deduction contributions to IRAs could be an important means of increasing retirement savings among employees. The advantages of saving through payroll deduction -- the convenience of contributions continuing after the employee's initial election, reinforcement of the value of savings by peer groups in the workplace, and the incentive of tax-favored treatment of contributions -- encourage employees to save more for retirement. One way to encourage employers to offer, and employees to make, payroll deduction contributions to IRAs would be to provide employees with a convenient way to receive an immediate tax benefit for these contributions that eliminates the need for most employees to report the contributions on their tax returns and enables some employees to use simpler tax forms.

Proposal

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

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

SMALL BUSINESS TAX CREDIT FOR RETIREMENT PLAN START-UP EXPENSES

Current Law

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

Reasons for Change

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

Proposal

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

The credit would be available to employers that did not employ, in the preceding year, more than 100 employees with compensation in excess of $5,000, but only if the employer did not have a plan or payroll deduction IRA arrangement during any part of 1997. In order for an employer to get the credit, the plan would have to cover at least 2 individuals. In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement would have to be made available to all employees of the employer who have worked with the employer for at least 3 months.

The credit would be effective beginning in the year of enactment and would be available only for plans established on or before December 31, 2000. For example, if an eligible employer adopted a plan in the year 2000, the credit would be available for the years 2000, 2001 and 2002.

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

Current Law

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

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

Reasons for Change

There is no alternative, similar to SIMPLE plans or SEPs, that is available for small business employers seeking to provide their employees with a simplified, tax-favored defined benefit pension plan. The need for complex actuarial calculations, administrative costs, and the unpredictability of funding requirements may inhibit these employers from adopting such plans.

Proposal

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

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

Employer Eligibility

An employer generally would be eligible to maintain a SMART Plan if the employer did not employ more than 100 employees who received at least $5,000 in compensation in the prior year, the employer is not a professional service employer (i.e., an employer substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial sciences, performing arts, or consulting), and the employer has not maintained a defined benefit pension plan or a money purchase pension plan within the preceding five years.

Employee Eligibility and Vesting

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

Benefits and Funding

Minimum Defined Benefit

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

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

Funding and Investment Returns

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

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

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

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

Distributions

Timing

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

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

Form

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

Taxation

Distributions from SMART Plans would be subject to tax under current rules applicable to the taxation of annuities under Code section 72.

A 20 percent additional tax would be imposed for violating the pre-age 65 distribution restrictions under a SMART Annuity or SMART Account.

PBGC Guarantee and Premiums

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

Reporting and Disclosure

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

Nondiscrimination Requirements and Benefit Limitations

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

Miscellaneous

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

Employee contributions. No employee contributions would be permitted to a SMART Plan.

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

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

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

These provisions would be effective for calendar years beginning after 1998.

FASTER VESTING OF EMPLOYER MATCHING CONTRIBUTIONS

Current Law

Generally, employer matching contributions on behalf of an employee under a section 401(k) plan (or other type of plan) either must be fully vested after the employee has completed five years of service, or must become vested in increments of 20 percent for each year beginning after the employee has completed three years of service, with full vesting after the employee has completed seven years of service. If a plan is a "top-heavy plan" within the meaning of section 416, employer matching contributions either must be fully vested after an employee has completed three years of service, or must become vested in increments of 20 percent for each year beginning after the employee has completed two years of service, with full vesting after the employee has completed six years of service. Employer matching contributions that are treated as elective contributions for purposes of the actual deferral percentage test under section 401(k) ("qualified matching contributions") must be fully vested immediately.

Reasons for Change

The popularity and importance of 401(k) plans has grown substantially over the years. Employers often choose to contribute to 401(k) plans by matching the salary reduction contributions made by employees. Given the mobile nature of today's workforce, there is a significant risk that many participants will leave employment before fully vesting in employer matching contributions under 401(k) plans. One way to increase the portability of benefits for 401(k) plan participants is to require faster vesting for employer matching contributions.

Proposal

Employer matching contributions under 401(k) plans (or other qualified plans) would be required either to be fully vested after an employee has completed three years of service, or to become vested in increments of 20 percent for each year beginning after the employee has completed two years of service, with full vesting after the employee has completed six years of service. Qualified matching contributions would continue to be fully vested immediately, as under current law.

These provisions would be effective for plan years beginning after December 31, 1998, with an extended effective date for plans maintained pursuant to a collective bargaining agreement.

PENSION RIGHT TO KNOW PROPOSALS

A. Spouse's Right to Know Distribution Information

Current Law

In general, when a tax-qualified pension plan commences a distribution of retirement benefits to a participant in the plan, the benefits must be distributed as an annuity over the life of the participant. If the participant is married on the annuity starting date, the annuity must continue to pay at least one-half of these monthly amounts to the surviving spouse following the participant's death (a form of benefit known as a "qualified joint and survivor annuity"). If the participant dies before the annuity starting date, the surviving spouse generally must be paid an annuity (known as a "qualified preretirement survivor annuity") that is not less than what the spouse would have been paid under the survivor portion of the qualified joint and survivor annuity. Most defined contribution plans (such as 401(k) plans) are not required to provide these annuities if certain conditions are satisfied, including the condition that, upon the participant's death, the participant's vested account balance is payable in full to the surviving spouse.

A plan may allow a participant to waive the right to receive these survivor annuities if certain conditions are satisfied. In particular, the spouse generally must provide a written consent to the waiver, witnessed by a plan representative or a notary public, which acknowledges the effect of the waiver. Further, the participant must have been provided with a written explanation of the terms and conditions of the survivor annuity, the participant's right to make, and the effect of, a waiver of the survivor annuity, the rights of the spouse to waive the survivor annuity, and the right of a participant to revoke the waiver. (Similar waiver and explanation rules apply concerning the death benefit payable to the spouse under a defined contribution plan.)

Reasons for Change

Although the survivor rules provide important rights to spouses, these rules do not require plans to furnish spouses a copy of the written explanation of survivor benefits that is required to be furnished to participants. In order to help spouses understand their rights and the implications of waiving these survivor benefits, spouses should be able to receive a copy of the explanation of survivor benefits.

Proposal

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

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

B. Election Periods and Right to Know Employer Contribution Formula

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 ADP test is satisfied if the average percentage of elective contributions for highly compensated employees does not exceed the average percentage of elective contributions for nonhighly compensated employees by a specified percentage. Because the ADP test looks to the actual pattern of deferrals by the highly compensated and nonhighly compensated employees, the employer has an incentive to increase participation by the nonhighly compensated employees and will take steps (such as publicizing the ease of saving through the plan and providing matching contributions) in order to encourage employees to contribute.

As an alternative to annual testing under the ADP test (and the similar ACP test that applies to matching contributions and after-tax employee contributions), the Small Business Job Protection Act of 1996 provides two alternative "design-based" 401(k) safe harbors, effective beginning in 1999. If the employees are provided a specified matching contribution (or a specified nonelective contribution), the employer can avoid all ADP and ACP testing of employee elective contributions and employer matching contributions. Unlike the similar safe-harbor designs under the SIMPLE plan and the SIMPLE 401(k) plan that require annual 60-day election periods and notification tied to those election periods, for 401(k) plans using a safe harbor, there are no specific requirements that prescribe the length and frequency of the election period or that tie the timing of the notice describing employee rights and obligations under the plan to the election period.

Reasons for Change

Employers that use the safe harbor plan design have no built-in incentive to make it easy for employees to elect to make contributions and to notify employees of the employer matching contribution in connection with that election period. In order for the safe harbor plan design to be an adequate substitute for nondiscrimination tests, employees need to have reasonable opportunities to start making elective deferrals and need to receive information about the employer contribution formula in connection with these opportunities.

Proposal

Employers that use either one of the safe harbor plan designs to avoid ADP and ACP testing would be required to provide notice and contribution opportunities comparable to those provided under SIMPLE plans. Thus, employees would have to be offered an opportunity to elect to make contributions (or modify a prior election) during a 60-day period before the beginning of each year and a 60-day period when they first become eligible. In addition, the current law requirement that employers provide employees with notice of their rights to make

contributions and notice of the safe harbor contribution formula the employer is currently using (in order to notify employees of their rights and obligations) would be modified to require the notice within a reasonable period of time before the 60-day periods begin rather than before the beginning of the year.

The proposal would be effective for years beginning after December 31, 1998, when the safe harbors themselves take effect.

SIMPLIFIED METHOD FOR IMPROVING BENEFITS OF NONHIGHLY COMPENSATED EMPLOYEES UNDER THE SAFE HARBOR 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 average percentage of elective contributions for highly compensated employees does not exceed the average percentage of elective contributions for nonhighly compensated employees by a specified percentage. Thus, the ADP tests looks to the actual pattern of deferrals by the highly compensated and nonhighly compensated employees who are eligible to make elective contributions. 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.

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

Reasons for Change

Under the section 401(k) safe harbor plan design, employers need not perform nondiscrimination tests and may not have adequate incentives to educate nonhighly compensated employees about the value of tax-deferred savings for retirement. Providing a one percent nonelective contribution to all eligible nonhighly compensated employees, in addition to the matching contribution, would help demonstrate the value of tax-deferred compounding to those employees who initially might not make deferrals. This one percent contribution would also help ensure that more low- and moderate-wage workers begin accumulating savings for retirement and acquire the saving habit.

Proposal

The proposal would modify the section 401(k) matching formula safe harbor by requiring that, in addition to the matching contribution, employers would make a contribution of one

percent of compensation for each eligible nonhighly compensated employee, regardless of whether the employee makes elective contributions.

The new safe harbor formula would be effective for years beginning after December 31, 1998, when the safe harbors themselves take effect.

SIMPLIFY DEFINITION OF HIGHLY COMPENSATED EMPLOYEE

Current Law

A qualified retirement plan must satisfy various nondiscrimination tests to ensure that it does not discriminate in favor of "highly compensated employees." In order to apply these tests, the employer must identify its "highly compensated employees." Under current law, effective for plan years beginning after December 31, 1996, an employee is treated as a highly compensated employee if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) for the preceding year, had compensation in excess of $80,000 (indexed for inflation), and, if the employer elects, was in the top-paid group of employees for the preceding year. For this purpose, an employee is in the top-paid group if the employee was among the top 20 percent of employees of the employer when ranked on the basis of compensation paid to the employees during the preceding year.

Reasons for Change

The definition of highly compensated employee, while simpler than the seven-part test that applied under prior law, could be further simplified by elimination of the top-paid group election. Permitting elections that may vary from year to year increases complexity. In addition, under the current definition, it is possible for employees earning very high compensation (of several hundred thousand dollars or more) to be treated as nonhighly compensated for testing purposes if the employer has a sufficient percentage of high-paid employees in its workforce. This would allow some employers to effectively eliminate benefits for low- and moderate-wage workers without violating the nondiscrimination rules. The simplified definition of highly compensated employee should better reflect the purpose of promoting meaningful benefits for low- and moderate-wage workers, not only the high-paid.

Proposal

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

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

SIMPLIFY BENEFIT LIMITS FOR MULTIEMPLOYER PLANS UNDER SECTION 415

Current Law

Annual benefits payable under a defined benefit plan are limited to the lesser of $130,000 (for 1998) 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 ten years of plan participation or service.) If benefits under a defined benefit plan begin before the social security retirement age, the dollar limit must be actuarially reduced to compensate for the earlier commencement. Certain special rules apply to governmental plans.

Reasons for Change

The qualified plan limitations present significant administrative problems for many multiemployer plans. These plans typically base benefits on years of credited service, not on a participant's compensation. In addition, the 100 percent-of-compensation limit is based on an employee's average compensation for the three highest consecutive years. This rule often produces an artificially low limit for employees in certain industries, such as building and construction, where wages vary significantly from year to year.

Proposal

The section 415 limits applicable to multiemployer plans would be modified to eliminate the 100 percent-of-compensation limit (but not the $130,000 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. This would be comparable to the changes made to the section 415 limits for governmental plans in the Small Business Job Protection Act of 1996.

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

SIMPLIFY FULL FUNDING LIMITATION FOR MULTIEMPLOYER PLANS

Current Law

An employer's annual deduction for contributions to a defined benefit plan may not exceed the plan's full funding limitation. The full funding limitation is generally defined as the excess of the plan's accrued liability (or, if less, a specified percentage of the plan's current liability) over the value of the plan's assets. The specified percentage is 150 percent for plan years beginning before January 1, 1999 and it increases by 5 percent every other year beginning in 1999, until it reaches 170 percent for plan years beginning on or after January 1, 2005. Whenever the specified percentage of current liability is less than the plan's accrued liability, the full funding limitation restricts the extent to which an employer can deduct contributions for benefits that have not yet accrued.

Defined benefit plans are required 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, yet, under current law, the employer must perform the calculations to apply this limit. The amount an employer contributes to a multiemployer plan is determined by the collective bargaining agreement, and a particular employer's contributions are not set aside to pay benefits solely to the employees of that employer.

Proposal

The limit on deductible contributions based on a specified percentage of current liability would be eliminated for multiemployer plans. Therefore, the annual deduction for contributions to such a plan would be limited to the amount by which the plan's accrued liability exceeds the value of the plan's assets. In addition, actuarial valuations would be required under the Code no less frequently than every three years for multiemployer plans. Parallel changes would be made to the Employee Retirement Income Security Act of 1974, as amended.

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

ELIMINATE 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 specific facts and circumstances, 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 under certain circumstances.

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, 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 after December 31, 1998.

TAX CREDITS FOR HOLDERS OF QUALIFIED SCHOOL MODERNIZATION BONDS AND QUALIFIED ZONE ACADEMY BONDS

Current Law

Under current law, State and local governments fund public school construction by issuing bonds the interest on which generally is exempt from Federal income tax. In addition, State and local governments can issue "qualified zone academy bonds" to fund the improvement of certain eligible public schools. An eligible holder of a qualified zone academy bond receives annual Federal income tax credits. These annual credits compensate the holder for lending money and, therefore, are treated like taxable interest payments for Federal tax purposes. Eligible holders are banks, insurance companies, and corporations actively engaged in the business of lending money. The "credit rate" on a qualified zone academy bond is used to determine the amount of the annual tax credit and is set at 110 percent of the applicable Federal rate (AFR) for the month in which the bond is issued. The maximum term of a qualified zone academy bond issued during any month is determined by reference to the "adjusted" AFR for the month in which the bond is issued.

A total of $400 million of qualified zone academy bonds may be issued in each of 1998 and 1999. The annual cap is allocated among the States in proportion to their respective populations of individuals with incomes below the poverty line. Unused authority to issue qualified zone academy bonds may be carried forward to subsequent years.

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

Reasons for Change

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

Proposal

Qualified school modernization bonds

State and local governments would be able to issue "qualified school modernization bonds" to fund the construction or rehabilitation of public schools. Much like the holder of a qualified zone academy bond, the holder of a qualified school modernization bond would receive annual Federal income tax credits in lieu of interest payments. Because the annual credits compensate the holder for lending money, they would be treated as payments of interest for Federal income tax purposes, and accordingly would be included in the holder's gross income. As is the case with qualified zone academy bonds, the "credit rate" for qualified school modernization bonds would be set by the Secretary of the Treasury so that, on average, bonds would be issued without interest, discount or premium. The maximum term of the bonds would be 15 years. Importantly, unlike qualified zone academy bonds, any person, not just financial institutions, would be able to hold a qualified school modernization bond and thereby claim the tax credit. The proposal would require information returns to be provided with respect to holders (including corporations) that are entitled to credits.

Under the proposal, a total of $9.7 billion of authority to issue qualified school modernization bonds would be allocated among States and the 100 largest school districts in each of 1999 and 2000. Half of this annual cap would be allocated among the 100 school districts with the largest number of low-income children. The cap will be allocated among these districts based on the amounts of Federal assistance each district receives under the Basic Grant Formula for Title I of the Elementary and Secondary Education Act of 1965. This assistance is based primarily upon the number of low-income children residing in the district, with an adjustment for differences in per pupil expenditures. The other half of the annual cap would be divided among States and Puerto Rico in proportion to their shares of Federal assistance under the Basic Grant Formula, adjusted for amounts allocated to the 100 large districts. A small portion of the total cap would be set aside for each U.S. possession (other than Puerto Rico) based on its share of the total U.S. poverty population. The relative shares of assistance provided under the Basic Grant Formula would be determined by the Secretary based on the most recent data available from the Department of Education on November 1 of the year prior to the year for which the allocation of authority to issue qualified school modernization bonds is made. A State, possession, or eligible school district would be permitted to carry forward any unused portion of its allocation until September 30, 2003.

Under the proposal, a bond would be treated as a qualified school modernization bond if three requirements are met. First, the Department of Education must approve the school construction plan of the State or eligible school district. The school construction plan must (1) demonstrate that a comprehensive survey has been undertaken of the construction and renovation needs in the jurisdiction, and (2) describe how the jurisdiction will assure that bond proceeds are used for the purposes of this proposal. Second, the issuing government must receive an

allocation for the bond from the State educational agency or the eligible school district. Third, 95 percent or more of the bond proceeds must be used to construct or rehabilitate public school facilities. In determining whether this third requirement is met, taxpayers may rely on principles used to determine satisfaction of similar requirements with respect to tax-exempt obligations. Unlike qualified zone academy bonds, qualified school modernization bonds would not be subject to a requirement that private business entities contribute a specified amount of goods or services to the school.

Qualified zone academy bonds

The proposal would make three changes to the existing qualified zone academy bond statute. First, the proposal would increase the bond cap for 1999 from $400 million to $1.4 billion and add an additional $1.4 billion of bond cap in 2000. Second, the proposal would expand the list of permissible uses of proceeds to include new school construction. Third, the proposal would set the maximum term of qualified zone academy bonds at 15 years.

EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

Current Law

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

The exclusion applies with respect to undergraduate courses beginning before June 1, 2000. The exclusion does not apply to graduate level courses beginning after June 30, 1996.

Reasons for Change

Well-educated workers are essential to an economy experiencing technological change and facing global competition. Extension of section 127, including reinstatement of its application to graduate courses, will expand educational opportunity and increase productivity. In addition, these provisions will encourage the retraining of current and former employees to reflect the changing needs of the workplace. The extension of section 127 also will simplify the rules for employers and workers by eliminating the need to distinguish between job-related expenses and other employer-provided educational assistance.

Proposal

The current law exclusion would be extended by one year to apply to undergraduate courses beginning before June 1, 2001. In addition, the exclusion would be reinstated for graduate education, effective for courses beginning after June 30, 1998 and before June 1, 2001.

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

Current Law

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

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

Reasons for Change

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

Proposal

A taxpayer would exclude from income any amount the taxpayer would otherwise include as a result of the forgiveness of a student loan made under the Direct Loan program. The proposal would be effective for loan cancellations after December 31, 1998.

INCREASE LOW-INCOME HOUSING TAX CREDIT PER CAPITA CAP

Current Law

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

Reasons for Change

The need for decent low-income housing exceeds the amount markets provide at affordable rents. Most State agencies receive qualified proposals for far more low-income rental housing than they can support with available credits. Without the tax credits, these projects will not be undertaken. A modest increase in the per capita amount will allow additional low-income housing to be provided but still will require that State agencies choose projects that meet specific housing needs.

Proposal

The annual State low-income housing credit limitation would be increased to $1.75 per capita, effective for calender years beginning after 1998.

EXTEND THE WORK OPPORTUNITY TAX CREDIT

Current Law

A work opportunity tax credit (WOTC) currently is provided for hiring individuals from certain targeted groups. The credit equals a percentage of qualified wages paid during the first year of the individual's employment with the employer. The credit percentage is 25 percent for employment of at least 120 hours but less than 400 hours and 40 percent for employment of 400 or more hours. The maximum amount of qualified wages paid to an individual is $6,000. The credit expires with respect to employees who begin work after June 30, 1998.

Reasons for Change

The goal of the Work Opportunity Tax Credit is to provide employers with a tax incentive to hire individuals who have traditionally had difficulty entering and remaining in the work force. An extended wage credit would continue to serve as an inducement for employers to hire these individuals and to invest in their training.

Proposal

The Work Opportunity Tax Credit would be extended so that the credit would apply with respect to employees who begin work before May 1, 2000.

EXTEND THE WELFARE-TO-WORK TAX CREDIT

Current Law

The welfare-to-work credit enables employers to claim a tax credit for eligible wages paid to certain long-term family assistance recipients. The credit is 35 percent of the first $10,000 of eligible wages in the first year of employment and 50 percent of the first $10,000 of eligible wages in the second year of employment. Thus, the maximum credit is $8,500 per qualified employee.

For purposes of qualifying for the credit, the long-term family assistance recipients are defined to include: (1) members of families that have received family assistance (AFDC or its successor program) for at least 18 consecutive months ending on the hiring date; (2) members of families that have received family assistance for a total of at least 18 months beginning on the date of enactment, provided that they are hired within two years of the date that the 18-month total is reached; and (3) members of families who are no longer eligible for family assistance because of Federal or State time limits, provided that they are hired within two years of the date that they became ineligible for family assistance.

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

The credit is effective for individuals who begin work before May 1, 1999.

Reasons for Change

Extending the welfare-to-work credit would continue to encourage employers to hire, invest in training, and provide certain benefits and more permanent employment, to longer-term welfare recipients.

Proposal

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

EXTEND THE R&E TAX CREDIT

Current Law

The research tax credit generally applies on an incremental basis to a taxpayer's "qualified research" expenses for a taxable year. The credit generally is equal to 20 percent of the amount by which the taxpayer's qualified research expenses for the taxable year exceed a base amount. The base amount is the product of the taxpayer's "fixed base percentage" and the average of the taxpayer's gross receipts for the four preceding years. The base amount cannot be less than 50 percent of the taxpayer's qualified research expenses for the taxable year.

Under the Small Business Job Protection Act of 1996 (SBJPA), taxpayers are allowed to elect an alternative incremental research credit regime for the first taxable year of the taxpayer beginning after June 30, 1996. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced.

The research credit expired on June 30, 1995. In the SBJPA, the research credit was extended (in modified form) for eleven months, from July 1, 1996 to May 31, 1997. The credit was subsequently extended by the Taxpayer Relief Act of 1997 (TRA 97) to apply to expenses generally incurred from June 1, 1997 to June 30, 1998. TRA 97 also modified the alternative incremental research credit regime to permit taxpayers to elect the regime for any taxable year beginning after June 30, 1996.

Reasons for Change

The Administration supports the extension of the research tax credit. The Administration recognizes the importance of technology to our national ability to compete in the global marketplace, and the research credit is useful in supporting and fostering technology. The credit provides incentives for private-sector investment in research and innovation that can help increase America's economic competitiveness and enhance U.S. productivity.

Proposal

The research tax credit would be extended for twelve months, from July 1, 1998, through June 30, 1999.

EXTEND THE DEDUCTION PROVIDED FOR CONTRIBUTIONS OF APPRECIATED STOCK TO PRIVATE FOUNDATIONS

Current Law

Generally, when donors contribute property to a private foundation, they are allowed to deduct no more than their adjusted basis in the property. However, section 170(e)(5) provides a full fair market value deduction for gifts of publicly traded stock to private foundations. This provision expires after June 30, 1998. For gifts of such stock to private foundations made after that date, donors will be allowed to deduct only their basis in the stock. Donors will still be able to deduct the full fair market value of the publicly traded stock if it is contributed to a public charity.

Reasons for Change

Private foundations provide financial support for many essential and innovative charitable and educational activities. Allowing donors to deduct the full fair market value of publicly traded stock given to private foundations encourages taxpayers to devote the stock exclusively to charitable purposes.

Proposal

The proposal would extend for one year, from July 1, 1998, through June 30, 1999, the provision allowing a full fair market value deduction for gifts of publicly traded stock to private foundations.

MAKE PERMANENT THE EXPENSING OF BROWNFIELDS REMEDIATION COSTS

Current Law

Generally, costs incurred to clean up land and groundwater increase the value of any property and are not currently deductible, but must be capitalized. In a ruling issued in 1994 (Revenue Ruling 94-38), the IRS concluded that certain costs incurred 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.

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

A "qualified containment site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas are defined as: (1) empowerment zones and enterprise communities; (2) sites that were announced before February 1997 as being subject to one of the 76 Environmental Protection Agency ("EPA") Brownfields Pilots; (3) any population census tract with a poverty rate of 20 percent or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above.

This special treatment does not apply to expenditures paid or incurred after December 31, 2000.

Reasons for Change

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

Proposal

The proposal would eliminate the restriction requiring that expenditures must be paid or incurred on or before December 31, 2000 in order to be deductible as environmental remediation expenditures.

EXTEND AND MODIFY PUERTO RICO TAX CREDIT (SECTION 30A)

Current Law

Domestic corporations with business operations that were established by October 13, 1995 in U.S. possessions (including, for this purpose, Puerto Rico and the U.S. Virgin Islands) may continue to elect the benefits available under Code section 936 or 30A to reduce or eliminate the U.S. tax on certain income which is related to their possession-based operations. The credit available under Code section 936 or 30A may offset the U.S. tax on income arising from the active conduct of a trade or business within a U.S. possession or from the sale or exchange of substantially all of the assets used by the taxpayer in the active conduct of such trade or business. The credit offsets the beneficiary corporation's U.S. tax whether or not it pays income tax to the possession.

Limitations on the credit were enacted in 1993, and a phase-out of the credit was enacted in 1996. Beneficiary companies may elect either (1) a reduced percentage of the income-based credit as allowed under pre-1993 law (45 percent in 1997 and 40 percent beginning in 1998), subject beginning in 1998 to a cap based on pre-1996 possessions income, or (2) a limitation based on the company's economic activity in the possessions (measured by wages and other compensation, depreciation, and certain taxes paid), subject beginning in 2002 to a cap based on pre-1996 possessions income. (In the case of Puerto Rico, the credit under the economic-activity limitation is provided under section 30A of the Code.) No credit is available in taxable years beginning after December 31, 2005. No credit is available for business operations established in Puerto Rico or the possessions after October 13, 1995.

Reasons for Change

The Administration proposed to reformulate the credit in 1993 and again in 1996 to make it a more efficient incentive for job creation and economic activity in Puerto Rico; the amendments enacted in 1993 moved part way toward the Administration's proposals, but the phase-out enacted in 1996 eliminated all incentives for new investment in Puerto Rico. The Administration continues to believe that the credit should provide an incentive for increased economic activity in Puerto Rico rather than merely an incentive to attribute profits there.

Proposal

To provide a more efficient and effective tax incentive for the economic development of Puerto Rico and to continue the shift from an income-based credit to an economic-activity credit that was begun in the 1993 Act, the proposal would modify the economic-activity credit under section 30A by (1) extending it indefinitely, (2) opening it to newly established business operations, effective for taxable years beginning after December 31, 1998, and (3) removing the income cap.

SPECIALIZED SMALL BUSINESS INVESTMENT COMPANY TAX INCENTIVES

Current Law

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

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

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

Reasons for Change

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

Proposal

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

The proposal also provides that a SSBIC that is organized as a corporation may convert to a partnership within 180 days of enactment, without giving rise to tax at either the corporate or

shareholder levels (although the shareholders would be taxed on gain to the extent of boot received in addition to partnership interests). To qualify for this treatment, the corporation must contribute its assets to a partnership (in which it holds an interest of at least 80-percent immediately after the contribution), distribute the partnership interests to its shareholders, and immediately liquidate. The shareholders' basis in the partnership interests generally would carry over from their basis in the SSBIC stock. The partnership would remain subject to an entity level tax at any time that it later disposed of assets that were held at the time of conversion on the amount of "built-in" gains inherent in such assets at the time of conversion.

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

The tax-free rollover and section 1202 provisions are effective for sales occurring after the date of enactment.

ACCELERATE AND EXPAND INCENTIVES AVAILABLE TO TWO NEW EMPOWERMENT ZONES

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 nominate distressed areas and propose strategic plans to stimulate economic and social revitalization.

Among other benefits, businesses located in the nine original 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.

The Taxpayer Relief Act of 1997 authorized the designation of two additional empowerment zones located in urban areas (the "additional empowerment zones") which generally are eligible for the same tax incentives as are available within the empowerment zones authorized by OBRA '93. The designations of these two additional empowerment zones will be made in early 1998, but the tax incentives provided for them do not take effect until January 1, 2000. These incentives generally remain in effect for 10 years. The wage credit, however, is phased down beginning in 2005 and expires after 2007.

Reasons for Change

The Administration believes that the availability of the tax incentives for the two additional empowerment zones should be accelerated and expanded in order to help combat the pervasive poverty and stimulate the revitalization of these areas.

Proposal

The proposal would accelerate the start-up date of the tax incentives for the two additional empowerment zones to January 1, 1999. The proposal also would provide that the wage credit would remain in effect for 10 years from that date and would be phased down using the same percentages that apply to the original empowerment zones designated under OBRA '93.

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

Current Law

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

Reasons for Change

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

Proposal

Under the proposal, up to $2,000 of certain severance payments would be excludable from the income of the recipient. This exclusion would apply to payments received by an individual who was separated from service in connection with a reduction in the employer's work force. The exclusion is not available if the individual attains employment within six months of the separation from service at a compensation level that is 95 percent of the compensation the individual received before the separation from service. The exclusion does not apply if the total severance payments received by the individual exceed $125,000.

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

OPTIONAL SELF-EMPLOYMENT CONTRIBUTIONS ACT (SECA) COMPUTATIONS

Current Law

The Self-Employment Contributions Act (SECA) imposes taxes on net earnings from self-employment to provide social security coverage to self-employed workers. The maximum amount of earnings subject to the self-employment (or SECA) tax is coordinated with, and is set at the same level as, the maximum level of wages and salaries subject to FICA taxes ($68,400 for OASDI taxes in 1998 and indexed annually, and without limit for the Hospital Insurance tax).

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

Reasons for Change

Combining the two different optional methods of computing self-employment income for self-employment tax purposes into a single combined optional method will simplify the self-employment tax for the approximately 45,000 taxpayers (in 1994) who use one of these methods. Forms and instructions will also be simplified for the millions of self-employed workers who do not use the optional methods.

There is no policy reason for providing different methods for farm and non-farm self-employed workers. By permitting non-farm self-employed workers to use the more liberal requirements that currently apply to the farm optional method, more non-farm self-employed persons would be expected to use the combined optional method and, thereby, to obtain additional social security and Medicare coverage and, eventually, to receive higher social security benefits.

Proposal

The two current optional methods would be combined into a single combined optional method under which self-employment income for SECA tax purposes would be two-thirds of the first $2,400 of gross income. A self-employed worker could elect the proposed combined optional method an unlimited number of times. If it is used, it would have to be applied to all self-employment earnings for the year, both farm and non-farm. As under current law, the $2,400 amount would not be indexed for inflation.

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

PROVIDE STATUTORY HEDGING AND OTHER RULES TO ENSURE BUSINESS PROPERTY IS TREATED AS ORDINARY PROPERTY

Current Law

Under current law, there is a significant issue of whether income from hedging transactions is capital or ordinary. The Supreme Court in Arkansas Best established a restrictive definition of ordinary assets that resulted in certain business hedges being treated as capital assets. The decision and subsequent IRS interpretation caused considerable efforts by affected industries to change the rules legislatively.

In 1993, the Department of the Treasury issued temporary regulations (finalized in 1994) that were similar to industry proposals. The regulations provide ordinary character for most business hedges and provide timing rules to ensure that hedging transactions are taken into account in a manner that matches the income or loss from hedged items.

The straddle rules of section 1092 limit the ability of taxpayers to claim losses on offsetting positions in personal property.

Reasons for Change

The hedging regulations issued by the Department of the Treasury do not eliminate the possibility that a business hedge can be improperly characterized for tax purposes. The rules under which assets are treated as ordinary assets and under which hedging transactions are accounted for need to be modernized. In addition, the loss deferral provision under the straddle rules can be punitive and sometimes results in a total disallowance of losses.

Proposal

The proposal generally would codify the approach taken by the Treasury regulations and make some modifications to help clarify the rules. The proposal would add three categories of ordinary assets to section 1221: (1) derivative contracts entered into by derivative dealers; (2) supplies of a type regularly used by the taxpayer in the provision of services or the production of ordinary property; and (3) hedges. A new provision would define a hedging transaction as a transaction entered into primarily to manage the risk of ordinary property held or to be held, or certain liabilities incurred or to be incurred, and identified as a hedge of specified property. If a transaction was improperly identified as a hedging transaction, losses would retain their usual character (i.e., usually capital), but gains would be ordinary. If a hedging transaction was not identified (and there was no reasonable basis for the failure), gains would be ordinary but losses would retain their non-hedging character. Other rationales for ordinary treatment (such as surrogacy for a non-capital asset or insurance against a business risk) generally would not be allowed, and the proposed provisions would be the exclusive means to obtain ordinary treatment. Treasury would have authority to apply these rules to related parties.

The proposal would require that the timing of income, gain, deduction, or loss from a hedging transaction must reasonably match the income, gain, deduction, or loss from the item(s) being hedged. Taxpayers could, to the extent allowed in regulations, elect this timing for straddles as well, provided the positions in the straddles are identified by the taxpayer, instead of being subject to the rule that defers losses on straddles to the extent of unrecognized gain in the offsetting position. The proposal would repeal the exception from the straddle rules for stock. Further, Treasury would have regulatory authority to integrate offsetting positions in a straddle.

The proposal would be effective after the date of enactment, with the effective date for the hedging identification requirements deferred until 60 days after date of enactment. Treasury would be given authority to issue regulations governing transactions entered into prior to the effective date. The regulations would provide treatment similar to that provided in the statute.

CLARIFY RULES RELATING TO CERTAIN DISCLAIMERS

Current Law

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

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

Reasons for Change

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

Proposal

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

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

Current Law

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

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

Reasons for Change

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

Proposal

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

foreign taxes, in appropriate circumstances. The proposal would be effective for taxable years beginning after December 31, 1997.

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

Current Law

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

Reasons for Change

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

Proposal

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

SUSPEND COLLECTION BY LEVY DURING REFUND SUIT

Current Law

Neither the Internal Revenue Code nor the regulations contains any provision that prohibits the IRS from levying to collect tax liabilities that are the subject of a refund suit during the pendency of the litigation. Generally, full payment of the tax at issue is a prerequisite to a refund suit, Flora v. United States, 357 U.S. 63 (1958), aff'd on reh'g, 362 U.S. 145 (1960), but this rule does not apply in the case of "divisible" taxes (such as employment taxes or the "100 percent penalty" under section 6672). The Service's policy and the Internal Revenue Manual generally provide, however, that when a refund suit is pending on a divisible assessment, the IRS will exercise forbearance with respect to collection, so long as the interests of the Government are adequately protected (e.g., by the filing of a notice of Federal tax lien) and collection is not in jeopardy. Any refunds due the taxpayer may be credited to the unpaid portion of the liability pending the outcome of the suit.

Reasons for Change

Taxpayers who are litigating a refund action over divisible taxes should be protected from collection of the full assessed amount, for which they may not be liable, so long as the Government's ultimate ability to collect the amount determined by the court to be properly due is preserved.

Proposal

This proposal would require the IRS to withhold collection by levy of liabilities that are the subject of a refund suit during the pendency of the litigation. This would only apply when refund suits can be brought without the full payment of the tax, i.e., in the case of divisible taxes. Collection by levy would be withheld unless jeopardy exists or the taxpayer waives the suspension of collection in writing. This proposal would not affect the IRS's ability to collect other assessments that are not the subject of the refund suit, to offset refunds, or to file a notice of Federal tax lien. The statute of limitations on collection would be stayed for the period during which the IRS is prohibited from collecting by levy. The proposal would be effective for refund suits brought with respect to tax years beginning after December 31, 1998.

SUSPEND COLLECTION BY LEVY WHILE OFFER IN COMPROMISE IS PENDING

Current Law

The Code and regulations do not preclude collection of a tax liability while an offer in compromise with respect to that liability is pending. The regulations and IRS policy statements do, however, provide that collection may be deferred while an offer in compromise is pending, unless the interests of the United States are jeopardized or the offer was filed solely for the purpose of delaying collection. Collection is ordinarily barred, pursuant to the parties' agreement, if an offer in compromise is accepted.

Reasons for Change

If a taxpayer is making a legitimate effort to resolve a tax liability through an offer in compromise, and the interests of the United States are adequately protected, it is appropriate to preclude enforced collection of the liability.

Proposal

The IRS would be barred from collecting a tax liability by levy during any period that a taxpayer's offer in compromise of that liability is being processed, during the 30 days following rejection of an offer, and for any period during which an appeal of a rejected offer is being considered. Levy would not be precluded if the IRS determines that collection is in jeopardy or that the offer is submitted solely to delay collection. This proposal would not affect liabilities or assessments that are not the subject of the offer in compromise, the IRS's ability to make refund offsets under section 6402, or its ability to file a notice of Federal tax lien. The proposal would not require the IRS to stop any levy action that was initiated, or withdraw any lien that was filed, prior to the taxpayer's making an offer in compromise. The statute of limitations on collection would be stayed for the period during which collection by levy is barred. The proposal would be effective with respect to taxes assessed 60 days after the date of enactment.

SUSPEND COLLECTION TO PERMIT RESOLUTION OF DISPUTES AS TO LIABILITY

Current Law

Under current law, once a valid assessment is made the IRS is not required to suspend collection if the taxpayer claims not to owe the taxes. This is true even if the assessment was made as a result of the taxpayer's failure to respond to a statutory notice of deficiency sent to the taxpayer's last known address. However, the Internal Revenue Code allows a taxpayer to submit an offer in compromise based on doubt as to the taxpayer's liability, except when the issue has been determined previously by a court. The IRS's policy is to suspend collection while an offer in compromise is pending, except in cases of jeopardy or if the IRS determines that the offer is submitted solely to delay collection.

Reasons for Change

Some taxpayers who fail to receive or respond to a proper statutory notice of deficiency are not actually liable for the tax. If such a taxpayer is making a legitimate effort to resolve a tax liability through an offer in compromise, and the interests of the United States are adequately protected, it is appropriate to preclude enforced collection of the liability.

Proposal

This proposal would permit an individual taxpayer to request that collection be suspended temporarily with regard to an income tax liability that is assessed based upon a statutory notice of deficiency that the taxpayer failed to receive or to which the taxpayer failed to respond. The IRS would suspend collection for a 60-day period, during which the taxpayer may dispute the merits of the underlying assessment. The 60-day period would be extended in appropriate cases where progress is being made in resolving the liability. Collection by refund offset and jeopardy levies would be exempted. The statute of limitations on collection would be stayed while the taxpayer's claim is pending. The proposal also would not affect the IRS's ability to file a notice of Federal tax lien. The proposal would be effective for taxes assessed with respect to taxable years beginning after December 31, 1998.

REQUIRE DISTRICT COUNSEL APPROVAL OF CERTAIN THIRD PARTY COLLECTION ACTIVITIES

Current Law

Circumstances may exist where property nominally held in a name other than the taxpayer is in fact the taxpayer's property or is deemed to be the taxpayer's property. For instance, where a corporation is the alter ego of an individual taxpayer, the IRS may treat the corporation's assets as those of the taxpayer and can properly take administrative collection action against those assets. Similarly, it is sometimes possible to show that property held in the name of a third party individual is being held in a nominal or representative capacity for a taxpayer. In such situations, IRS policy is to require written advice by District Counsel as to the need for a supplemental assessment, a new notice and demand, and the language to be incorporated in the notices of lien and levy on such property. However, District Counsel approval is not presently required before a notice of Federal tax lien can be filed in connection with property held by a nominee, transferee, or alter ego of the taxpayer, or before the seizure of property to which a Federal tax lien attaches but which is presently neither owned by the taxpayer nor titled in the name of the taxpayer.

Reasons for Change

The collection of tax liabilities from property held by nominees, transferees, or alter egos of the taxpayer often involves difficult legal issues. Similar issues may arise whenever the IRS seizes property that is not currently owned by the taxpayer nor titled in the taxpayer's name. These issues should be reviewed by District Counsel before the IRS files a notice of Federal tax lien against, or levies on, such property.

Proposal

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

REQUIRE MANAGEMENT APPROVAL OF LEVIES ON CERTAIN ASSETS

Current Law

The Secretary of the Treasury is authorized to collect taxes by levying on property or rights to property of the taxpayer. This authority has been delegated to various IRS officials, and different levels of IRS review are required before a levy is made on certain kinds of taxpayer assets. Under section 6334(e), the IRS can levy on a taxpayer's personal residence only after the District Director or Assistant District Director approves such a levy (or in jeopardy situations).

Reasons for Change

Potential levies on other kinds of important personal assets should be subject to the same level of review and scrutiny as levies on personal residences.

Proposal

This proposal would require the personal approval of a District Director or Assistant District Director of any levy against non-Federal pensions or the cash value of life insurance policies. The proposal would thus place these assets in the same class as principal residences pursuant to section 6334(e). The only exception would be in jeopardy situations. If the requisite approval was not obtained, the taxpayer would be entitled to obtain release of the levy, and, if the IRS failed to make such release, to appeal first to the Collections Appeals process and then to the U.S. District Court. The proposal would be effective with respect to taxes assessed after the date of enactment.

REQUIRE DISTRICT COUNSEL REVIEW OF JEOPARDY AND TERMINATION ASSESSMENTS AND JEOPARDY LEVIES

Current Law

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

Reasons for Change

Jeopardy and termination assessments and jeopardy levies often involve difficult legal issues. These issues should be reviewed by District Counsel before the IRS takes such action, particularly as the Government may bear the burden of proof on the reasonableness of the IRS action if the taxpayer contests it in court.

Proposal

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

REQUIRE MANAGEMENT APPROVAL OF SALES OF PERISHABLE GOODS

Current Law

Under section 6336 of the Internal Revenue Code, if it is determined that any property seized to satisfy unpaid taxes is liable to perish or become greatly reduced in price or value by keeping, or that the property cannot be kept without great expense, the property may be sold after it has been appraised and the owner has been given an opportunity to pay the appraised value or furnish bond for payment. The procedures governing the sale of seized property that are set forth in section 6335 (e.g., requiring ten-days notice before sale and the determination of a minimum bid) are not applicable to sales of perishables. Rather, different procedures set forth in section 6336 and the regulations thereunder apply to the sale of perishable goods.

Reasons for Change

Because of the nature of the property at issue, it is appropriate that special, accelerated procedures apply to the sale of perishable goods that have been seized. However, a revenue officer's determination that the perishable goods procedures apply should be subject to higher level management review.

Proposal

The proposal would require approval by the IRS District Director or Assistant District Director before the IRS sells perishable goods pursuant to section 6336. The proposal would also clarify what a "perishable" good is for these purposes. The proposal would be effective with respect to taxes assessed after the date of enactment.

CODIFY CERTAIN FAIR DEBT COLLECTION PROCEDURES

Current Law

Government agencies, including the IRS, are generally exempt from the Fair Debt Collection Practices Act, 15 U.S.C. 1692. In the past, however, appropriations legislation funding the IRS has required IRS officers and employees to comply with sections 805(a) (relating to communications in connection with debt collection) and 806 (relating to harassment or abuse) of the Fair Debt Collection Practices Act. The first provision prohibits a creditor from communicating with a debtor at any unusual time and place, generally prohibiting telephone calls other than between the hours of 8:00 a.m. to 9:00 p.m. local time. The second provision prohibits creditors from harassing or abusing debtors in attempts to collect.

Reasons for Change

The IRS should be required to comply with sections 805(a) and 806 of the Fair Debt Collection Practices Act, which impose reasonable constraints on debt collection activities. Placing these requirements in the Internal Revenue Code would ensure that both taxpayers and employees of the IRS are fully aware of these requirements.

Proposal

The proposal would add to the Internal Revenue Code the provisions of the Fair Debt Collection Procedure Act concerning communications in connection with debt collection (section 805) and the prohibition on harassment or abuse (section 806) (15 U.S.C. §§ 1692c and 1692d). The proposal would be effective on the date of enactment.

MODIFY PAYMENT OF TAXES

Current Law

The Secretary of the Treasury is authorized to accept payments by stamps, check, or money orders, as provided in regulations. Under the regulations, see Treas. Reg. Sec. 301.6311-1(a)(1), checks or money orders are currently made payable to the "Internal Revenue Service."

Reasons for Change

Allowing checks to be made payable to the United States Treasury will make it clearer to taxpayers that their tax payments support the entire U.S. Government, not just the IRS.

Proposal

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

REQUIRE DISCLOSURES RELATING TO EXTENSION OF STATUTES OF LIMITATION BY AGREEMENT

Current Law

Under section 6501, the statute of limitations within which the IRS may assess additional taxes is generally three years from the date a return is filed. The statute of limitations within which a tax may be collected after assessment is generally 10 years after assessment, see section 6502. Prior to the expiration of these periods of limitations, the taxpayer and the IRS may agree in writing to extend the statutory period, either for a specified period or for an indefinite period.

Reasons for Change

Taxpayers should be fully informed of their rights with respect to extending, or refusing to extend, the applicable statute of limitations.

Proposal

The proposal would require that, on each occasion on which the taxpayer is requested by the IRS to extend the statutory period of limitations on assessment or collection, either for a specified period or for an indefinite period, the IRS must notify the taxpayer of the taxpayer's right to refuse to extend the statute of limitations or to limit the extension to particular issues. The proposal would apply to requests to extend the statute of limitations made after the date of enactment.

PUBLISH LIVING ALLOWANCE SCHEDULES RELATING TO OFFERS IN COMPROMISE

Current Law

Section 7122 permits the IRS to compromise a taxpayer's tax liability for less than the full amount due. In general, there are two grounds on which an offer can be made: doubt as to the taxpayer's liability for the full amount, or doubt as to the taxpayer's ability to pay in full the amount owed.

Reasons for Change

In evaluating the sufficiency of an offer in compromise, the IRS should take into consideration a taxpayer's need to provide for the basic living expenses of his or her family, based on the cost of living in the taxpayer's locality.

Proposal

The proposal would require the IRS to develop and publish schedules of national and local living allowances, taking into account variations in the cost of living in different areas. These schedules would be designed to provide taxpayers entering into an offer in compromise with adequate means to provide for basic living expenses. The IRS would be expected to use this information in evaluating the sufficiency of offers in compromise. The schedules required by this provision would be published as soon as practicable, but no later than 180 days after the date of enactment.

ENSURE AVAILABILITY OF INSTALLMENT AGREEMENTS

Current Law

The IRS is authorized under Code section 6159 to enter into agreements with taxpayers under which taxpayers are permitted to pay taxes in installments "if the Secretary determines that such agreement will facilitate collection of such liability." The Secretary of the Treasury has discretion to determine when such an agreement is appropriate; installment agreements generally require extensive and ongoing financial disclosures by taxpayers, the continued filing of notices of Federal tax liens, and a plan for full payment of the taxes due. See Treas. Reg. § 301.6159-1.

Reasons for Change

The IRS generally permits a taxpayer with an outstanding liability of less than $10,000 to enter an installment payment agreement, under certain conditions. The proposal would essentially codify the IRS's current practice.

Proposal

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

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

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

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

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

(5) the taxpayer extends the statute of limitations on collection during the term of the agreement; and

(6) the taxpayer agrees to continue to comply with the tax laws and the terms of the agreement for the period (up to 3 years) that the agreement is in place.

The proposal would be effective on the date of enactment.

INCREASE SUPERPRIORITY DOLLAR LIMITS

Current Law

Section 6323(b) provides protection to certain interests even though a Notice of Federal Tax Lien has been filed before those competing interests arise. These interests are said to have "superpriorities."

Two of these interests are limited by a specific dollar amount. Under section 6323(b)(4), purchasers of personal property at a casual sale are currently protected to the extent the sale is for less than $250. Section 6323(b)(7) provides protection to mechanic's lienors with respect to the repairs or improvements made to owner-occupied personal residences, but only to the extent that the contract for repair or improvement is for not more than $1,000.

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

Reasons for Change

The dollar limits on the superpriority amounts have not been increased for decades and do not reflect current prices or values. Increasing these limits would provide superpriority protection against the Federal tax lien for more competing claimants to the property of debtors. Similarly, the passbook loan requirement does not reflect current banking practices.

Proposal

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

PERMIT PERSONAL DELIVERY OF SECTION 6672(b) NOTICES

Current Law

Section 6672(b)(1) requires that before the IRS may assess a "100 percent penalty" against a taxpayer, the IRS must mail to that taxpayer's last known address a written preliminary notice informing the taxpayer of the proposed penalty. Prior to this change in section 6672, the IRS often conducted personal meetings with taxpayers against whom a 100 percent penalty was proposed and delivered a written preliminary notice informing them of the proposed assessment and their appeal rights during that meeting. It is not clear, however, whether the Internal Revenue Code permits such delivery.

Reasons for Change

Permitting personal service of the preliminary notice required by section 6672(b)(1) of the Code may eliminate unnecessary disputes over whether the notice was properly addressed or received, and may additionally afford taxpayers and IRS employees the opportunity to resolve some 100 percent penalty cases at an earlier stage.

Proposal

The proposal would permit personal delivery, in addition to the Code's current requirement of mail delivery, of a preliminary notice that the IRS intends to assess a 100 percent penalty against the taxpayer. The proposal would be effective on the date of enactment.

ALLOW TAXPAYERS TO QUASH ALL THIRD-PARTY SUMMONSES

Current Law

When the IRS issues a summons to a "third-party recordkeeper" relating to the business transactions or affairs of a taxpayer, section 7609 requires that notice of the summons be given to the taxpayer within three days by certified or registered mail. The taxpayer is thereafter given up to 23 days to begin a court proceeding to quash the summons. Third-party recordkeepers are prohibited from complying with the summons until the court rules on the taxpayer's petition to quash, but the statute of limitations for assessment and collection with respect to the taxpayer is stayed during the pendency of such a proceeding. Third-party recordkeepers are generally persons who hold financial information about the taxpayer, such as banks, brokers, attorneys, and accountants.

Reasons for Change

A taxpayer should have notice when the IRS utilizes its summons power to gather information in an effort to determine the taxpayer's liability. While the current definition of third-party recordkeeper probably encompasses the vast majority of third-party summonses that are issued each year, expanding the definition to include all third parties would have the beneficial effect of ensuring taxpayers will receive notice and an opportunity to contest any summons issued to a third party in connection with the determination of their liability. It will not, however, seriously impair IRS investigations.

Proposal

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

REQUIRE DISCLOSURE OF CRITERIA FOR EXAMINATION SELECTION

Current Law

The IRS examines Federal tax returns to determine the correct liability of taxpayers. Returns are selected for examination in a number of ways, such as through "matching" of tax returns and information returns or through the use of a computerized classification system (the discriminant function or "DIF" system).

Reasons for Change

Taxpayers should better understand the reasons why they may be selected for examination.

Proposal

The proposal would require the IRS to add to Publication 1 ("Your Rights as a Taxpayer") a statement setting forth, in simple and nontechnical terms, the criteria and procedures for selecting taxpayers for examination. The statement would not include any information the disclosure of which would be detrimental to law enforcement, but it must specify the general procedures used by the IRS, including whether taxpayers are selected for examination on the basis of information in the media or from informants. Drafts of the statement would be required to be submitted to the House Committee on Ways and Means, the Senate Committee on Finance, and the Joint Committee on Taxation prior to publication. The addition to Publication 1 would have to be made not later than 180 days after the date of enactment.

PROHIBIT THREAT OF AUDIT TO COERCE TIP REPORTING ALTERNATIVE COMMITMENT AGREEMENTS

Current Law

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

Reasons for Change

It is inappropriate for IRS agents or employees to use the threat of an audit to induce participation in a voluntary program such as a TRAC agreement.

Proposal

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

PERMIT SERVICE OF SUMMONSES BY MAIL

Current Law

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

Reasons for Change

Most IRS summonses are used to obtain financial data from large corporate financial institutions such as banks and brokers. Under current law, IRS officials must appear personally and serve the summons on an officer of the corporation designated to receive service of process. This intrusion can prove to be unnecessarily disruptive to the financial institution. Moreover, since notice of the summons can be given to the taxpayer by mail, it makes administrative sense to permit service of the summons itself by mail as well.

Proposal

This proposal would permit the IRS to serve summonses by mail, in addition to the present law requirement that all summonses be personally served. The proposal would thus bring the service of the actual summons into line with the notice requirements regarding third party recordkeeper summonses and the service of process requirements of the Federal Rules of Civil Procedure. The provision would be effective for summonses served after the date of enactment.

ALLOW SUITS FOR DAMAGES IF THE IRS VIOLATES CERTAIN BANKRUPTCY PROCEDURES

Current Law

No remedy exists under the Internal Revenue Code if the IRS wilfully violates the automatic stay provision of the Bankruptcy Code. Section 362(h) of the Bankruptcy Code permits individuals to obtain attorney's fees and damages from the IRS for such violations, but it offers no such remedies for corporations, partnerships, or other entities. Thus, courts have to devise creative remedies under their equitable and contempt powers in order to compensate some debtors and bankruptcy estates.

Present law is similarly unclear as to whether an IRS violation of the discharge provisions of the Bankruptcy Code creates a cause of action for damages under section 7433 of the Internal Revenue Code. Furthermore, the Bankruptcy Code provides no statutory remedy for damages and attorney fees for violation of the discharge order. As a result, courts have relied on their contempt powers to compensate debtors for such violations.

Reasons for Change

The IRS should be held responsible when it willfully violates the automatic stay or discharge provisions of the Bankruptcy Code. The law should be clarified to permit taxpayers who are injured by such IRS actions to recover their damages and attorney's fees and costs.

Proposal

This proposal would amend section 7433 of the Internal Revenue Code to provide for payment of damages, plus attorney's fees and costs, for willful violations by officers or employees of the IRS of either the automatic stay under section 362 of the Bankruptcy Code or the discharge injunction under section 524 of the Bankruptcy Code. Jurisdiction over such cases would lie with the Bankruptcy Court, but the claimant would be required to exhaust administrative remedies at the IRS to the same extent as for other claims under section 7433. The provision would be effective with respect to violations occurring after the date of enactment.

INCREASE TAX COURT'S "SMALL CASE" LIMIT

Current Law

Taxpayers may choose to contest many tax disputes in the Tax Court. Under section 7463 of the Internal Revenue Code, special "small case procedures" apply to certain disputes involving $10,000 or less, if the taxpayer chooses to utilize these procedures (and the Tax Court concurs).

Reasons for Change

The small case procedures, which are simpler and less expensive than ordinary litigation, should be accessible to taxpayers in more cases.

Proposal

The proposal would increase the cap for small case treatment in the Tax Court from $10,000 to $25,000. The proposal would apply to proceedings commenced after the date of enactment.

PROVIDE EQUITABLE TOLLING

Current Law

Section 6511 sets forth the limitations periods for claiming refunds of Federal taxes. The general rule is that a refund claim is timely if it is made within three years of the date of filing the return or two years of the date of payment, whichever is later. A refund claim that is not filed within certain specified time periods is rejected as untimely. The Supreme Court recently held in United States v. Brockamp, 117 S.Ct. 849 (1997), that these limitations periods cannot be extended, or "tolled," for equitable reasons.

Reasons for Change

The law at times may reach harsh results for some taxpayers, particularly when they fail to seek a refund because a well-documented disability or similar compelling circumstance prevents them from doing so.

Proposal

The proposal would permit "equitable tolling" of the limitation period on claims for refund for the period of time during which an individual taxpayer is under a sufficient medically determined physical or mental disability as to be unable to manage his or her financial affairs. Tolling would not apply during periods in which the taxpayer's spouse or another person is authorized to act on the taxpayer's behalf in financial matters. The proposal would apply with respect to taxable years ending after the date of enactment.

REQUIRE NOTICE OF DEFICIENCY TO SPECIFY TAX COURT FILING DEADLINES

Current Law

Under section 6213, taxpayers must file a petition with the Tax Court within 90 days after the notice of deficiency is mailed (150 days if the person is outside the United States). If the petition is not filed within that time period, the Tax Court does not have jurisdiction to consider the petition. Because timely filing in Tax Court is a jurisdictional prerequisit, the IRS cannot extend the filing period, nor can the Tax Court hear the case of a taxpayer who relies on erroneous information from the IRS and files too late.

Reasons for Change

Taxpayers should receive better assistance from the IRS in determining the time period within which they must file a petition in Tax Court. Taxpayers should also be able to rely on the computation of the appropriate filing period by the IRS.

Proposal

The proposal would require the IRS to include on each notice of deficiency the date determined by the IRS as the last day on which the taxpayer may file a petition with the Tax Court. The last day on which a taxpayer who is outside the United States may file a petition with the Tax Court would be shown as an alternative. Any petition filed with the Tax Court by the later of the statutory date or the date shown on the deficiency notice would be timely. The proposal would apply to notices mailed after December 31, 1998.

ALLOW ACTIONS FOR REFUND WITH RESPECT TO CERTAIN ESTATES WHICH HAVE ELECTED THE INSTALLMENT METHOD OF PAYMENT

Current Law

Under section 7422, the U.S. Court of Federal Claims and the U.S. district courts have jurisdiction over suits for the refund of taxes, as long as full payment of the assessed tax liability has been made. See Flora v. United States, 357 U.S. 63 (1958), aff'd on reh'g, 362 U.S. 145 (1960). However, under section 6166 of the Code, if certain conditions are met, the executor of a decedent's estate may elect to pay the estate tax attributable to certain closely-held businesses over a 14-year period. Courts have held that U.S. district courts and the U.S. Court of Federal Claims do not have jurisdiction over claims for refunds by taxpayers that defer estate tax payments pursuant to section 6166 unless the entire estate tax liability has been paid (i.e., timely payment of the installments due prior to the bringing of an action is not sufficient to invoke jurisdiction). See, e.g., Rocovich v. United States, 933 F.2d 991 (Fed. Cir. 1991); Abruzzo v. United States, 24 Ct. Cl. 668 (1991).

Reasons for Change

The refund jurisdiction of the U.S. Court of Federal Claims and the U.S. district courts should apply without regard to whether the taxpayer has elected, and the Secretary has accepted, the payment of the estate tax in installments.

Proposal

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

EXPAND AUTHORITY TO AWARD COSTS AND FEES

Current Law

Any person who substantially prevails in any action by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding. In general, only an individual whose net worth does not exceed $2 million is eligible for an award, and only a corporation or partnership whose net worth does not exceed $7 million is eligible for an award. However, awards of reasonable litigation costs and reasonable administrative costs cannot exceed amounts actually paid or incurred, and cannot exceed a statutorily limited rate ($110 per hour, indexed for inflation).

Reasons for Change

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

Proposal

The proposal would permit the award of attorney's fees (in amounts up to the statutory limit) to specified persons who represent a prevailing taxpayer for no more than a nominal fee. This would encourage specialists to take pro bono cases and thereby ensure that low-income taxpayers are able to obtain necessary assistance. The proposal would be effective with respect to costs incurred and services performed after the date of enactment.

EXPAND AUTHORITY TO ISSUE TAXPAYER ASSISTANCE ORDERS

Current Law

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

Reasons for Change

The Taxpayer Advocate program is an effective mechanism for resolving taxpayer complaints. Last year, nearly 300,000 cases were brought to the attention of Taxpayer Advocate offices around the country, and cases were resolved in an average of 38 days. Strengthening the Taxpayer Advocate will allow the Taxpayer Advocate to provide even greater assistance to taxpayers.

Proposal

The proposal would provide that in determining whether to issue a TAO, the Taxpayer Advocate will be authorized to consider, among other factors, the following: unreasonable delays in resolving the taxpayer's account problems; immediate threats of substantial adverse action (such as the seizure of a residence to pay overdue taxes); the likelihood of irreparable harm if relief is not granted; whether the taxpayer will have to pay significant professional fees if relief is not granted; and the possibility of long-term adverse impact on the taxpayer. The proposal would be effective on the date of enactment.

PROVIDE NEW REMEDY FOR THIRD PARTIES WHO CLAIM THAT THE IRS HAS FILED AN ERRONEOUS LIEN

Current Law

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

Reasons for Change

The Williams Court left many important questions unresolved, such as: the class of third parties who have standing; what administrative procedure is required before litigation; the applicable statutes of limitations; the IRS's authority to pay interest on such a refund; and how to prevent expiration of the collection period on the taxpayer while the third party from whom the tax was collected challenges the IRS. These questions should be resolved statutorily rather than through litigation.

Proposal

The proposal would create an administrative procedure similar to the wrongful levy remedy for third parties in section 7426. Under this procedure, a record owner of property against which a Federal tax lien had been filed could obtain a certificate of discharge of property from the lien as a matter of right. The third party would be required to apply to the Secretary of the Treasury for such a certificate and either to deposit cash or to furnish a bond sufficient to protect the lien interest of the United States. Although the Secretary would determine the amount necessary to protect the Government's lien interest, if this procedure was followed the Secretary would have no discretion to refuse to issue a certificate of discharge, thus curing the defect in this remedy that the Supreme Court found in Williams. A certificate of discharge of property from a lien issued pursuant to the procedure would enable the record owner to sell the property free and clear of the Federal tax lien in all circumstances. The proposal also would authorize the refund of all or part of the amount deposited, plus interest at the same rate that would be made on an overpayment of tax by the taxpayer, or the release of all or part of the

bond, if the Secretary otherwise satisfies the tax liability or determines that the United States does not have a lien interest or has a lesser lien interest than the amount initially determined.

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

The proposal would be effective on the date of enactment.

ALLOW DAMAGE SUITS BY PERSONS OTHER THAN THE TAXPAYER

Current Law

Section 7433 of the Internal Revenue Code provides a right to taxpayers to sue for damages if, in connection with any collection of Federal tax, any officer or employee of the IRS recklessly or intentionally disregards any provision of the Internal Revenue Code or any regulation thereunder. Recoverable damages are the lesser of actual, direct economic damages sustained as a proximate result of the reckless or intentional act, plus attorneys' fees, or $1 million. Actions under this provision may only be brought by an injured taxpayer, however, and not by an injured third party.

Under section 7426(a), by contrast, a person other than the taxpayer may bring an action in district court for the return of property that has been wrongfully levied upon.

Reasons for Change

Persons other than the taxpayer who have been harmed by reckless or intentionally wrongful actions by IRS officers or employees should have the same remedies as taxpayers who are harmed by such actions. The remedies available to such third parties should not be limited to the wrongful levy situation.

Proposal

The proposal would provide persons other than the taxpayer from whom collection is sought a right to sue for damages under section 7433. Thus if, in connection with any collection of Federal tax, any officer or employee of the IRS recklessly or intentionally disregards any provision of the Code or any regulations thereunder, and a person other than the taxpayer is injured, that person could bring an action pursuant to section 7433. The current law limitations on awards for damages would apply to third party plaintiffs as well. The proposal would be effective with respect to collection actions taken after the date of enactment.

SUSPEND COLLECTION IN CERTAIN JOINT LIABILITY CASES

Current Law

When one spouse files a petition in the Tax Court concerning a joint return, there are no provisions in the Internal Revenue Code or the regulations addressing administrative collection action against a nonpetitioning spouse during the pendency of the Tax Court. The IRS's policy is generally to forebear from administrative collection where there is reasonable doubt that the assessment is correct, provided that adjustment of the claim is within the control of the IRS and the interests of the Government will not be jeopardized. There are some circumstances when collection action may be appropriate, however, such as when the petitioning spouse is seeking relief solely as an innocent spouse, or it is anticipated that the nonpetitioning spouse may file a bankruptcy petition, or when the majority of the assets are held in the name of the nonpetitioning spouse, or there is reason to believe that jeopardy exists with respect to collection from the nonpetitioning spouse.

Reasons for Change

A nonpetitioning spouse should generally receive the same protection against IRS collection action as the spouse who has filed a petition in Tax Court contesting a proposed deficiency.

Proposal

When a married couple's joint return is the subject of a Tax Court proceeding, this proposal would require the IRS to withhold collection by levy against a nonpetitioning spouse during the pendency of a Tax Court proceeding involving the other spouse. This would treat the nonpetitioning spouse the same as the petitioning spouse in most situations. Certain exceptions would be provided, including in jeopardy situations, when the taxpayer waives this protection (i.e., agrees to the collection action), or for some other, limited but automatic kinds of collection activity, such as automatic refund offset, filing of protective notices of Federal tax lien, or in certain other circumstances. The statute of limitations on assessment and collection would be stayed for the period during which collection is barred. If there is a final decision that reduces the proposed assessment against the petitioning spouse, the assessment against the nonpetitioning spouse would likewise be reduced. The proposal would not affect the IRS's ability to collect other liabilities or assessments that are not the subject of the Tax Court proceeding. The proposal would be effective for taxes assessed with respect to taxable years beginning after December 31, 1998.

REQUIRE EXPLANATION OF JOINT AND SEVERAL LIABILITY

Current Law

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

Reasons for Change

Married taxpayers need to better understand the legal implications of signing a joint return. The IRS should provide sufficient information concerning joint and several liability that such taxpayers fully understand their potential liability.

Proposal

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

RELIEVE INNOCENT SPOUSE OF LIABILITY IN CERTAIN CASES

Current Law

Spouses who file a joint tax return are each fully responsible for the accuracy of the return and for the full tax liability, even if only one spouse earned the wages or income shown on the return. This is "joint and several" liability. A spouse who wishes to avoid joint liability may file as a "married person filing separately." Relief from liability for tax, interest, and penalties is available for "innocent spouses" in certain limited circumstances. To qualify for such relief, the innocent spouse must establish: (1) that a joint return was made; (2) that an understatement of tax, which exceeds the greater of $500 or a specified percentage of the innocent spouse's adjusted gross income for the preadjustment (most recent) year, is attributable to a "grossly erroneous item" of the other spouse (defined as items of gross income that are omitted from reported income and claims of deductions, credits, or basis in an amount for which there is no basis in fact of law); (3) that in signing the return, the innocent spouse did not know, and had no reason to know, that there was an understatement of tax; and (4) that taking into account all the facts and circumstances, it is inequitable to hold the innocent spouse liable for the deficiency in tax. The specified percentage of adjusted gross income is 10 percent if adjusted gross income is $20,000 or less. Otherwise, the specified percentage is 25 percent.

The proper forum for contesting a denial by the Secretary of the Treasury of innocent spouse relief is determined by whether an underpayment is asserted or the taxpayer is seeking a refund of overpaid taxes. Accordingly, the Tax Court may not have jurisdiction to review all denials of innocent spouse relief. The IRS currently does not provide a form to assist taxpayers in applying for innocent spouse relief.

Reasons for Change

The innocent spouse provisions of present law are too narrowly limited. Furthermore, all taxpayers should have access to the Tax Court in resolving disputes concerning their status as an innocent spouse. Finally, taxpayers need to be better informed of their right to apply for innocent spouse relief in appropriate cases, and the IRS is the best source of that information.

Proposal

The proposal generally would make innocent spouse status easier to obtain. It would first eliminate all of the dollar amount thresholds for understatements of tax, and make the rules applicable in community property states and common law states parallel.

The proposal also would specifically provide the Tax Court with jurisdiction to review any denial (or failure to rule) by the Secretary regarding an application for innocent spouse relief. Under this proposal, the taxpayer must file a petition for review with the Tax Court during the

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

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

The proposal would be effective for understatements with respect to taxable years beginning after the date of enactment. With respect to overpayments, effective on or after the date of enactment an innocent spouse seeking relief under this provision would be required to claim innocent spouse status with regard to any assessment not later than two years after the date of such assessment.

ALLOW "GLOBAL" INTEREST NETTING OF UNDER- AND OVER-PAYMENTS

Current Law

Under section 6621, interest on underpayments differs from interest on overpayments by as much as 4.5 percent. The IRS ameliorates the effect of this interest rate differential in two situations. If a taxpayer previously paid underpayment interest and is now due a refund for the same tax period, the excess interest is refunded pursuant to Rev. Proc. 94-60. Further, if the IRS credits an overpayment against any other outstanding tax liability pursuant to section 6402(a) and Treas. Reg. § 301.6402-1, underpayment interest is not charged to the extent of the credit, pursuant to section 6601(f). There is, however, no authority to net in a third situation: netting an overpayment, or interest thereon, against a prior deficiency of tax or interest that has already been paid in full by the taxpayer, or conversely netting an underpayment (of tax or interest) against a prior refund (of tax or interest) that has already been paid by the IRS. See Northern States Power Co. v. United States, 73 F.3d 764, 765 (8th Cir.), cert. denied, 117 S. Ct. 168 (1996). This third situation is referred to as "global" netting.

Reasons for Change

Treasury's study of interest netting issues concluded that the IRS has not performed "global" netting for two reasons. First, there is no clear authority to credit an overpayment against any tax debt other than one that is still outstanding when the credit arises, nor to refund excess underpayment interest in global situations. Second, very complex interest netting computations across tax periods are done by hand, and they cannot be automated within the IRS's current systems capabilities. There is no policy reason, however, for netting interest only in some situations but not in others.

Proposal

Global interest netting for income taxes would be implemented by adding a new interest rate to section 6621. When the taxpayer reasonably identifies and establishes an appropriate situation for such netting -- an overlapping period of mutual indebtedness with respect to tax periods that are not barred by the expiration of the statute of limitations -- interest would be equalized (i.e., the net interest rate would be zero) to the extent and for the time of the overlapping amount. The proposal would apply prospectively to periods of overlapping mutual indebtedness that occur after the date of enactment.

FACILITATE ARCHIVING OF IRS RECORDS

Current Law

The IRS, like all other Federal agencies, must create, maintain, and preserve agency records, and must transfer significant and historical records to the National Archives and Records Administration (NARA) for retention or disposal. NARA has general authority to inspect records for the purpose of making recommendations for the improvement of records management practices. However, tax returns and return information can only be disclosed under the authority provided in section 6103 of the Internal Revenue Code. There is no exception to section 6103 that would authorize the disclosure of confidential return information to NARA. See American Friends Service Committee v. Webster, 720 F.2d 29 (D.C. Cir. 1983); Tax Analysts v. Internal Revenue Service, No. 97-0260 (D.D.C. August 21, 1997). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both, and a taxpayer whose records are disclosed without authorization may also bring an action for civil damages.

Reasons for Change

It is appropriate to permit limited disclosure of returns and return information to NARA for purposes of scheduling records for destruction or retention, while at the same time preserving the confidentiality of the taxpayer information in those documents.

Proposal

The proposal would provide an exception to the disclosure rules to authorize the IRS to disclose tax returns and return information to officers or employees of NARA, upon written request from the Archivist, for purposes of the appraisal of such records for destruction or retention in the National Archives. The present-law prohibitions on, and penalties for, unauthorized redisclosure of tax information would apply to NARA. The proposal would be effective for requests made by the Archivist after the date of enactment.

CLARIFY AUTHORITY TO PRESCRIBE MANNER OF MAKING ELECTIONS

Current Law

Except as otherwise provided by statute, section 7805(d) requires elections under the Internal Revenue Code to be made in such manner as the Secretary of the Treasury "shall by regulations or forms prescribe."

Reasons for Change

The question has arisen whether the Secretary can prescribe the manner of required elections other than by regulations or forms, for instance in revenue rulings or revenue procedures. Any confusion over the type of guidance in which the Secretary may prescribe the manner of making any election should be eliminated.

Proposal

The proposal would clarify that, except as otherwise provided, the Secretary may prescribe the manner of making of any election by any reasonable means. The proposal would be effective as of the date of enactment. No inference regarding the proper interpretation of section 7805(d) under current law is intended by the proposal.

GRANT IRS BROAD AUTHORITY TO ENTER INTO COOPERATIVE AGREEMENTS WITH STATE TAXING AGENCIES

Current Law

The IRS is generally not authorized to provide services to non-Federal agencies even if the cost is reimbursed. Taxpayers currently must file returns with both their State taxing agency and the IRS, and frequently must resolve issues with the agencies at different times.

Reasons for Change

If appropriate statutory authority were enacted, taxpayers could file only one return for both State and Federal taxes. Then, pursuant to a cooperative agreement between the IRS and the State, the information could be processed by one tax administrator and shared between the two. This would substantially simplify filing requirements and reduce taxpayer burden.

Proposal

The proposal would permit the IRS to enter agreements with the States to provide for joint filing and processing of returns, joint collection of taxes (other than Federal income taxes), and such other provisions as may enhance joint tax administration. It would further amend sections 6103 and 7431 of the Internal Revenue Code (relating to confidentiality of tax information) to permit sharing of common tax data; it would contain a number of statutory limitations on the effect of joint agreements; and it would include a thorough list of conforming amendments. The proposal would be effective on the date of enactment.

PROVIDE CLINICS FOR LOW-INCOME TAXPAYERS

Current Law

There are no provisions in present law authorizing legal clinics that assist low-income taxpayers.

Reasons for Change

Providing tax services to low-income individuals through accredited clinics that offer such services for a nominal fee would improve compliance with the Federal tax laws and should be encouraged.

Proposal

The proposal would authorize the Legal Services Corporation to make up to $3,000,000 in grants for the development, expansion, or continuation of certain low-income taxpayer clinics. Eligible clinics are those that charge no more than a nominal fee to represent low-income taxpayers in controversies with the IRS. The term "clinic" includes (1) a clinical program at an accredited law school in which students represent low-income taxpayers, and (2) an organization exempt from tax provides referral to qualified representatives. A clinic is treated as representing low-income taxpayers if at least 90 percent of the taxpayers represented by the clinic have incomes that do not exceed 250 percent of the poverty level and have amounts in controversy of $25,000 or less.

No taxpayer clinic could receive more than $100,000 per year. The clinic must provide matching funds on a dollar-for-dollar basis. Matching funds could include the allocable portion of both the salary (including fringe benefits) of individuals performing services for the clinic and clinic equipment costs, but not general institutional overhead. The following criteria would be considered in making awards: (1) the number of taxpayers served by the clinic; (2) the existence of other taxpayer clinics serving the same population; (3) the quality of the program; and (4) alternative funding sources available to the clinic.

The proposal would be effective on the date of enactment.

PROVIDE PROCEDURES FOR RELEASE OF FIELD SERVICE ADVICE

Current Law

Returns and return information are generally confidential and may be disclosed only as specifically authorized in the Internal Revenue Code. "Return information" is broadly defined in section 6103(b)(2) to include, inter alia, "any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of" a tax liability. Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both, and a taxpayer whose records are disclosed without authorization may also bring a civil action for damages.

Certain kinds of return information ("written determinations," i.e., rulings, determination letters, technical advice memoranda, and background file documents relating to such written determinations) are subject to disclosure under section 6110 of the Code. However, the taxpayer who is the subject of the written determination has the right to participate in the process of redacting certain specific taxpayer information, and procedures governing this redaction process are set forth in section 6110.

In Tax Analysts v. Internal Revenue Service, 117 F.3d 607 (D.C. Cir. July 8, 1997), the court generally held that portions of IRS Field Service Advice Memoranda ("FSAs") are not return information and are to be disclosed pursuant to a Freedom of Information Act request. However, the court did not specify what standards should govern the process of redacting the FSAs when they are to be released.

Reasons for Change

Taxpayers who are the subject of FSAs have a significant interest in protecting their confidential tax information. They should have the right to participate in the redaction of their confidential information before the FSAs are released. Without taxpayer participation in the redaction process, taxpayer rights to confidentiality of their tax information could be jeopardized. Moreover, without legislation, there is a risk that taxpayers in jurisdictions other than the District of Columbia whose FSAs are released pursuant to the court's order might bring suit for damages resulting from the unauthorized disclosure of such information.

Proposal

The proposal would clarify that FSAs are return information in their entirety, thus prohibiting their unauthorized disclosure. Also, however, it would provide a structured mechanism for public inspection of FSAs, subject to a redaction process similar to that under present section 6110, in which the taxpayer whose liability is the subject of the FSA would participate. The proposal would be effective on the date of enactment, but it would include a

schedule of time over which the IRS would make the FSAs subject to the lawsuit available under the taxpayer participation and redaction procedure.

Revenue Offsets

DEFER DEDUCTION FOR INTEREST AND ORIGINAL ISSUE DISCOUNT ON CONVERTIBLE DEBT

Current Law

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

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

Reasons for Change

In many cases, the issuance of convertible debt instrument is viewed by market participants as a de facto issuance of equity. Allowing issuers to deduct accrued interest and OID is inconsistent with this market view.

Proposal

The proposal would defer the deduction for accrued stated interest and OID on convertible debt until actual 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 or interest. Payments in equity of the issuer or a related party, 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 (i) debt exchangeable for the stock of the issuer or a related party, (ii) debt that provides for cash-settlement conversion features, or (iii) debt issued with warrants (or similar instruments) as part of an investment unit in which the debt component 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's or related party's equity that has a value equal to the amount of the fixed payment. The proposal would not affect the treatment of holders.

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

ELIMINATE DIVIDENDS-RECEIVED DEDUCTION FOR CERTAIN PREFERRED STOCK

Current Law

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

The dividends-received deduction is disallowed if the taxpayer has held the stock for 45 days or less during the 90-day period beginning on the date that is 45 days before the date on which such share becomes ex-dividend with respect to such dividend. In the case of certain preferred stock, the dividends-received deduction is disallowed if the taxpayer has held the stock for 90 days or less during the 180-day period beginning on the date which is 90 days before the date on which such share becomes ex-dividend with respect to such dividend. The holding period generally does not include any period during which the taxpayer has a right or obligation to sell the stock, or is otherwise protected from the risk of loss otherwise inherent in the ownership of an equity interest. When an instrument is treated as stock for tax purposes, but provides for payment of a fixed amount on a specified maturity date and affords holders the rights of creditors to enforce such payment, no dividends-received deduction is allowed for distributions on the instrument. See Rev. Rul. 94-28.

The Taxpayer Relief Act of 1997 amended sections 351, 354, 355, 356, and 1036 to treat "nonqualified preferred stock" as boot in corporate transactions, subject to certain exceptions. Nonqualified preferred stock is defined in section 351(g) as preferred stock that does not participate (through a conversion privilege or otherwise) in corporate growth to any significant extent, if (i) the holder has the right to require the issuer or a related person 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 similar indices, regardless of whether such varying rate is provided as an express term of the stock (as in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (as in the case of auction rate stock). For this purpose, clauses (i), (ii), and (iii) apply if the right or obligation may be exercised within 20 years of the issue date and is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

Reasons for Change

Taxpayers have taken advantage of the benefit of the dividends received deduction for payments on instruments that, while treated as stock for tax purposes, economically perform as debt instruments and have debt-like characteristics (e.g., enhanced likelihood of recovery of principal or of maintaining a dividend over the term of the instrument, or both).

Proposal

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

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

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

REPEAL PERCENTAGE DEPLETION FOR NON-FUEL MINERALS MINED ON FEDERAL AND FORMERLY FEDERAL LANDS

Current Law

Taxpayers are allowed to deduct a reasonable allowance for depletion relating to certain hard mineral deposits. The depletion deduction for any taxable year is calculated under either the cost depletion method or the percentage depletion method, whichever results in the greater depletion allowance for the year.

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

Under the percentage depletion method, a deduction is allowed in each taxable year for a statutory percentage of the taxpayer's gross income from the property. The percentage depletion deduction for these minerals may not exceed 50 percent of the net income from the property for the taxable year (computed without allowance for depletion). Percentage depletion is not limited to the taxpayer's basis in the property; thus, the aggregate amount of percentage depletion deductions claimed may exceed the amount expended by the taxpayer to acquire and develop the property.

The 1872 mining act has allowed investors to acquire mining rights on Federal lands at 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 Federal lands where the mining rights were originally acquired under the 1872 law, and on private lands acquired under the 1872 law. The proposal would be effective for taxable years beginning after the date of enactment.

REPEAL TAX-FREE CONVERSIONS OF LARGE C CORPORATIONS TO S CORPORATIONS

Current Law

C corporations generally are 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, generally is tax-free for both the corporation 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.

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 of a C corporation 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 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, 1999. The proposal also would apply to acquisitions (e.g., the merger of a C corporation into an S corporation) after December 31, 1998. Thus, C corporations would continue to be permitted to elect S corporation status effective for taxable years beginning in 1998 or on January 1, 1999 without incurring the tax on conversion.

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.

REPLACE SALES SOURCE RULES WITH ACTIVITY-BASED RULE

Current Law

The foreign tax credit generally reduces U.S. tax on foreign source income, but does not reduce U.S. tax on U.S. source income. Where products are manufactured in the United States and sold abroad, Treasury regulations provide that 50 percent of such income generally is treated as earned in production activities, and sourced on the basis of the location of assets held or used to produce income which is derived from the export sales. The remaining 50 percent of the income is treated as earned in sales activities and sourced based on where title to the inventory transfers. Thus, if a U.S. manufacturer sells inventory abroad, half of the income generally is treated as derived from domestic sources, and half of the income generally is treated as derived from foreign sources. However, the taxpayer may use a more favorable method if it can establish to the satisfaction of the IRS that more than half of its economic activity occurred in a foreign country. Different rules apply to the export of natural resources.

Reasons for Change

The existing 50/50 rule provides a benefit for U.S. exporters that also operate in high-tax foreign countries. Thus, U.S. multinational exporters have a competitive advantage over U.S. exporters that conduct all their business activities in the United States. Different categories of exporters should be treated equally.

In addition, the United States has established an income tax treaty program that encompasses more than 50 countries during the 70 years since the 50/50 rule of present law has been in place. These treaties protect export sales income from local taxation in the country where the goods are sold. Now that export sales income generally is not subject to foreign tax, it is not appropriate to maintain the existing allowance of foreign tax credits against that income.

Proposal

Under the proposal, if a U.S. manufacturer sells inventory abroad, the apportionment of its income between production activities and sales activities would be based on actual economic activity. The proposal would not change the tax rules that apply to the export of natural resources.

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

MODIFY RULES RELATING TO FOREIGN OIL AND GAS EXTRACTION INCOME

Current Law

The United States taxes U.S. persons on their worldwide income. A credit against U.S. tax on foreign income is allowed for foreign income taxes paid by the U.S. person. In addition, a credit is allowed to a U.S. corporation for foreign taxes paid by certain foreign subsidiary corporations upon payment of an actual or deemed dividend by the subsidiary (the "deemed paid" or "indirect" foreign tax credit).

To be a creditable income tax, a foreign levy must be the substantial equivalent of an income tax in the U.S. sense, regardless of the label the foreign government attaches to it. Under regulations, a foreign levy is a tax if it is a compulsory payment under the authority of a foreign government to levy taxes and is not compensation for a specific economic benefit provided by the foreign country. Taxpayers that are subject to a foreign levy and that also receive (directly or indirectly) a specific economic benefit from the levying country are referred to as "dual capacity" taxpayers and may not claim a credit for that portion of the foreign levy paid as compensation for the specific economic benefit received. Under a regulatory safe-harbor test, if a country has a generally imposed income tax, the dual-capacity taxpayer may treat as a creditable tax the portion of the levy that application of the generally imposed income tax would yield (to the extent the levy otherwise constitutes an income tax or an "in lieu of" tax); the balance is treated as compensation for the specific economic benefit. If there is no generally imposed income tax, the regulation treats as a creditable tax that portion of the payment that does not exceed the applicable U.S. tax rate applied to net income. A foreign tax is treated as "generally imposed" even if it applies only to persons who are not residents or nationals of that country.

There is no separate section 904 foreign tax credit "basket" for oil and gas income. However, under section 907, the amount of creditable foreign taxes imposed on FOGEI is limited in any year to the applicable U.S. tax on that income.

Reasons for Change

The purpose of the foreign tax credit is to avoid double taxation of income by both the United States and a foreign jurisdiction. When a payment to a foreign government is made as compensation for a specific economic benefit, there is no incidence of double taxation. Current law recognizes the distinction between creditable taxes and non-creditable payments for a specific economic benefit but fails to achieve the appropriate split between the two in a case where a foreign country imposes a levy on, for example, oil and gas income only, but has no generally imposed income tax.

Proposal

The proposal would treat payments by a dual-capacity taxpayer to a foreign country that would otherwise qualify as income taxes or "in lieu of" taxes as taxes only if there is a "generally applicable income tax" in that country. For this purpose, a generally applicable income tax is an income tax (or a series of income taxes) that applies to trade or business income from sources in that country, so long as the levy has substantial application both to non-dual-capacity taxpayers and to persons who are citizens or residents of that country. The proposal thus would replace that part of the regulatory safe harbor that treats a foreign levy as a tax up to the amount of the U.S. tax where the foreign country has no generally applicable income tax. The proposal generally would retain the rule of present law where the foreign country does generally impose an income tax. In that case, credits would be allowed up to the level of taxation that would be imposed under that general tax, so long as the tax satisfies the statutory definition of a "generally applicable income tax."

The proposal also would convert the special foreign tax credit limitation rules of present-law section 907 into a new foreign tax credit basket within section 904 for foreign oil and gas income.

The proposal would be effective for taxable years beginning after the date of enactment. The proposal would yield to U.S. treaty obligations that allow a credit for taxes paid or accrued on certain oil or gas income.

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 also would be included. The proposal would be treated as a change in the method of accounting for inventories, and any resulting section 481(a) adjustment 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.

INCREASE PENALTIES FOR FAILURE TO FILE CORRECT INFORMATION RETURNS

Current Law

Any person who fails to file required information returns in a timely manner or incorrectly reports such information is subject to penalties. The amount of the penalty is generally $50 for each return with respect to which a penalty is incurred, not to exceed $250,000 during any calendar year. If any failure or error is corrected within 30 days after the required filing date, the penalty imposed is $15 per return, not to exceed $75,000. Failures corrected more than 30 days after the required filing date but before August 1 are subject to a $30 per return penalty, not to exceed $150,000 in any calendar year.

Reasons for Change

For taxpayers filing large volumes of information returns or reporting significant payments, the general penalty provisions may not be sufficient to encourage timely and accurate reporting. By basing the penalty amount on either the number of returns or amount to be reported, the proposal encourages taxpayers to assure both the accuracy and timeliness of information on each return and in the aggregate.

Proposal

The proposal would increase the general penalty amount for any failure to the greater of $50 per return or 5 percent of the total amount required to be reported, subject to the overall dollar limitations. The increased penalty would not apply if the aggregate amount actually reported by the taxpayer on all returns filed for that calender year was at least 97 percent of the amount required to be reported. The proposal would be effective for returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment of the proposal.

TIGHTEN THE SUBSTANTIAL UNDERSTATEMENT PENALTY FOR LARGE CORPORATIONS

Current Law

Currently, taxpayers may be penalized for erroneous, but non-negligent, return positions only if the taxpayer did not have "substantial authority" for the claimed position, the taxpayer did not disclose the position in a statement or return, and the amount of the understatement is "substantial." (Special rules apply in the case of tax shelters.) "Substantial" is defined for this purpose as the greater of $5,000 ($10,000 for certain corporations) or 10 percent of the taxpayer's total tax liability, which for large taxpayers can be a very sizeable amount.

Reasons for Change

The current definition of "substantial" has led some large corporations to take very aggressive reporting positions for transactions with respect to which the potential tax liability does not exceed 10 percent of the company's total tax bill. In effect, they can "play the audit lottery" without any downside risk of a penalty if they are caught, even if huge amounts of potential tax liability are at stake.

Proposal

The proposal would treat a corporation's deficiency of more than $10 million as substantial for purposes of the substantial understatement penalty, whether or not it exceeds 10 percent of the taxpayer's total tax liability. This proposal should help to deter aggressive tax planning by large corporate taxpayers that have corrected tax liabilities of $100 million or more.

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

REPEAL EXEMPTION FOR WITHHOLDING ON GAMBLING WINNINGS FROM BINGO AND KENO IN EXCESS OF $5,000

Current Law

Proceeds of most wagers with odds of less than 300 to 1 are exempt from withholding, as are all bingo and keno winnings.

Reasons for Change

Withholding on gambling winnings would improve compliance and enforcement.

Proposal

The proposal would impose withholding on proceeds of bingo or keno in excess of $5,000 at a rate of 28 percent, regardless of the odds of the wager. The proposal would be effective for payments made after the beginning of the first month that begins at least 10 days after the date of enactment.

REINSTATE OIL SPILL 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 Department of the Treasury's authority to advance up to $1 billion to the Trust Fund expired in 1994.

Proposal

The Oil Spill Liability Trust Fund excise tax would be reinstated for the period after the date of enactment and before October 1, 2008. In addition, the full funding limitation would be increased from $1 billion to $5 billion, effective on the date of enactment.

MODIFY DEPOSIT REQUIREMENT FOR FUTA

Current Law

The Federal Unemployment Tax Act (FUTA) currently imposes a federal payroll tax on employers of 6.2 percent of the first $7,000 paid annually to each employee. The tax funds a portion of the federal/state unemployment benefits system. States also impose an unemployment tax on employers. Employers in states that meet certain federal requirements are allowed a credit for state unemployment taxes of up to 5.4 percent, making the minimum net federal tax rate 0.8 percent. Generally, federal and state unemployment taxes are collected quarterly and deposited in federal trust fund accounts.

Reasons for Change

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

Proposal

The proposal would require an employer to pay federal and state unemployment taxes on a monthly basis in a given year if the employer's FUTA tax liability in the prior year was $1,100 or more (reflecting approximately 20 employees earning at least $7,000). A safe harbor would be provided for the required deposits for the first two months of each calendar quarter. For the first month in each quarter, the payment would be required to be the lesser of 30 percent of the actual FUTA liability for the quarter or 90 percent of the actual FUTA liability for the month. The cumulative deposits paid in the first two months of each quarter would be required to be the lesser of 60 percent of the actual FUTA liability for the quarter or 90 percent of the actual FUTA liability for the two months. The employer would be required to pay the balance of the actual FUTA liability for each quarter by the last day of the month following the quarter. States would be allowed to provide a similar mechanism for paying state unemployment taxes.

The collection proposal would be effective for months beginning after December 31, 2003.

EXTEND PRO RATA DISALLOWANCE OF TAX-EXEMPT INTEREST EXPENSE THAT APPLIES TO BANKS TO ALL FINANCIAL INTERMEDIARIES

Current Law

No income tax deduction is allowed for interest on debt used directly or indirectly to acquire or hold investments that produce tax-exempt income. The determination of whether debt is used to acquire or hold tax-exempt investments differs depending on the holder of the instrument. For banks and a limited class of other financial institutions, debt generally is treated as financing all of the taxpayer's assets proportionately. For other corporations, and for individuals, however, a tracing rule is employed. Under this approach, deductions are disallowed only when indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt investments. Securities dealers are not included in the definition of "financial institution," and although they are subject to a case-law-based, pro-rata rule similar to the one that applies to other financial institutions, they benefit from a special exception to which financial institutions are not entitled. Securities dealers are allowed to trace borrowings to non-exempt purposes and to exclude the interest on those borrowings from the interest that is subject to the pro-rata disallowance rule. Thus, in general, the portion of a securities dealer's interest subject to possible disallowance under the pro-rata rule is generally much smaller than, for example, a bank's portion. Other financial intermediaries, such as finance companies, are also excluded from the definition of "financial institution," and therefore are subject only to the direct tracing rule, even though they operate similarly to banks.

Reasons for Change

The current rules applicable to securities dealers and financial intermediaries other than banks permit them to reduce their tax liabilities inappropriately through double Federal tax benefits of interest expense deductions and tax-exempt interest income, notwithstanding that they operate similarly to banks. The treatment of banks should be applicable to other taxpayers engaged in the business of financial intermediation, such as securities dealers. There is no reason to distinguish between banks and other financial intermediaries in this context. In both cases it is difficult to trace funds within the institution and nearly impossible to assess the taxpayer's purpose in accepting deposits or making other borrowings.

Proposal

Under the proposal, the definition of "financial institution" under section 265(b) should be amended to include any person engaged in the active conduct of a banking, financing, or similar business, such as securities dealers and other financial intermediaries. Thus, a financial intermediary investing in tax-exempt obligations would be disallowed deductions for a portion of its interest expense equal to the portion of its total assets that is comprised of tax-exempt investments. The proposal would be effective for taxable years beginning after the date of enactment with respect to obligations acquired on or after the date of first committee action.

INCREASE THE PRORATION PERCENTAGE FOR PROPERTY CASUALTY (P&C) INSURANCE COMPANIES

Current Law

Property casualty insurance companies generally are taxable on the sum of their underwriting income, investment income and other income. In computing their underwriting income, property casualty companies deduct reserves for losses and loss expenses incurred from their premiums earned. These loss reserves are funded in part with the property casualty company's investment income. The taxable investment income of property casualty companies generally does not include interest on tax-exempt bonds, the deductible portion of certain dividends received, or inside buildup on most insurance policies.

In 1986, Congress concluded that it was inappropriate for property casualty companies to fund fully deductible loss reserves with investment income that might be exempt from tax, such as interest on tax-exempt bonds or the deductible portion of certain dividends received. Thus, Congress reduced the reserve deductions of property casualty companies by 15 percent of the tax-exempt interest or the deductible portion of certain dividends received, for stock or obligations acquired after August 7, 1986.

In 1997, Congress concluded that it also was inappropriate for property casualty companies to fund fully deductible loss reserves with investment income that might be tax-exempt or tax-deferred under certain types of insurance contracts. Given this conclusion, Congress expanded the 15 percent proration rule to apply to the inside buildup on certain annuity, endowment, or life insurance contracts.

Reasons for Change

The existing 15 percent proration rule still enables property casualty insurance companies to fund a substantial portion of their deductible reserves with tax-exempt or tax-deferred income. Other financial intermediaries, such as life insurance companies and banks, are subject to more stringent proration rules that substantially reduce or eliminate their ability to use tax-exempt or tax-deferred investments to fund currently deductible reserves or interest on loans.

Proposal

The proration percentage would be increased from 15 percent to 30 percent, for taxable years beginning after the date of enactment with respect to investments acquired on or after the date of first committee action.

PRECLUDE CERTAIN TAXPAYERS FROM PREMATURELY CLAIMING LOSSES FROM RECEIVABLES OR FROM CREATING RESERVES FOR BAD DEBTS

Current Law

An accrual method taxpayer generally must recognize income when all events have occurred which fix the right to its receipt and its amount can be determined with reasonable accuracy. In the event that a receivable arising in the ordinary course of the taxpayer's trade or business becomes uncollectible, the accrual method taxpayer may deduct the account receivable as a business bad debt in the year in which it becomes wholly or partially worthless.

Accrual method service providers are provided a special exception to the general rule requiring an accrual method taxpayer to deduct an uncollectible account receivable only in the year in which it becomes wholly or partially worthless. Under the exception, a taxpayer using an accrual method with respect to amounts to be received for the performance of services is not required to accrue any portion of such amounts which (on the basis of experience) will not be collected ("non-accrual experience method"). This exception applies as long as the taxpayer does not charge interest or a penalty for failure to timely pay on such amounts.

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

Under Treasury regulations, if a taxpayer would not be a dealer in securities but for its purchases and sales of debt instruments that, at the time of purchase or sale, are customer paper with respect to either the taxpayer or a corporation that is a member of the same consolidated group as the taxpayer, then the taxpayer is not a dealer in securities, unless the taxpayer elects out of this exception to dealer status (the "customer paper election"). For this purpose, a debt instrument is "customer paper" with respect to a person at a point in time if (i) the person's principal activity is selling nonfinancial goods or providing nonfinancial services; (ii) the debt instrument was issued by the purchaser of the goods or services at the time of the purchase of those goods and services in order to finance the purchase; and (iii) at all times

since the debt instrument was issued, it has been held either by the person selling those goods or services or by a corporation that is a member of the same consolidated group as that person.

The Taxpayer Relief Act of 1997 extended, on an elective basis, mark-to-market treatment to traders in securities and dealers and traders in commodities.

Reasons for Change

The Administration believes that the non-accrual experience method is an inappropriate method of accounting for tax purposes. The Administration also is aware that taxpayers are using the customer paper election to obtain certain inappropriate results for tax purposes.

The non-accrual experience method permits a taxpayer to reduce current taxable income by an estimate of its future bad debt losses. Thus, this method is the equivalent of establishing a bad debt reserve. The reserve method of accounting for bad debts has repeatedly been determined an unacceptable method of accounting for tax purposes because it results in a mismeasurement of economic income. Accordingly, it is inappropriate to continue to provide this tax benefit to service providers. In addition, because the tax benefit only applies to amounts to be received for performance of services, it promotes controversy over whether a taxpayer's receivables represent amounts to be received for the performance of services or for the provision of goods.

Similarly, significant number of taxpayers whose principal activities are selling nonfinancial goods or providing nonfinancial services are making the customer paper election as a means of restoring bad debt reserves. The use of the customer paper election to mark-to-market trade receivables bearing little or no interest in order to recognize loss is inappropriate and inconsistent with the repeal of reserves for bad debts.

Proposal

Under the proposal, the non-accrual experience method would be repealed for taxable years ending after the date of enactment. A taxpayer required to change its method of accounting would treat such change as a change initiated by the taxpayer, and having been made with the consent of the Secretary of the Treasury. Any required section 481(a) adjustment would be taken into account ratably over a four-year period.

In addition, the proposal would provide that certain trade receivables would not be eligible for mark-to-market treatment. Trade receivables excluded from mark-to-market treatment would include non-interest bearing receivables, and account, note, and trade receivables unrelated to an active business of a securities dealer. The Secretary of the Treasury would be granted regulatory authority to carry out the purposes of the proposal. The proposal would be effective for taxable years ending after the date of enactment. No inference regarding the tax treatment of receivable under current law is intended by this proposal.

RESTRICT SPECIAL NET OPERATING LOSS CARRYBACK RULES FOR SPECIFIED LIABILITY LOSSES

Current Law

Under current law, that portion of a net operating loss that qualifies as a "specified liability loss" may be carried back 10 years rather than being limited to the general two-year carryback period. A specified liability loss includes amounts allowable as a deduction with respect to product liability, and also certain liabilities that arise under Federal or State law or out of any tort of the taxpayer. In the case of a liability arising out of a Federal or State law, the act (or failure to act) giving rise to the liability must occur at least 3 years before the beginning of the taxable year. In the case of a liability arising out of a tort, the liability must arise out of a series of actions (or failures to act) over an extended period of time a substantial portion of which occurred at least 3 years before the beginning of the taxable year. A specified liability loss cannot exceed the amount of the net operating loss, and is only available to taxpayers that used the accrual method throughout the period that the acts (or failures to act) giving rise to the liability occurred.

Reasons for Change

The proper interpretation of the specified liability loss provisions as they apply to liabilities arising under Federal or State law or out of any tort of the taxpayer has been the subject of significant controversy. Although the legislative history suggests that these specified liability loss rules apply only to liabilities for which a deduction is deferred as a result of the economic performance rules of section 461(h), many taxpayers have not limited their claimed specified liability losses to such deductions. In addition, many taxpayers have interpreted the 3-year requirement and the requirement that the liability arises out of a Federal or State law in a manner that is plainly contrary to the intent and purpose of the specified liability loss provisions. (See, for example, Notice 97-36, 1997-26 I.R.B. 6, June 1, 1997.) In a recent decision, *Sealy Corp. v. Commissioner*, 107 T.C. 177 (1996), the Tax Court determined that based on the legislative history Congress intended the specified liability loss provisions to apply only to liabilities for which a deduction is deferred as a result of the economic performance rules. The court further concluded that Congress intended the 10-year carryback provisions to apply to a relatively narrow class of liabilities similar to those identified in the statute. The court did not specify what types of liabilities satisfied the narrow class of liabilities intended by Congress.

To minimize future controversy, the specified liability loss provisions should be clarified to provide that only a limited class of liabilities qualify as a specified liability loss. This change should also ensure that only the types of liabilities that truly warrant relief are subject to the specified liability loss provisions.

Proposal

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

FREEZE GRANDFATHERED STATUS OF STAPLED OR PAIRED SHARE REITS

Current Law

Real Estate Investment Trusts ("REITs") are conduit-like entities that generally are limited to making passive investments in real estate and certain securities. The Internal Revenue Code places significant constraints on the types of services that a REIT may provide in running its properties, and these limitations often discourage REITs from holding certain types of property.

"Stapled REITs" were designed to largely circumvent these limitations. Under a stapled REIT structure, the stock of two corporations, one a REIT and a subchapter C corporation, trade as a single unit. The REIT acquires properties, such as hotels, retirement homes, or race-tracks, that generally cannot be operated directly by a REIT. The REIT then leases the properties to the stapled subchapter C corporation, which is free to operate the properties unconstrained by the limitations that apply to REITs. As an alternative, in some situations the operating company may own and operate the properties but may pay a portion of the income from the properties to the REIT in the form of interest on a loan secured by the property.

In the Deficit Reduction Act of 1984, Congress restricted REITs' ability to avoid the investment limitations by providing that stapled entities must be treated as one entity for purposes of determining qualification under the REIT rules. However, Congress provided indefinite grandfather relief for a few existing stapled REITs.

Reasons for Change

While the market largely ignored the grandfathered entities for a significant period of time after 1984, recently promoters have begun exploiting these stapled REITs to accumulate large holdings of properties that could not be operated directly by a REIT. These entities have used their tax-favored grandfathered status to obtain a competitive advantage over others and to expand their operations greatly beyond the levels and types of businesses conducted in 1984.

Proposal

The proposal would limit the grandfathered status of the existing stapled REITs. Under the proposal, for purposes of determining whether any grandfathered entity is a REIT, the stapled entities would be treated as one entity with respect to properties acquired on or after the date of first committee action and with respect to activities or services relating to such properties (i.e., properties acquired on or after the effective date) that are undertaken or performed by one of the stapled entities on or after such date.

RESTRICT IMPERMISSIBLE BUSINESSES INDIRECTLY CONDUCTED BY REITS

Current Law

Real Estate Investment Trusts ("REITs") generally are restricted to making passive investments in real estate and certain securities. In furtherance of this stated purpose, REITs generally are limited under the 95 percent gross income test to receiving income that qualifies as rents from real property and, to a more limited degree, portfolio income.

The REIT provisions also contain a number of rules that limit a REIT's ownership of other corporations in order to prevent REITs from becoming active in the management and operations of companies that engage in activities that are not permissible activities for a REIT. One of these rules provides that a REIT may not own more than 10 percent of the outstanding voting securities of any issuer.

Reasons for Change

The Administration understands that REITs are conducting businesses through subsidiary corporations that, if operated directly, would generate nonqualifying income under the 95 percent gross income test. The impermissible business generally is a third-party development or management business and often is conducted using many of the REIT's employees and officers. In order to avoid running afoul of the 10 percent voting securities limitation, the business is operated through a corporation with two classes of stock. Non-voting stock that entitles the holder to a disproportionately large amount of the corporation's income is issued to the REIT. At least 90 percent of the voting stock, which entitles the holder to a comparatively insignificant amount of the corporation's income, is issued to parties that are affiliated with the REIT, and the remainder is issued to the REIT. The corporation often is significantly leveraged with debt held by the REIT, which generates interest deductions intended to greatly reduce or eliminate the taxable income of the corporation. Through the retention of non-voting stock and debt, the REIT is able to retain most, if not all, of the income generated by the impermissible business and, due to the transmuting of operating income into interest paid to the REIT, that income often is not subject to any corporate level tax.

Proposal

The proposal would amend section 856(c)(5)(B) to prohibit REITs from holding stock possessing more than 10 percent of the vote or value of all classes of stock of a corporation.

The proposal would be effective with respect to stock acquired on or after the date of first committee action. In addition, to the extent that a REIT's stock ownership is grandfathered by virtue of this effective date, that grandfathered status will terminate if the subsidiary corporation engages in a trade or business that it is not engaged in on the date of first committee action or acquires substantial new assets on or after that date.

MODIFY TREATMENT OF CLOSELY HELD REITS

Current Law

When originally enacted, the Real Estate Investment Trust ("REIT") legislation was intended to provide a tax-favored vehicle through which small investors could invest in a professionally managed real estate portfolio. REITs are intended to be widely held entities, and certain requirements of the REIT rules are designed to ensure this result. Among other requirements, in order for an entity to qualify for REIT status, the beneficial ownership of the entity must be held by 100 or more persons. In addition, a REIT cannot be closely held, which is determined by reference to the stock ownership requirement in the personal holding company rules. Under these rules, generally no more than 50 percent of the value of the REIT's stock can be owned by five or fewer individuals during the last half of the taxable year. Certain attribution rules apply in making this determination.

Reasons for Change

The Administration has become aware of a number of tax avoidance transactions involving the use of closely held REITs. In order to meet the 100 or more shareholder requirement, the REIT generally issues common stock and a separate class of non-voting preferred stock. The common stock, which reflects virtually all of the REIT's economic value, is acquired by a single shareholder, and the preferred stock is acquired by 99 other "friendly" shareholders (generally employees of the majority shareholder). The closely held limitation does not disqualify the REITs that are utilizing this ownership structure because the majority shareholder of these REITs is not an individual.

Proposal

The proposal would impose as an additional requirement for REIT qualification that no person can own stock of a REIT possessing more than 50 percent of the total combined voting power of all classes of voting stock or more than 50 percent of the total value of shares of all classes of stock. For purposes of determining a person's stock ownership, rules similar to the attribution rules contained in section 856(d)(5) would apply.

The proposal would be effective for entities electing REIT status for taxable years beginning on or after the date of first committee action.

MODIFY DEPRECIATION METHOD FOR TAX-EXEMPT USE PROPERTY

Current Law

Accelerated depreciation generally is unavailable for property that is tax-exempt use property, including leased property used by a foreign or tax-exempt entity. Instead, such property is depreciated using the straight-line method over a period equal to the greater of (1) the property's class life, or (2) 125 percent of the lease term.

Reasons for Change

The purpose of the special depreciation rules for tax-exempt use property is to prevent the benefits of accelerated depreciation from accruing to users of property who do not pay U.S. income taxes. However, because the class life of an asset may be shorter than the economic useful life of the asset and because taxpayers have control over the term of a lease, current law may continue to provide depreciation that is accelerated as compared to economic depreciation.

Proposal

Tax-exempt use property would be depreciated using the straight-line method over a period equal to 150 percent of the class life of the property. This is expected to prevent depreciation deductions from accruing more rapidly than economic depreciation. The proposal would not affect the depreciation of property other than tax-exempt use property.

The proposal would be effective for property placed in service after December 31, 1998. The proposal would also be effective for property that first becomes tax-exempt use property after December 31, 1998, or becomes subject to a new lease after that date.

IMPOSE EXCISE TAX ON PURCHASE OF STRUCTURED SETTLEMENTS

Current Law

Current law facilitates the use of structured personal injury settlements by permitting a defendant to assign to a structured settlement company ("SSC") the liability to make periodic payments to an injured person, such that the defendant can deduct the payment immediately, but the SSC does not include the amount received from the defendant in income. This favorable treatment is conditioned on a requirement that the periodic payments cannot be accelerated, deferred, increased or decreased by the injured person. If the SSC purchases a deferred annuity contract to fund the liability, it is exempted from the section 72(u) inclusion of inside buildup, and is subject to the more favorable rules of annuity taxation usually applicable only to individual owners. As a result, the income under the annuity is taxable to the SSC only upon receipt by the SSC, at which time the SSC is entitled to an offsetting deduction for corresponding payments to the injured person. The exclusion for physical personal injury damages applies also to amounts received periodically, thus effectively exempting the interest income in the hands of the injured person from tax as well.

Reasons for Change

Congress enacted favorable tax rules intended to encourage the use of structured settlements -- and conditioned such tax treatment on the injured person's inability to accelerate, defer, increase or decrease the periodic payments -- because recipients of structured settlements are less likely than recipients of lump sum awards to consume their awards too quickly and require public assistance.

Consistent with the condition that the injured person not be able to accelerate, defer, increase or decrease the periodic payments, SSC agreements with injured persons uniformly contain anti-assignment clauses. Notwithstanding these contractual provisions, however, many injured persons are willing to accept heavily discounted lump sum payments from certain "factoring" companies in consideration for their payment streams. These "factoring" transactions directly undermine the Congressional objective to create an incentive for injured persons to receive periodic payments as settlements of personal injury claims.

Proposal

Under the proposal, any person purchasing (or otherwise acquiring for consideration) a structured settlement payment stream would be subject to a 20 percent excise tax on the purchase price, unless such purchase is pursuant to a court order finding that the extraordinary and unanticipated needs of the original intended recipient render such a transaction desirable. The proposal would apply to purchases occurring after the date of enactment. No inference is intended as to the contractual validity of the factoring transaction or its effect on the tax treatment of any party other than the purchaser.

CLARIFY AND EXPAND MATH ERROR PROCEDURES

Current Law

In order to claim certain tax benefits, taxpayers are required to include correct taxpayer identification numbers (TINs) on their tax returns for themselves, and in certain cases, their children. For example, taxpayers are required to include a TIN on their tax returns in order to claim a personal exemption, earned income tax credit (EITC), and child and dependent care tax credit. For most individual taxpayers, their Social Security Number (SSN) is their TIN.

A failure to provide a correct TIN in connection with a claim for certain tax benefits, e.g., EITC, is treated as a mathematical or clerical error. Mathematical or clerical error treatment permits the IRS to assess additional tax due without sending the individual a notice of deficiency. Generally, taxpayers have 60 days in which they can either provide a correct TIN or request that the IRS follow the current-law deficiency procedures. If the taxpayer fails to respond within this period, he or she must file an amended return with a correct TIN in order to obtain the tax benefit originally claimed. The Taxpayer Relief Act of 1997 extended math error procedures to taxpayers who fail to provide correct TINs when claiming the child tax credit, the Hope Scholarship Credit, and the Lifetime Learning Credit.

In determining whether a taxpayer who claims the EITC, child and dependent care tax credit, child tax credit, the Hope Scholarship Credit, or Lifetime Learning Credit has provided a correct TIN, the IRS matches the number shown on the tax return with information the IRS receives from the Social Security Administration (SSA). If a comparison between the TIN shown on the taxpayer's return and the data the IRS receives from the SSA shows that the taxpayer has provided an incorrect SSN, the incorrect number is treated as a mathematical or clerical error.

Reasons for Change

Current law does not provide the IRS with clear guidance on what constitutes a correct TIN. Under current practice, the IRS may determine that an SSN is invalid if there is a mismatch between the name and TIN on the return with the name and TIN on SSA or IRS records. Thus, the IRS might deny the EITC to a taxpayer who claims a child with either a nonexistent SSN or an SSN belonging to an individual with a different name. In some cases, taxpayers claim children who are not their own for the EITC with the correct SSN and name information; however, because the taxpayers do not know the children whom they claim, they provide age information on the tax return that is inconsistent with date-of-birth information in the SSA records. The IRS should be able to treat an age discrepancy as an indicator that the SSN is invalid.

Eligibility for the EITC, the child tax credit, and the child and dependent care tax credit is based on the age of the qualifying child or, in some cases, the taxpayer's age. Date-of-birth data

from SSA records can also be used to identify taxpayers who do not qualify for these tax benefits because of age restrictions.

Proposal

For purposes of the mathematical or clerical error procedures, the term "correct TIN" would be defined as the TIN assigned by the SSA (or in certain limited cases, the IRS) to the individual identified on the return. The IRS would be authorized to use data obtained from SSA (including name, age, date of birth, and SSN) to determine whether the individual identified on the return corresponds in every respect to the individual to whom the TIN has been assigned. Thus, for example, if an individual is identified on the return as having an age that does not correspond to the SSA's record of the age of the individual with that TIN, then the TIN is not correct, even if the SSA's data shows that the taxpayer has matched the correct name to that TIN.

Further, the IRS would be authorized to use mathematical or clerical error procedures to deny eligibility for the child tax credit, the child and dependent care tax credit, and the EITC if the taxpayer provides a TIN for either the taxpayer or qualifying child, and the IRS determines, using data from SSA, that the recipient does not meet the statutory age restrictions.

Thus, if a taxpayer claims the child and dependent care tax credit with respect to a child and the IRS determines, using data obtained from the SSA, that the claimed child is too old to qualify the taxpayer for the credit, the IRS may deny the taxpayer's claim under the mathematical or clerical error procedures. Similarly, a taxpayer who claims the EITC as a low-income worker without qualifying children, but who is determined to be 70 as a result of a comparison of the SSN included on the taxpayer's return and data obtained from the SSA (even though the taxpayer is not required to report his or her age on the return), the IRS may deny the taxpayer's claim under the mathematical or clerical error procedures.

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

CLARIFY THE MEANING OF "SUBJECT TO" LIABILITIES UNDER SECTION 357(c)

Current Law

Section 351 provides that no gain or loss shall be recognized if property is exchanged solely for stock of a controlled corporation. If the sum of the amount of liabilities assumed by the transferor, plus the amount of the liabilities to which the transferred property is subject, exceeds the total adjusted basis of the property transferred pursuant to a section 351 exchange, the transferor must recognize gain from the sale or exchange of the property (with certain exceptions) pursuant to section 357(c).

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

Reasons for Change

Where a recourse liability is secured by multiple assets, the tax treatment is unclear under present law whether a transfer of one asset where the transferor remains liable is a transfer "subject to" the liability. As a result, many taxpayers lack the certainty necessary to engage in legitimate transactions while others have structured transactions to take advantage of different interpretations. For example, if a foreign transferor transfers an asset that partially secures a line of credit, taxpayers have taken the position that gain would be computed under section 357(c) by treating the entire liability as an amount realized and the transferee's basis in the asset would be increased accordingly. Alternatively, under this interpretation, if a transferor transfers the assets securing a single liability to several different subsidiaries, taxpayers have taken the position that each asset has a basis increased by the entire liability. Similar issues arise with respect to nonrecourse liabilities.

Proposal

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

fair market values (determined without regard to section 7701(g)) of the assets securing the liability. The proposal would authorize the Secretary of the Treasury to issue regulations to carry out the purposes of this proposal, including anti-abuse rules.

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

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

SIMPLIFY FOSTER CHILD DEFINITION UNDER EITC

Current Law

A taxpayer is eligible to claim the earned income tax credit (EITC) if he or she resides with a son, daughter, or grandchild for over half the year. EITC qualifying children also include foster children, defined to mean individuals who reside with a taxpayer for a full year and whom the taxpayer "cares for as the taxpayer's own child." All EITC qualifying children (including foster children) must either be under the age of 19 (24 if a full-time student) or permanently and totally disabled.

When more than one taxpayer can meet the eligibility criteria with respect to the same child, only the taxpayer with the highest modified adjusted gross income may claim the credit.

Reasons for Change

The foster child rule is difficult to administer. For example, some taxpayers claim unrelated children for EITC purposes, by arguing that they lived with the child's parent and "cared for the child as if the child was their own." Without more objective standards regarding the definition of a foster child, the IRS cannot easily determine whether, in fact, these taxpayers are eligible for the EITC.

Clarifying the definition of a foster child would prevent unintentional errors by confused taxpayers, reduce potential abuse by noncompliant taxpayers, and provide better guidance to the IRS when investigating questionable claims.

Proposal

In addition to the existing requirement that the foster child be a child who is cared for by the taxpayer as if he or she were the taxpayer's own child, the proposal requires that a foster child, for purposes of claiming the EITC, also meet a specified relationship test. Under this test, the foster child must be the taxpayer's sibling (or descendant of the taxpayer's sibling), or be placed in the taxpayer's home by an agency of a State or one of its political subdivisions or a tax-exempt child placement agency licensed by a State. The proposal would be effective for taxable years beginning after December 31, 1998.

CLARIFY TIE-BREAKER RULE UNDER EITC

Current Law

If two or more taxpayers are eligible to claim the earned income tax credit (EITC) with respect to the same qualifying child, then only the individual with the highest modified adjusted gross income ("AGI") may claim the credit with respect to that child.

Historically, the IRS has interpreted this tie-breaker rule to deny the EITC to the lower-income taxpayer, regardless of whether the higher-income taxpayer has claimed the EITC on his or her tax return. Last year, however, the Tax Court held that the tie-breaker rule does not apply if the higher-income individual did not actually claim the credit with respect to the child in question on his or her tax return. See Lestrange v. Commissioner, T.C.M. 1997-428 (1997) (holding that the definition of "qualifying child" is satisfied only if the child is identified on the tax return). Under this view, if the higher-income individual does not satisfy this "identification requirement," the child is not a qualifying child with respect to that individual, and the tie-breaker rule does not apply to prevent the lower-income individual from claiming the child for purposes of the credit.

Reasons for Change

The Omnibus Budget Reconciliation Act of 1990 simplified eligibility for the EITC by replacing a complicated and unverifiable support test with the tie-breaker rule. The tie-breaker rule was intended to serve the same purpose as the support test: to ensure that only the most needy and deserving families are eligible for the EITC. Thus, a taxpayer with a child should not qualify for the EITC because his or her own income is low, if, for example, the taxpayer also shares a household with his or her own higher-income parent.

The rule was not and is not intended to become operative only in the event that two individuals actually claim the child in question on their respective tax returns.

Proposal

The proposal clarifies that the identification requirement is a requirement for claiming the credit, rather than an element of the definition of "qualifying child." Thus, the tie-breaker rule would apply where more than one individual otherwise could claim the same child as a qualifying child on their respective tax returns, regardless of whether the child is actually listed on any tax return. A similar change would be made to the definition of "eligible individual."

The proposal is effective with respect to taxable years ending after the date of enactment.

No inference is intended as to the operation of the tie-breaker rule under current law.

ELIMINATE NON-BUSINESS VALUATION DISCOUNTS

Current Law

Under current law, taxpayers making gratuitous transfers of fractional interests in entities routinely claim discounts on the valuation of such interests. The concept of valuation discounts originated in the context of active businesses, where it has long been accepted that a willing buyer would not pay a willing seller a proportionate share of the value of the entire business when purchasing a minority interest in a non-publicly traded business.

Without legislation in this area, tax planners have carried this concept over into the family estate planing area, where a now common planning technique is to contribute marketable assets to a family limited partnership or limited liability company and make gifts of minority interests in the entity to other family members. Taxpayers then claim large discounts on the valuation of these gifts.

Reasons for Change

The use of family limited partnerships and similar devices is eroding the transfer tax base. Taxpayers take the position that they can make value disappear by making contributions of marketable assets to an entity, and then making gifts of interests in such entity to family members. This disappearing value is illusory, because family members are not minority interest holders in any meaningful sense. Moreover, it is implausible that the donor would intentionally take an action (contribution of the property to an entity) if the donor really believed that such action would cause the family's wealth to decline substantially.

Proposal

The proposal would eliminate valuation discounts except as they apply to active businesses. Interests in entities would be required to be valued for transfer tax purposes at a proportional share of the net asset value of the entity to the extent that the entity holds readily marketable assets (including cash, cash equivalents, foreign currency, publicly traded securities, real property, annuities, royalty-producing assets, non-income producing property such as art or collectibles, commodities, options and swaps) at the time of the gift or death. To the extent the entity conducts an active business, the reasonable working capital needs of the business would be treated as part of the active business (i.e., not subject to the limits on valuation discounts). No inference is intended as to the propriety of these discounts under current law.

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

ELIMINATE "CRUMMEY" RULE

Current Law

Under section 2503(c), gifts of "present interests" of a value of up to $10,000 (indexed for inflation beginning in 1999) per donor per donee each year are excepted from the gift tax. Generally, a transfer in trust is not considered a transfer of a present interest to the beneficiary of the trust. Under the decision in Crummey v. Commissioner, 397 F.2d 82 (9th Cir 1968), however, a transfer in trust is considered a transfer of a present interest if the trust instrument permits the beneficiary to withdraw the transferred amount for a limited period of time (often 30 days or less). Thus, so-called "Crummey powers" are often used to enable a transfer of a $10,000 gift to a trust to qualify for the annual exclusion under section 2503(c).

In the Crummey case, the holder of the withdrawal power was the ultimate beneficiary of the trust. In more recent cases, such as Estate of Cristofani v. Commissioner, 97 TC 74 (1991), and Estate of Kohlsaat v. Commissioner, 73 TCM 2732 (1997), the trust agreement has been drafted to give withdrawal rights to individuals who do not have substantial economic interests in the trust. Typically, by pre-arrangement or understanding, none of these withdrawal rights will be exercised.

Reasons for Change

The use of the Crummey power is essentially a legal fiction. It is extremely rare for a Crummey power to be exercised. The continued existence and expansion of the Crummey decision undermines the statutory requirement of a present interest.

Proposal

The proposal would overrule the Crummey decision by amending Section 2503(c) to apply only to outright gifts of present interests. Gifts to minors under a uniform act would be deemed to be outright gifts.

The proposal would be effective for gifts completed after December 31, 1998.

ELIMINATE GIFT TAX EXEMPTION FOR PERSONAL RESIDENCE TRUSTS

Current Law

Under section 2702, if an interest retained by a grantor in a trust when other interests are transferred to family members, the retained interest is valued at zero for gift tax purposes unless it takes the form of an annuity (a GRAT), a unitrust (a GRUT), or a remainder interest after a GRAT or a GRUT. However, section 2702(a)(3)(A)(ii) provides an exception for a trust "all the property in which consists of a residence to be used as a personal residence by persons holding term interests in such trust." As written, this exemption completely removes personal residence trusts from the purview of section 2702.

Reasons for Change

Because the exemption under section 2702 completely removes personal residence trusts from section 2702, such trusts receive more favorable gift tax treatment than that given to the statutorily authorized GRATs and GRUTs. Specifically, when valuing the gift made to the remainderman in a personal residence trust, the value of any reversionary interest in the grantor can be taken into account, and such value reduces the amount of the taxable gift. In contrast, even if the grantor has a reversionary interest in a GRAT or a GRUT, section 2702 prohibits the actuarial value of that interest from being taken into account in valuing the gift.

Furthermore, by requiring a grantor's retained interest in a trust to take the form of an annuity or a unitrust, section 2702 was attempting to make sure that the grantor would actually receive the interest valued by the actuarial tables. This requirement was designed to prohibit the pre-2702 grantor retained *income* trusts (GRITs), in which the actuarial tables were used to value the grantor's retained income interest even when the projected income was zero or minimal.

Experience has shown that the use value of the residence retained by the grantor is a poor substitute for an annuity or unitrust interest. In the personal residence trust, the grantor ordinarily remains responsible for the insurance, maintenance and property taxes on the residence. Therefore, the true rental value of the house should be less than fair market rent. In these circumstances, the actuarial tables overstate the value of the grantor's retained interest in the house.

Proposal

The proposal would repeal the personal residence exception of section 2702(a)(3)(A)(ii). If a residence is used to fund a GRAT or a GRUT, the trust would be required to pay out the required annuity or unitrust amount; otherwise the grantor's retained interest would be valued at zero for gift tax purposes.

The proposal would be effective for transfers in trust after the date of enactment.

INCLUDE QUALIFIED TERMINABLE INTEREST PROPERTY (QTIP) TRUST ASSETS IN SURVIVING SPOUSE'S ESTATE

Current Law

A marital deduction is allowed for qualified terminable interest property (QTIP) passing to a qualifying trust for a spouse either by gift or by bequest. Under Section 2044, the value of the recipient spouse's estate includes the value of any such property in which the decedent had a qualifying income interest for life and a deduction was allowed under the gift or estate tax.

Reasons for Change

The marital deduction is intended to defer the estate tax until the death of the surviving spouse, not to excuse payment of the tax permanently. In some cases, taxpayers have attempted to whipsaw the government by claiming the marital deduction for QTIP property in the first estate and then after the statute of limitations for assessing tax on the first estate has elapsed, arguing against inclusion under section 2044 in the second estate due to some technical flaw in the QTIP eligibility or election in the first estate. Since the surviving spouse has benefitted from the deferral of estate tax due to the marital deduction taken in the first estate, the property should be includible in the surviving spouse's estate even if the surviving spouse later discovers that the marital trust did not in fact qualify for the QTIP election in the first estate.

Proposal

The proposal would amend section 2044 to provide that if a marital deduction is allowed with respect to QTIP property under section 2523(f) or 2056(b)(7), inclusion is required in the beneficiary spouse's estate under section 2044.

The proposal would be effective for decedents (i.e., surviving spouses) dying after the date of enactment.

APPLY 7.7 PERCENT CAPITALIZATION RATE TO CREDIT LIFE INSURANCE PREMIUMS

Current Law

Insurance companies are required to capitalize different percentages of their total premiums for various lines of business as a proxy for their capitalizable acquisition expenses such as commissions. Under current law, companies capitalize 1.75 percent of the net premiums for specified insurance contracts that are annuity contracts, 2.05 percent of net premiums for specified insurance contracts that are group life insurance contracts, and 7.7 percent of net premiums for specified insurance contracts, such as individual life insurance contracts. These capitalized amounts generally are amortized over 10 years. A company that issues group credit life insurance contracts is required to capitalize 2.05 percent of its net premiums for such contracts.

Reasons for Change

Credit life insurance contracts generally have acquisition expenses that are substantially higher than most group life insurance contracts. In general, commissions and other policy acquisition expenses for credit life insurance contracts are comparable to or higher than policy acquisition expenses for individual life insurance contracts. Thus, the statutory proxy rate for an insurance company's policy acquisition costs on credit life insurance does not accurately reflect the level of commissions and other policy acquisition expenses for credit life insurance.

Proposal

Insurance companies would be required to capitalize 7.7 percent of their net premiums for a taxable year with respect to all credit life insurance contracts.

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

MODIFY CORPORATE-OWNED LIFE INSURANCE (COLI) RULES

Current Law

In general, no Federal income tax is imposed on a policyholder with respect to earnings under a life insurance contract or endowment contract, and Federal income tax generally is deferred with respect to the earnings under an annuity contract. In addition, amounts received under a life insurance contract paid by reason of death of the insured are excluded from gross income.

Interest on policy loans or other indebtedness with respect to life insurance, endowment or annuity contracts generally is not deductible unless the insurance contract insures the lives of a key person of a business. A key person includes a 20 percent owner of the business, as well as a limited number of the business' officers or employees. However, this interest disallowance rule applies to businesses only to the extent that the indebtedness can be traced to a life insurance, endowment or annuity contract.

In addition, the interest deductions of a business other than an insurance company are reduced under a proration rule if the business owns or is a direct or indirect beneficiary with respect to certain life insurance, endowment or annuity contracts. This proration rule generally does not apply if the contract covers an individual who is a 20 percent owner of the business, or an officer, director, or employee of such business. This proration rule also does not apply if the contract is a joint life policy covering a 20 percent owner of the business and his or her spouse.

Special proration rules apply to life insurance companies and property casualty insurance companies if such insurance companies own or are direct or indirect beneficiaries under the same types of life insurance, endowment and annuity contracts. Under the special life insurance company proration rules, the life insurance company's reserve and policyholder dividend deductions are reduced to the extent that such reserves or dividends are funded by the inside buildup on certain life insurance, endowment and annuity contracts. Under the special rules, the losses incurred deductions of a property casualty insurance company are reduced by 15 percent of the inside buildup on certain life insurance, endowment and annuity contracts.

Reasons for Change

Leveraged businesses can still fund deductible interest expenses with tax-exempt or tax-deferred inside buildup on life insurance, endowment or annuity contracts insuring certain types of individuals. For example, banks, commercial credit companies and other leveraged businesses frequently invest in single premium or other investment-oriented insurance policies covering the lives of their employees, officers, directors or owners. These entities do not take out policy loans or other indebtedness that is secured by, or otherwise traceable to, the insurance contracts. Instead, they borrow from depositors or other lenders, or issue bonds.

Similar tax arbitrage benefits result when insurance companies invest in certain insurance contracts that cover the lives of their employees, officers, directors or 20 percent shareholders. Life insurance companies can still fund deductible reserves or policyholder dividends with tax-exempt or tax-deferred investment income on insurance contracts with respect to their employees, officers, directors or 20 percent owners. Similarly, property casualty insurance companies can still fund deductible loss reserves with tax-exempt or tax-deferred investment income on insurance contracts with respect to their employees, officers, directors or 20 percent owners.

Proposal

The proposal would repeal the exception under the COLI proration rules for contracts covering employees, officers or directors, other than 20 percent owners of the business that is the owner or beneficiary of an annuity, endowment or life insurance contract. The proposal would be effective for taxable years beginning after the date of enactment.

MODIFY RESERVE RULES FOR ANNUITY CONTRACTS

Current Law

A life insurance company that issues an annuity contract claims a reserve deduction equal to the greater of the net surrender value of the contract and an amount that is based on the Commissioner's Annuities Reserve Valuation Method ("CARVM") in effect on the date that the annuity contract is issued, subject to the requirement that tax reserves cannot exceed annual statement reserves. In computing the CARVM reserve for tax purposes, the life insurance company is required to use the prevailing commissioners' standard tables for mortality and morbidity.

In 1997, the NAIC adopted new actuarial guidelines interpreting CARVM. According to the guidelines, life insurance companies previously interpreted CARVM inconsistently, and some companies assumed that the CARVM reserve was equal to cash surrender value. The guidelines generally require life insurance companies to compute CARVM reserves by determining the greatest possible present value of all guaranteed benefits, using a number of worst-case ro conservative assumptions. The guidelines are effective on December 31, 1998, and apply to contracts issued on or after January 1, 1981. In addition, the NAIC is developing new mortality tables to be used in computing annuity reserves, which will assume that annuity holders will live substantially longer than their actual current life expectancies.

Under the new CARVM guidelines, life insurance companies generally will increase their CARVM reserves substantially for previously issued annuity contracts. The use of the new CARVM guidelines is a change in the basis for determining reserves. Thus, any deduction arising from increased annuity reserves that result from this change in the company's basis for determining its annuity reserves will be taken into account over a 10-year period.

Reasons for Change

The "conservative" assumptions that the NAIC requires companies to use in computing their annuity CARVM reserves may be appropriate in the regulatory context, which is intended to minimize the risk that companies will become insolvent and unable to pay policyholders. However, these "conservative" assumptions result in excessive reserves, which cause a material understatement in the economic income of life insurance companies issuing annuities.

Proposal

Reserves for all annuity contracts with cash surrender values would equal the lesser of the CARVM reserve or the contract's adjusted account value, subject to the current law requirement that reserves cannot exceed annual statement reserves. The adjusted account value for a contract would equal the net cash surrender value plus a percentage of the contract's net cash surrender value, which would be set at 5.5 percent in the taxable year in which the contract was issued, 5.0

percent in the second year, 4.0 percent in the third year, 3.0 percent in the fourth year, 2.5 percent in the fifth year, 1.5 percent in the 6th year, 0.5 percent in the seventh year, and 0.0 percent in all subsequent years. The proposal would be effective for taxable years ending on or after the date of enactment.

TAX CERTAIN EXCHANGES OF INSURANCE CONTRACTS AND REALLOCATIONS OF ASSETS WITHIN VARIABLE INSURANCE CONTRACTS

Current Law

Generally, investors are taxed upon the sale or exchange of assets. For example, an individual who owns a share of a mutual fund generally will pay Federal income tax on any gain realized from the sale of that share of the mutual fund, in addition to paying Federal income taxes each year on distributions from the mutual fund.

Special rules apply to investors in life insurance, endowment, and annuity contracts who exchange their contracts for certain other insurance contracts. Holders of life insurance contracts generally may exchange their contracts for other life insurance, endowment, or annuity contracts tax-free. Holders of endowment contracts generally may exchange their contracts for other endowment contracts or annuity contracts tax-free. Holders of annuity contracts generally may exchange their contracts for other annuity contracts tax-free.

Special rules also apply to holders of variable life insurance and variable annuity contracts. A holder of a variable contract can choose to invest his funds in any of a number of different mutual funds offered (but not necessarily managed) by the insurance company that issues the variable contract. An investor in a variable contract who liquidates part or all of his investment in one fund, and reallocates the proceeds to a different fund within a variable contract, is not treated as having exchanged any property.

Reasons for Change

Variable contracts are used substantially as investment vehicles. Some variable contracts give holders the ability to choose from over 30 mutual fund options and virtually all variable contracts give holders the ability to choose from over 10 mutual fund options. The mutual funds are increasingly managed by well-known independent mutual fund companies, rather than by the insurance company issuing the contract. The legal rights granted to holders of variable contracts also differ from the legal rights granted holders of traditional insurance contracts where premiums are invested in an insurance company's general account. Variable contract assets invested in mutual funds through an insurance company separate account are not at risk if the insurance company becomes insolvent, and variable contracts are regulated as securities by the Securities and Exchange Commission.

The special tax-free treatment for exchanges of insurance policies originated before people could direct the insurance company to invest in various mutual funds. Policyholders who purchased cash value contracts could only invest in the insurance company's general account, which in turn was invested primarily in fixed-income securities. Because most insurance companies invested their general account assets in similar types of securities, investments through insurance contracts were economically similar. After the development of variable

contracts, however, investment options for life insurance, endowment, and annuity contracts became less similar. In addition, the ability to select from a range of mutual funds with different investment objectives meant that the reallocation of assets within a single variable contract or the ability to exchange one variable contract for another insurance contract could be used to exchange one investment for a significantly different investment.

Proposal

Any exchange of a life insurance, endowment or annuity contract for a variable contract would be a taxable exchange. Similarly, any exchange of a variable contract for a life insurance, endowment, or annuity contract would be a taxable exchange. In addition, each investment in a separate account mutual fund or in the insurance company's general account pursuant to a variable contract would be treated as a separate contract.

These rules would apply to contracts issued after the date of first committee action. A material change in an existing contract would be treated as the issuance of a new contract.

REDUCE "INVESTMENT IN THE CONTRACT" FOR MORTALITY AND EXPENSE CHARGES ON CERTAIN INSURANCE CONTRACTS

Current Law

Investors in cash value life insurance generally pay no tax on their investment income, unless the contract is surrendered for cash before the insured person dies. Investors in cash value life insurance contracts that are surrendered before the insured person dies and investors in annuity contracts issued by insurance companies can defer tax on investment income until the investment income is deemed distributed. In general, cash withdrawals or other taxable distributions from cash value life insurance contracts are assumed to be paid first from basis, and second from investment income. Cash withdrawals and other taxable distributions from annuity contracts and certain highly investment-oriented cash value life insurance contracts generally are assumed to be paid first from investment income.

For purposes of computing the amount of taxable investment income under section 72 from distributions under cash value life insurance or annuity contracts, the holder's basis includes premiums used to pay mortality and associated expense charges. These charges can be used to purchase term life insurance, other types of insurance coverage, or to pay for an option to buy a life annuity at rates guaranteed in a deferred annuity contract.

Except for limited amounts of employer-provided group term life insurance, premiums for term life insurance generally are not deductible and must be paid with after-tax dollars. The special basis rules under section 72 permit investors in cash value insurance contracts to use pre-tax dollars to purchase term life insurance coverage, even if such coverage is not provided by the employer.

A portion of the mortality and expense charges for deferred annuity contracts is used to pay for an option to purchase a life annuity at guaranteed rates specified in the deferred annuity contract. If an investor surrenders a deferred annuity contract for cash, the investor cannot exercise its option to obtain a life annuity at guaranteed rates. However, the special basis rules cause the mortality and expense charge associated with the life annuitization option to be included in the holder's basis under section 72, even if the option was not exercised. The average annual mortality and expense charge on a deferred annuity contract is approximately 125 basis points.

In determining whether a contract with a death benefit qualifies as a life insurance contract under section 7702, insurance companies are required to use reasonable mortality charge assumptions. These mortality charge assumptions also are used to determine when a contract is a modified endowment contract under section 7702A.

Reasons for Change

Existing rules used to determine a holder's basis in a cash value life insurance or annuity contract for purposes of section 72 overstate basis, and thus understate the amount of tax-deferred income associated with investments in such contracts. If premiums are used to buy current insurance coverage, these amounts should not be included in the holder's tax basis if the contract is surrendered for cash. If premiums are used to buy an option to purchase a life annuity at guaranteed rates, such amounts should only be included in basis if the option is exercised. To the extent that holders withdraw cash or receive other distributions under cash value life insurance or annuity contracts, the holders' basis in their contracts generally should be limited to the portion of their premiums not used to purchase term life insurance, other current insurance protection, or options that are not exercised.

Proposal

The Administration proposes to conform the computation of investment in the contract under section 72 for cash value life insurance contracts and certain annuity contracts to the general tax definition of basis for other purposes by subtracting mortality and associated expense charges.

For cash value life insurance contracts, the holder's investment in the contract would equal the investment in the contract as currently defined under section 72, less any mortality charges that the company assumes purposes of section 7702 and section 7702A. In addition, the Secretary of the Treasury would have authority to issue guidance requiring the subtraction of appropriate expense charges for cash value life insurance contracts.

For any annuity contract other than an immediate life annuity contract that is described in section 72(u)(4), the holder's investment in the contract generally would equal the investment in the contract as currently defined under section 72 less the contract's assumed mortality and expense charges. The assumed mortality and expense charges would equal the contract's average cash value during the year multiplied by 1.25 percent. The assumed mortality and expense charges on deferred annuity contracts would be added back to the holder's investment in the contract only if and to the extent that the holder exercised his or her contractual option in the deferred annuity contract to use the accumulated funds to purchase a life annuity at specific rates guaranteed in the deferred annuity contract. This proposal would apply to contracts issued after the date of first committee action.

AMEND 80/20 COMPANY RULES

Current Law

A portion of interest and dividends paid by a domestic corporation is effectively exempt from U.S. withholding tax provided the corporation qualifies as a so-called 80/20 corporation. In general, interest or dividends paid by a domestic corporation will be treated as interest or dividends from an 80/20 corporation if at least 80 percent of the gross income of the corporation for the testing period is foreign source income attributable to the active conduct of a foreign trade or business (or the foreign business of a subsidiary). The testing period is the three year period preceding the year of the dividend.

Reasons for Change

The testing period relevant for determining 80/20 company status is subject to manipulation such that certain foreign persons may utilize the 80/20 company rules in order to improperly avoid U.S. withholding tax with respect to certain distributions attributable to U.S. source earnings of a U.S. subsidiary.

Proposal

The proposal would prevent taxpayers from manipulating the testing period in order to avoid U.S. withholding tax on certain distributions attributable to U.S. source earnings by applying the 80/20 test on a group-wide basis.

The proposal would apply to interest or dividends paid or accrued more than 30 days after the date of enactment.

PRESCRIBE REGULATORY DIRECTIVE TO ADDRESS TAX AVOIDANCE INVOLVING FOREIGN BUILT-IN LOSSES

Current Law

Under current law, no specific provisions prevent taxpayers from "importing" built-in losses incurred outside U.S. taxing jurisdiction to offset income or gain that would otherwise be subject to U.S. tax. General anti-abuse provisions such as sections 269, 446(b) and 482, and loss limitation provisions such as section 382, prevent abusive loss trafficking in certain circumstances, but other similar abuses are not specifically addressed under current law.

Section 367(a) generally limits a U.S. taxpayer's ability to transfer built-in gain outside the U.S. taxing jurisdiction and escape paying U.S. tax on the gain. Similarly, section 864(c)(7) limits the ability of a foreign person to remove built-in gain property used in a U.S. trade or business from U.S. taxing jurisdiction without paying U.S. tax on the gain. Also, section 877 limits a U.S. citizen's ability to avoid paying U.S. tax on built-in gain by expatriating. There are no analogous Code provisions, however, that prevent built-in losses from being injected into U.S. taxing jurisdiction to shelter income otherwise subject to U.S. tax.

Reasons for Change

Some taxpayers are acquiring built-in losses incurred outside U.S. taxing jurisdiction or are seeking to generate related income and loss in circumstances where the income is attributable to a foreign entity that is not subject to U.S. tax and the related loss can be utilized to reduce U.S. taxable income (collectively, "built-in loss" transactions). U.S. taxpayers may seek to use losses from these transactions to avoid Subpart F inclusions or capital gains tax and foreign taxpayers investing in the U.S. may seek to utilize such losses to avoid U.S. tax on U.S. operations.

Although certain built-in-loss transactions can be curtailed under existing authority, additional regulatory authority is necessary to provide the Secretary the flexibility to address a broader range of potential abuses and to deal with built-in-loss abuses in a simple, comprehensive manner.

Proposal

The provision would require that the Secretary prescribe regulations to determine the basis of assets held directly or indirectly by a person other than a United States person and the amount of built-in deductions with respect to a person other than a U.S. person or an entity held directly or indirectly by such a non-U.S. person, as may be necessary or appropriate to prevent the avoidance of tax. No inference is intended as to the treatment under present law of transactions that purport to result in the use for U.S. tax purposes of losses arising outside the U.S. taxing jurisdiction. The proposal would be effective on the date of enactment.

PRESCRIBE REGULATORY DIRECTIVE TO ADDRESS TAX AVOIDANCE THROUGH USE OF HYBRIDS

Current Law

Certain foreign and U.S. persons are entering into transactions (collectively, "hybrid transactions") that utilize so-called hybrid entities (i.e., entities that are treated as corporations in one jurisdiction and as branches or partnerships in another jurisdiction), so-called hybrid securities (e.g., securities that are treated as debt or royalty rights for U.S. tax purposes and as equity interests for foreign tax purposes) or other types of hybrid structures, including hybrid transactions involving repurchase arrangements that are characterized as loans in one jurisdiction and as non-taxable exchanges in another jurisdiction. Certain hybrid transactions are used to generate tax results that are inconsistent with the purposes of U.S. tax law (including tax treaties). Taxpayers entering into these transactions may be interpreting U.S. law in an overly aggressive manner. Other hybrid transactions do not attempt to generate tax results that are inconsistent with the purposes of U.S. tax law. Taxpayers contemplating entering into these transactions may not have adequate guidance to enable them to conclude with sufficient certainty that they can achieve their intended results.

Reasons for Change

The extent to which hybrids are featured in transactions used to circumvent the purposes of U.S. law (including tax treaty provisions) indicates that it is appropriate to scrutinize carefully hybrid transactions for consistency with the purposes of the substantive provisions of U.S. law that are implicated in such transactions. The consequences of these transactions should be clarified in promptly issued administrative guidance both to prevent inappropriate results and to provide taxpayers with greater certainty regarding the U.S. tax consequences of hybrid transactions.

Proposal

The proposal would direct the Secretary to prescribe regulations clarifying the tax consequences of hybrid transactions. The regulations would set forth the appropriate tax results under hybrid transactions in which the intended results are inconsistent with the purposes of U.S. tax law (including treaties), and would make clear that such results obtain in hybrid transactions in which the intended results are not inconsistent with the purposes of U.S. law. In particular, the regulations would not be authorized to deny tax benefits or results that arise in connection with hybrid transactions solely because such transactions involve the inconsistent treatment of entities, items and transactions (i.e., "tax arbitrage").

For example, where U.S. tax law considers a U.S. person the owner of a leased asset (and the U.S. person contemporaneously and consistently reports the transaction accordingly), and foreign law applied to the same facts nevertheless characterizes a foreign person as the owner of

the same asset, U.S. depreciation deductions claimed by the U.S. person generally would not be denied on the basis that such deductions are inconsistent with the purposes of Code section 168. See Tech. Adv. Mem. 9748005 (Aug. 19, 1997). Similarly, interest deductions of a U.S. person with respect to a hybrid debt security that is treated as equity in the jurisdiction of the security holder generally are consistent with the purposes of Code section 163, and thus should be allowed unless such deductions are inconsistent with the purposes of other U.S. law (including U.S. treaty obligations) (e.g., because application of a treaty to the hybrid security would inappropriately eliminate worldwide tax rather than serve to alleviate double taxation).

Conversely, it is anticipated that the Secretary may utilize its regulatory authority under the proposal to deny tax benefits or results arising in connection with various types of tax arbitrage transactions, including transactions that circumvent the purposes of the U.S. Subpart F rules, U.S. tax treaty provisions, and the U.S. foreign tax credit rules. For example, in the Subpart F area, the Secretary would be expected to issue regulations that prevent the use of hybrid entities and hybrid securities that, contrary to the purposes of the Subpart F rules, result in deductions for foreign tax purposes with respect to certain cross-border payments that do not generate Subpart F income. See Notice 98-11 relating to the use of hybrid branch structures to obtain such a result. Similarly, the Secretary would be expected to prescribe regulations that would prevent the use of hybrid securities and other hybrid transactions in order to achieve results that can not be achieved through the use of hybrid entities (see Code section 894(c) and Regulations section 1.894-1T), as well as regulations that would deny inappropriate foreign tax credits not otherwise denied pursuant to the rules to be issued pursuant to Notice 98-5, that arise in connection with certain hybrid transactions.

As applied to many cases, the proposal merely makes the Secretary's current general regulatory authority more specific, and directs the Secretary to promulgate regulations pursuant to such authority. In many of these cases, it has not been suggested that the Secretary's authority is in question. In other cases, however, such as was the case regarding the hybrid entity transactions ultimately covered by the regulations under section 894(c), the Secretary's authority may be questioned and should be clarified. In yet other cases, the Secretary may not have sufficient authority under current law to provide for the appropriate results and the proposal provides this authority.

For example, the proposal authorizes the Secretary to prescribe regulations to deny interest deductions of a U.S. person with respect to a hybrid debt security that is treated as equity in the jurisdiction of the security holder where such deductions are incompatible with the purposes of U.S. treaty obligations (e.g., because application of a treaty to the hybrid security would inappropriately eliminate worldwide tax rather than serve to alleviate double taxation). Similarly, the proposal authorizes the Secretary to prescribe regulations to require a deemed income inclusion by a U.S. person in the following case: Assume that a controlled foreign corporation (ACo) issues an instrument to its U.S. parent corporation (PCo) in exchange for cash. Assume that the instrument is viewed as debt for purposes of the laws of country A but as equity for U.S. purposes. Assume further that country A has original issue discount rules similar to our

own. ACo can use its OID accruals to reduce its country A effective tax rate without PCo or its affiliates recognizing any income, achieving inappropriate tax results similar to those described in Notice 98-11. Although the authority for regulations requiring an income inclusion by PCo in this transaction is unclear under current law, such regulations would be authorized under the proposal. It is intended that the proposal generally would create no inference regarding the Secretary's current regulatory authority to address hybrid transactions or the general treatment under present law of hybrid transactions.

It is intended that any regulations issued pursuant to the proposal would lead to results consistent with purposes of the provisions of all U.S. tax treaties.

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

MODIFY FOREIGN OFFICE MATERIAL PARTICIPATION EXCEPTION APPLICABLE TO INVENTORY SALES ATTRIBUTABLE TO NONRESIDENT'S U.S. OFFICE

Current Law

Foreign corporations and nonresident alien individuals engaged in a trade or business within the United States are taxable on a net basis on their taxable income that is effectively connected with the conduct of the U.S. trade or business. The determination of whether income is effectively connected depends in part on whether the income is from sources within the United States or without the United States. In general, if a nonresident maintains an office or other fixed place of business in the United States, income from any sale of personal property (including inventory property) attributable to such place of business is sourced in the United States. As a result, such income is treated as effectively connected with the conduct of the U.S. trade or business and is subject to net basis taxation.

However, this general rule does not apply to any sale of inventory property that is sold for use, disposition, or consumption outside the United States if an office or other fixed place of business of the taxpayer in a foreign country materially participates in the sale. Under these circumstances, the source of the income depends on where title to the inventory property passes. As a result, if title passes outside the United States the income is not treated as effectively connected with the conduct of a U.S. trade or business, and is not subject to tax by the United States.

Reasons for Change

As a result of this material participation exception, the sale of inventory property for use, disposition, or consumption outside the United States may not be subject to United States taxation even though the sale is attributable to an office or fixed place of business in the United States. Moreover, the sale may not be subject to taxation in any other jurisdiction. The United States should not cede its jurisdiction to tax sales of inventory property that are attributable to an office or fixed place of business in the United States unless the sale is actually taxed by a foreign country at some minimal level.

Proposal

The proposal would provide that the source rule exception for sales of inventory property for use, disposition, or consumption outside the United States in which the nonresident's foreign office or other fixed place of business materially participates shall apply only if an income tax equal to at least 10 percent of the income from the sale is actually paid to a foreign country with respect to such income. The proposal would be effective for transactions occurring on or after the date of enactment.

STOP ABUSE OF CFC EXCEPTION TO OWNERSHIP REQUIREMENTS OF SECTION 883

Current Law

Section 887 of the Code imposes a 4 percent tax on the United States source gross transportation income of nonresident alien individuals and foreign corporations, if the income is not effectively connected with a United States trade or business. Sections 871 and 882 impose tax on income that is effectively connected with a United States trade or business at the graduated rates that apply to U.S. persons. However, sections 872(b)(1) and (2) and section 883 provide that the gross income of nonresident alien individuals and foreign corporations is not to include income from the international operation of ships or aircraft derived by such foreign persons resident in a foreign country that grants an equivalent exemption to U.S. persons, either by agreement or under domestic law. To prevent abusive use of "exemption"-country corporations by residents of non-exemption countries, section 883(c) denies the exclusion from gross income to corporations that are 50 percent or more owned by individuals who are not residents of an exemption country. That exception to the exclusion does not apply, however, to a foreign corporation that is a controlled foreign corporation (a "CFC"). Code section 883(c)(2). That is, if a foreign corporation is a CFC, there are no (further) restrictions placed on its ownership with respect to eligibility for the exclusion. Thus, a CFC formed in an exemption country may exclude its international shipping income from gross income, regardless of the nationality of its ultimate owners.

In general, a CFC is a foreign corporation that is more than 50 percent owned by U.S. persons that each own 10 percent or more of the foreign corporation. A partnership organized in the U.S. or under U.S. law is a U.S. person for these purposes, regardless of nationality of its owners. Thus, a foreign corporation that is wholly owned by non-resident aliens through a U.S. partnership is a CFC. Such a corporation is thereby eligible for the exemption regardless of whether its ultimate individual owners are residents of exemption countries.

Reasons for Change

Foreign persons from non-exemption countries are forming U.S. partnerships and then having the partnerships form corporations resident in exemption countries. The foreign corporations are CFCs because they are wholly-owned by U.S. persons (the U.S. partnerships), and therefore the anti-abuse rule of section 883(c) requiring exemption country ownership does not apply. In this manner, the foreign persons achieve exemption of their foreign corporations' international ship and aircraft transportation income from the section 887 tax of 4 percent of gross and from the tax on effectively connected income. Thus, interposing the U.S. partnership eliminates an otherwise applicable U.S. tax by circumventing an anti-abuse rule. Besides allowing foreign persons to avoid U.S. tax, the provisions as currently drafted provide a disincentive for countries to enter into reciprocal exemption agreements with the United States,

as the exemption from United States tax is already easily and generally available to their residents.

Proposal

The Code would be amended to provide that the anti-abuse rule of Code section 883(c)(2) requiring at least 50 percent ownership by foreign individuals who are residents of an exemption country shall apply unless the CFC is owned more than 50 percent by U.S. shareholders that are individuals or corporations. This narrows the exception and assures that it is available only when U.S. persons subject to U.S. tax own the CFC. That should prevent the abuse and, in addition, encourage countries to negotiate reciprocal exemptions with the United States. It is intended that no inference be drawn from this proposal regarding the authority of the Secretary to achieve the same result through the issuance of regulations. The provision would be effective for taxable years beginning after the date of enactment.

REINSTATE ENVIRONMENTAL TAX IMPOSED ON CORPORATE TAXABLE INCOME AND DEPOSITED IN THE HAZARDOUS SUBSTANCE SUPERFUND TRUST FUND

Current Law

For taxable years beginning before January 1, 1996, a corporate environmental income tax was imposed at a rate of 0.12 percent on the amount by which the modified alternative minimum taxable income of a corporation exceeded $2 million. Modified alternative minimum taxable income was defined as a corporation's alternative minimum taxable income, determined without regard to the alternative tax net operating loss deduction and the deduction for the corporate environmental income tax.

The tax was dedicated to the Hazardous Substance Superfund Trust Fund (the Superfund Trust Fund). Amounts in the Superfund Trust Fund are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment under specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (as amended). Spending from the Superfund Trust Fund is classified as discretionary domestic spending for Federal budget purposes.

Reasons for Change

The corporate environmental income tax should be reinstated because of the continuing need for funds to remedy damages caused by releases of hazardous substances.

Proposal

The corporate environmental income tax would be reinstated for taxable years beginning after December 31, 1997, and before January 1, 2009.

REINSTATE EXCISE TAXES DEPOSITED IN THE HAZARDOUS SUBSTANCE SUPERFUND TRUST FUND

Current Law

The following Superfund excise taxes were imposed before January 1, 1996:

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

(2) An excise tax on listed hazardous chemicals at a rate that varied from $0.22 to $4.87 per ton; and

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

Amounts equivalent to the revenues from these taxes were dedicated to the Hazardous Substance Superfund Trust Fund (the Superfund Trust Fund). Amounts in the Superfund Trust Fund are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment under specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (as amended). Spending from the Superfund Trust Fund is classified as discretionary domestic spending for Federal budget purposes.

Reasons for Change

The Superfund excise taxes should be reinstated because of the continuing need for funds to remedy damages caused by releases of hazardous substances.

Proposal

The three Superfund excise taxes would be reinstated for the period after the date of enactment and before October 1, 2008.

EXTEND EXCISE TAXES ON GASOLINE, DIESEL FUEL, AND SPECIAL MOTOR FUELS

Current Law

Excise taxes are imposed on gasoline (other than aviation gasoline) at a rate of 18.4 cents per gallon, diesel fuel at a rate of 24.4 cents per gallon, and special motor fuels at rates varying from 9.25 to 18.4 cents per gallon. The revenues from these taxes, except to the extent attributable to the 0.1-cent-per-gallon Leaking Underground Storage Tank (LUST) tax, are generally dedicated to the Highway Trust Fund. Revenues from the LUST tax are dedicated to a separate LUST trust fund. Special rules apply to revenues from taxes on fuel used for certain off-highway purposes, such as in trains, recreational motorboats, and small engines. Depending on the purpose, part or all of the revenues from these taxes is retained in the general fund and the balance, if any, is dedicated to trust funds other than the Highway Trust Fund. In addition, part of the revenue attributable to the tax on certain alcohol fuels is retained in the general fund.

The tax rates are scheduled to fall to 4.4 cents per gallon (or comparable rates in the case of special motor fuels) on September 30, 1999. In addition, the LUST tax is scheduled to expire on March 31, 2005.

Reasons for Change

The extension of the taxes on nonaviation gasoline, diesel fuel, and special motor fuels is necessary to provide for the continued Federal investment in the improvement of the Nation's transportation infrastructure. The Administration's proposed National Economic Crossroads Transportation Efficiency Act (NEXTEA) describes these investments and also provides for the extension of these taxes at their current rates.

Proposal

The proposal would extend the current rates of tax on nonaviation gasoline, diesel fuel, and special motor fuels (with a 0.1 cent per gallon reduction, reflecting the expiration of the LUST tax, on April 1, 2005).

CONVERT EXCISE TAXES DEPOSITED IN THE AIRPORT AND AIRWAY TRUST FUND TO COST-BASED USER FEES ASSESSED FOR FEDERAL AVIATION ADMINISTRATION (FAA) SERVICES

Current Law

The Airport and Airway Trust Fund is supported by taxes on air passenger transportation, domestic air freight transportation, and noncommercial aviation fuel. The current tax on domestic air passenger transportation is 9 percent of the amount paid for the transportation plus $1.00 for each segment of the transportation, the current tax on international departures and arrivals is $12 per person, the tax on domestic air freight transportation is 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, is 17.5 cents per gallon (15 cents per gallon in the case of gasoline). The rate of tax on amounts paid for domestic air transportation is phased down to 8 percent after September 30, 1998, and to 7.5 percent after September 30, 1999. The domestic segment fee is phased up in five steps to a fully phased-in fee of $3.00 per segment after December 31, 2001. In addition, the segment fee is indexed for inflation beginning in calendar year 2003 and the international arrival and departure fees are indexed for inflation beginning in calendar year 1999.

Reasons for Change

As part of the Administration's effort to create a more business-like Federal Aviation Administration, the aviation excise taxes should be replaced with cost-based user fees.

Proposal

The Administration will propose legislation to phase out the aviation excise taxes and replace them with cost-based user fees. Under this proposal, the aviation excise taxes would be phased out over the period FY 1999 through FY 2003 (with the first reduction on October 1, 1999, and full phase out on October 14, 2002) and the FAA would be entirely funded by cost-based user fees by 2003.