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General Explanations
of the
Administration's Revenue Proposals

Department of the Treasury
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TAX CREDIT FOR DEPENDENT CHILDREN

Current Law

A tax exemption, in the form of a deduction, is allowed for each taxpayer and for each dependent of a taxpayer. A dependent includes a child of the taxpayer who is supported by the taxpayer and is under age 19 at the close of the calendar year or is a student under age 24. The deduction amount is $2,650 for tax year 1997. This amount is indexed annually for inflation.

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

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

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

Reasons for Change

Tax relief for middle-class families has been and continues to be an important goal of this Administration. The real value of the personal exemption has been eroded over the years by inflation, which has increased tax burdens on larger families relative to smaller families. The tax credit for dependent children helps reverse this long-term change in relative tax burdens.

Proposal

A nonrefundable tax credit would be allowed for each dependent child under age 13. The credit would be phased in, at $300 per child for tax years 1997, 1998, and 1999, and $500 per child for 2000, and indexed thereafter. The credit would be phased out for taxpayers with adjusted gross income between $60,000 and $75,000, with the phase-out range indexed beginning in 2001. The credit would not reduce any alternative minimum tax liability. The EITC would be applied after the dependent child credit.

Taxpayers claiming the dependent child credit would be required to provide valid taxpayer identification numbers for themselves, their spouses, and their children who qualify for the credit.

HOPE SCHOLARSHIP TUITION TAX CREDIT AND EDUCATION AND JOB TRAINING TAX DEDUCTION

Current Law

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

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

The interest from qualified U.S. savings bonds is excluded from a taxpayer's gross income to the extent the proceeds of the bonds are used to pay qualified educational expenses. To be qualified, the savings bonds must be purchased after December 31, 1989, by a person who has attained the age of 24. The interest exclusion is phased out for taxpayers with AGI over certain amounts. For 1996, the exclusion was phased out for taxpayers with modified AGI between $49,450 and $64,450 ($74,200 and $104,200 for joint returns). Qualified educational expenses consist of tuition and fees for enrollment of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent at a public or non-profit institution of higher education, including two-year colleges and vocational schools.

Reasons for Change

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

The expenses of higher education place a significant burden on many middle-class families. Grants and subsidized loans are available to students from low- and moderate-income families; high-income families can afford the cost of higher education. The combination of Federal grants and a tax credit reduces the after-tax cost of higher education, creating a Federal guarantee of a specified amount of assistance for higher education expenses by reducing the after-tax cost of higher education. This guarantee will help make 14 years of education the norm in America.

Proposal

As described in detail below, taxpayers would be able to claim a non-refundable tax credit or a tax deduction for qualified higher education expenses incurred for themselves, their spouses or their dependents during their first two years of postsecondary education in a degree or certificate program. If the requirements for both the credit and the deduction were met with respect to a particular student's expenses, the taxpayer would be free to choose either the credit or the deduction for those expenses. The deduction, but not the credit, would be available for qualified higher education expenses incurred after the first two years of postsecondary education or at any time for courses that enable the taxpayer, the taxpayer's spouse or dependent to acquire or improve job skills.

HOPE Scholarship Tuition Credit

A taxpayer would be allowed a non-refundable credit against Federal income tax for qualified higher education expenses paid during the taxable year for the education of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents. The credit would be available with respect to an individual student for two taxable years, provided the student has not completed the first two years of postsecondary education.

A credit for qualified higher education expenses would be available in the taxable year the expenses are paid, subject to the requirement that the education commence or continue during that year or during the first three months of the next year, and provided the student is enrolled during the year (or in the first three months of the next year) at least half-time in a degree or certificate program. Qualified higher education expenses paid with the proceeds of a loan generally would be eligible for the credit (rather than repayment of the loan itself). The credit would be recaptured where a student or the taxpayer received a refund (or reimbursement through insurance) of tuition and fees for which a credit had been claimed in a prior year.

With respect to an individual student, a taxpayer is limited to a tuition tax credit of the lesser of the taxpayer's qualified higher education expenses and the maximum credit amount. The maximum credit for a taxable year would be $1500, reduced by any Federal educational grants, such as Pell Grants, awarded for that year (or for education beginning in the first three months of the next year, if credits are claimed based on payments for that education). Beginning in 1998, the maximum credit amount would be indexed for inflation, rounded down to the closest multiple of $50.

The maximum credit amount would be phased out ratably for taxpayers with modified AGI between $50,000 and $70,000 ($80,000 and $100,000 for joint returns). Modified AGI would include taxable Social Security benefits and amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions), and would be

determined before the deduction for education expenses contained in this proposal. Beginning in 2001, the income phase-out ranges would be indexed for inflation, rounded down to the closest multiple of $5000.*

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

Qualified higher education expenses generally would include only out-of-pocket tuition and fees. Qualified higher education expenses would not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total tuition and required fees would be reduced by scholarship or fellowship grants excludable from gross income under section 117 of the Internal Revenue Code (scholarships and fellowships that pay for tuition, required fees, books and equipment) and any educational assistance received as veterans' benefits. However, assistance with expenses other than tuition, required fees and books, such as expenses associated with meals, lodging, student activities, athletics, health care and transportation, could be received without a reduction of creditable higher education expenses. In addition, qualified higher education expenses would be reduced by the interest from qualified U.S. savings bonds that is excluded from a taxpayer's gross income for the taxable year. However, no reduction would be required for a gift, bequest, devise, or inheritance within the meaning of section 102(a).

An eligible student would be one who is enrolled or accepted for enrollment during the taxable year in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible institution. The student must pursue a course of study on at least a half-time basis. In addition, for a student's qualified higher education expenses to be eligible for the credit, the student must not have been convicted of a Federal or state felony consisting of the possession or distribution of certain drugs, and generally cannot be a nonresident alien. Furthermore, a taxpayer would not be entitled to a credit for a student in a second taxable year unless the student obtained a qualifying grade point average for all previous postsecondary education. Generally, this would be an average of at least 2.75 on a 4-point scale, or a substantially similar measure of achievement. This provision would allow institutions that do not use a 4-point grading scale to retain their own system while still

* This description of the proposal reflects a modification of the indexing date contained in the OMB analytical materials relating to this proposal.

allowing their students to qualify for the credit: these institutions will determine what measure under the system they use reasonably approximates a B- GPA.

An "institution of higher education" is defined by reference to section 481 of the Higher Education Act. Such institutions generally would be accredited postsecondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized postsecondary credential. They could also be proprietary institutions or postsecondary vocational institutions. The institution must be eligible to participate in Department of Education student aid programs.

This proposed credit would not affect deductions claimed under any other section of the Code, except that if a student's qualified higher education expenses for a taxable year are deducted under another section of the Code (including the proposed deduction for education expenses) no credit would be available. If a taxpayer is eligible to claim either the credit or the deduction for qualified higher education expenses with regard to a single student, the taxpayer may choose between the credit and the deduction, but may not claim both. In addition, a taxpayer may claim the credit for some students and the deduction for others. An eligible student would not be entitled to claim a credit under this provision if that student is claimed as a dependent for tax purposes by another taxpayer. If a parent claims a student as a dependent, any education expenses paid by the student would be treated as paid by the parent for purposes of this proposal.

The Secretary of the Treasury and the Secretary of Education, operating in close consultation, will have authority to issue regulations to implement the provisions. The Secretary of the Treasury generally would be authorized to issue regulations to implement this section of the Internal Revenue Code. For example, the Secretary of the Treasury would have authority to issue regulations providing appropriate rules for recordkeeping and information reporting. These regulations would address the information reports institutions of higher education would file to assist students and the IRS in determining whether a student meets the eligibility requirements for the credit and calculating the amount of the credit that is potentially available. However, certain terms would be defined by reference to the Higher Education Act of 1965. The Secretary of Education would have the authority to issue regulations under those provisions as well as authority to define other education terms as necessary. The Secretary of the Treasury and the Secretary of Education would coordinate their work in developing their respective regulations.

The proposal would be effective for payments made on or after January 1, 1997, for education commencing on or after July 1, 1997.

Education and Job Training Tax Deduction

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

The term "eligible student" generally is defined in the same way for the proposed deduction as it is for the proposed tuition credit, that is, to include students enrolled at least half-time in a degree or certificate program at an institution of higher education. However, a student taking a course to improve or acquire job skills would also be an eligible student for purposes of the deduction. Qualified higher education expenses would also be defined in the same way for the deduction proposal as they are for the tuition credit proposal, that is, tuition and required fees that are directly related to an eligible student's course of study.

"Institution of higher education" is defined the same way for purposes of this proposal as it is in the tuition credit proposal.

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

In 1997 and 1998 the maximum deduction for a taxpayer would be $5,000. In 1999 and thereafter, this maximum would increase to $10,000. The deduction would be phased out ratably over an income range in the same way as the credit. The maximum deduction would not vary with the number of students in a family.

This proposal would not affect deductions claimed under any other section of the Code, except that any amount deducted under another section of the Code could not also be deducted under this provision. In addition, a taxpayer who claimed a deduction for a student's qualified higher education expenses for a particular taxable year could not also claim a tuition tax credit for any of the student's qualified higher education expenses for the year. A student would not be eligible to claim a deduction under this provision if that student is claimed as a dependent for tax purposes by another taxpayer. If a parent claims a student as a dependent, any education expenses paid by the student will be treated as paid by the parent for purposes of this proposal.

The proposal would grant the Secretary of the Treasury authority to issue regulations under this section, including rules requiring record keeping and information reporting.

This proposal would be effective for payments made on or after January 1, 1997, for education commencing on or after July 1, 1997.

TAX INCENTIVES FOR EXPANSION OF STUDENT LOAN FORGIVENESS

Current Law

Generally, a taxpayer has income when all or part of a loan made to the taxpayer is forgiven. However, an exception is provided in section 108(f) for the forgiveness of certain student loans. If the United States, a State or local government, or a public benefit corporation with control over a state, county, or municipal hospital makes a loan to a student to support the student's attendance at an educational institution and subsequently forgives all or part of the loan, the income resulting from the cancellation of indebtedness is excluded from the student's income, provided the loan forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.

Reasons for Change

The Administration believes in encouraging Americans to use their education and training in community service. Providing tax relief in connection with the forgiveness of certain student loans will help make it possible for students with valuable professional skills to accept lower-paying jobs that serve the public.

Proposal

The income exclusion for student loan forgiveness would be expanded to cover forgiveness of loans extended by nonprofit tax-exempt charitable or educational institutions to their students or graduates when the proceeds are to be used to repay outstanding student loans, provided the loan forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers. The income exclusion would not be available where a loan is extended and then forgiven by an institution that employs the borrower. The exclusion would also be expanded to cover forgiveness of direct student loans made through the William D. Ford Federal Direct Loan Program where loan repayment and forgiveness are contingent on the borrower's income level.

The proposal would be effective with respect to amounts otherwise includable in income after the date of enactment.

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 for undergraduate education expires in mid-1997. The exclusion does not apply to graduate level courses beginning after mid-1996.

Reason 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 section 127 exclusion would be extended through December 31, 2000 and reinstated for graduate education.

SMALL BUSINESS TAX CREDIT FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

Current Law

Under current law, job-related training and education expenses, as well as amounts paid or incurred by an employer for educational assistance provided to employees pursuant to a qualified educational assistance program, are deductible by the employer. Employer payments for job-related training and amounts paid under a qualified educational assistance program up to $5,250 annually are excluded from the gross income and wages of the employee. No special incentive is provided to assist small businesses in promoting employee education.

Reason for Change

Education and training builds skills and increases the productivity of the American workforce. Well-educated workers are better able to adapt to changes in the workforce and the demands of technological challenges and global competition. An additional incentive is needed to foster increased educational opportunities and workforce training for employees of small businesses that otherwise may be unable to devote sufficient resources to their employees' skill development.

Proposal

Small businesses would be allowed a 10 percent income tax credit for payments made in taxable years beginning after December 31, 1997, and before January 1, 2001, with respect to expenses incurred during those taxable years for education of employees by third parties under an employer-provided educational assistance program. The credit would be available to employers with average annual gross receipts of $10 million or less for the prior three years.

EXPANDED INDIVIDUAL RETIREMENT ACCOUNTS

Current Law

Under current law, an individual may make deductible contributions to an individual retirement account or individual retirement annuity (IRA) up to the lesser of $2,000 or compensation (wages and self-employment income.) (A couple may make deductible contributions of up to $2,000 for each spouse if the combined compensation of both spouses is at least equal to the contributed amount.) If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the $2,000 limit on deductible contributions is phased out for couples filing a joint return with adjusted gross income (AGI) between $40,000 and $50,000, and for single taxpayers with AGI between $25,000 and $35,000. To the extent that an individual is not eligible for deductible IRA contributions, he or she may make nondeductible IRA contributions (up to the contribution limit).

The earnings on IRA account balances are not includable in gross income until they are withdrawn. Withdrawals from an IRA (other than withdrawals of nondeductible contributions) are includable in income, and must begin by age 70½. Amounts withdrawn before age 59½ are generally subject to an additional 10-percent tax. This 10-percent early withdrawal tax does not apply to distributions upon the death or disability of the taxpayer or to substantially equal periodic payments over the life (or life expectancy) of the IRA owner or over the joint lives (or life expectancies) of the IRA owner and his or her beneficiary. The 10-percent early withdrawal tax also does not apply to distributions for certain medical care expenses (deductible medical expenses that are subject to a floor of 7.5 percent of AGI), or to distributions for medical insurance (without regard to the 7.5 percent of AGI floor) by individuals receiving at least 12 consecutive weeks of unemployment compensation. In general, an excess distribution tax of 15 percent applies to the extent that an individual receives an aggregate amount of retirement distributions in excess of $160,000 (indexed) in any year.

Reasons for Change

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

can be withdrawn tax free will provide an alternative savings vehicle that some middle-income taxpayers may find more suitable for their savings needs.

Individuals save for many purposes besides retirement. Broadening the tax incentives for non-retirement saving can help increase the nation's savings rate. IRAs that are flexible enough to meet a variety of essential savings needs, such as first-time home purchases and higher education expenditures, should prove to be more attractive to many taxpayers than accounts that are limited to retirement savings.

Proposal

Expand Deductible IRAs

Under the proposal, the income thresholds and phase-out ranges for deductible IRAs would be doubled, in two stages. Beginning in 1997, eligibility would be phased out for couples filing joint returns with AGI between $70,000 and $90,000 and for single individuals with AGI between $45,000 and $65,000. Beginning in 2000, eligibility would be phased out for couples filing joint returns with AGI between $80,000 and $100,000 and for single individuals with AGI between $50,000 and $70,000. The income thresholds and the present-law annual contribution limit of $2,000 would be indexed for inflation. As under current law, any individual who is not an active participant in an employer-sponsored plan and whose spouse is also not an active participant would be eligible for deductible IRAs regardless of income.

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

Special IRAs

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

The proposal would permit individuals whose AGI for a taxable year does not exceed the upper end of the new income eligibility limits ($100,000 for couples filing joint returns and $70,000 for single individuals) to convert balances in deductible IRAs into Special IRAs without being subject to the early withdrawal tax. The amount converted from the deductible IRA to the Special IRA generally would be includable in the individual's income in the year of the conversion. However, if a conversion was made before January 1, 1999, the converted amount included in the individual's income (and taken into account in applying the 15-percent excess distribution tax) would be spread evenly over four taxable years.

Distributions Not Subject to Early Withdrawal Tax

The 10-percent early withdrawal tax would not apply to amounts withdrawn from deductible IRAs or to amounts withdrawn, within five years after contribution, from Special IRAs, if the taxpayer used the amounts to pay post-secondary education costs, to buy or build a first home, or to cover living costs (not just medical insurance costs) if unemployed.

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

In addition, to further assist taxpayers who are saving to pay these qualified higher education expenses, deductible IRAs and Special IRAs would be expressly permitted to invest in instruments issued under qualified State tuition programs described in section 529 of the Code to the extent provided by the Secretary. To the extent a qualified instrument held by an IRA is converted into tuition and fees, the IRA owner will be treated as having received a distribution from the IRA to pay qualified higher education expenses.

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

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

In addition, the present-law exception to the early withdrawal tax for distributions for certain medical care expenses (deductible medical expenses that are subject to a floor of 7.5 percent of AGI) would be expanded to allow withdrawal for medical care expenses (in excess of 7.5 percent of AGI) of the taxpayer's child, grandchild, parent or grandparent, whether or not that person otherwise qualifies as the taxpayer's dependent.

The proposal would be effective January 1, 1997.

EXCLUSION OF CAPITAL GAINS ON SALE OF PRINCIPAL RESIDENCE

Current Law

Under current law, capital gains from the sale of principal residences are subject to taxation. However, as the result of two special provisions, only a small percentage of such gains are actually taxed.

First, a taxpayer can postpone the tax on the capital gain realized on the sale of a principal residence by purchasing another principal residence within a specified replacement period that begins two years before and ends two years after the date of the sale. To postpone the entire capital gain from a sale, the purchase price of the new principal residence must exceed the adjusted sales price of the prior principal residence.

Second, a taxpayer who has reached the age of 55 (or whose spouse has reached the age of 55) is eligible for a one-time exclusion of up to $125,000 of accumulated capital gains realized on the sale of principal residences. To elect the one-time exclusion, the taxpayer who is age 55 or older must have owned the home and used it as a principal residence for a total of at least three years during the five-year period before the sale. A taxpayer is eligible for the exclusion only if the taxpayer and the taxpayer's spouse have not previously benefited from the exclusion.

Reasons for Change

Calculating capital gain from the sale of a principal residence is among the most complex tasks faced by a typical taxpayer. By excluding from taxation capital gains on principal residences below a relatively high threshold, few taxpayers would have to refer to records in determining income-tax consequences of transactions related to their house. Many taxpayers buy and sell a number of homes over the course of their lifetime, and are generally not certain of how much housing appreciation they can expect. Thus, despite the fact that as a result of the rollover provisions and the $125,000 one-time exclusion, most homeowners never pay any income tax on the capital gain on their principal residences, detailed records of transactions and expenditures on home improvements must be kept, in most cases, for many decades. To claim the exclusion, many taxpayers must determine the basis of each home they have owned, and appropriately adjust the basis of their current home to reflect any untaxed gains from previous housing transactions. This determination may involve augmenting the original cost basis of each home by expenditures on improvements. In addition to the record-keeping burden this creates, taxpayers face the difficult task of drawing a distinction between improvements that add to cost basis, and repairs that do not. The failure to account accurately for all improvements leads to errors in the calculation of capital gains, and hence to an under- or over-payment of the capital gains on principal residences.

To postpone the entire capital gain from the sale of a principal residence, the purchase price of a new home must be greater than the sales price of the old home. This provision encourages some taxpayers to purchase larger and more expensive houses than they otherwise would in order to avoid a tax liability, particularly those who move from areas where housing costs are high to lower-cost areas. Current law also may discourage some older taxpayers from selling their homes. Taxpayers who would realize a capital gain in excess of $125,000 if they sold their home and taxpayers who have already used the exclusion may choose to stay in their homes even though the home no longer suits their needs. By raising the $125,000 limit and by allowing multiple exclusions, this constraint to the mobility of the elderly would be removed.

While most homeowners do not pay capital gains tax when selling their homes, current law creates certain tax traps for the unwary that can result in significant capital gains taxes or loss of the benefits of the current exclusion. For example, an individual is not eligible for the one-time capital gains exclusion if the exclusion was previously utilized by the individual's spouse. This restriction has the unintended effect of penalizing individuals who marry someone who has already taken the exclusion. Households that move from a high housing-cost area to a low housing- cost area may incur an unexpected capital gains tax liability. Divorcing couples may incur substantial capital gains taxes if they do not carefully plan their house ownership and sale decisions.

Proposal

Married taxpayers filing jointly would be allowed to exclude up to $500,000 of capital gains realized on the sale of a principal residence. The maximum exclusion for single taxpayers, heads of households and married persons filing separately would be $250,000. As long as the eligibility requirements are satisfied, this exclusion may be used on gains realized each time a taxpayer sells a principal residence. The amount of otherwise excludible gain would be reduced to the extent of depreciation allowed with respect to rental or business use of the principal residence for periods after December 31, 1996.

To be eligible for the exclusion, taxpayers generally must have owned a home and occupied it as their principal residence for at least two years during the five years prior to the sale of the residence. In addition, the exclusion will generally be available only once every two years. Taxpayers forced to move without meeting these requirements (for example, because of medical reasons or a change in place of employment) would be eligible for the exclusion, but the maximum exclusion would be the $500,000 (or $250,000) exclusion times the fraction of the two-year residency requirement that has been satisfied.

In the case of joint filers not sharing a principal residence, an exclusion of $250,000 would be available on a qualifying disposition of the principal residence of one of the spouses. Similarly, if a taxpayer who has not used the exclusion marries someone who has used the exclusion within the prior two-year period, the proposal would permit the newly-married

couple to exclude a gain on the sale of their principal residence of up to $250,000. (After the expiration of the prior two-year period, the couple would be able to exclude $500,000.)

The new exclusion would be available for all sales of homes occurring on or after January 1, 1997, and would replace both the current-law one-time exclusion of up to $125,000 of gains for taxpayers age 55 and over and the rollover of capital gains into replacement residences. In the case of sales occurring between January 1, 1997 and the date of enactment, taxpayers could elect whether to apply the new exclusion or prior law. For taxpayers who acquired their current home in a rollover transaction within five years prior to the date of enactment, the residency requirement of the proposal will be applied by taking into account the period of the taxpayer's residency in the previous home.

EXPAND EMPOWERMENT ZONES AND ENTERPRISE COMMUNITIES

Current Law

The Omnibus Budget Reconciliation Act of 1993 (OBRA '93) authorized a federal demonstration project in which nine empowerment zones and 95 enterprise communities would be designated in a competitive application process. Of the nine empowerment zones, six were to be located in urban areas and three were to be located in rural areas. State and local governments would jointly nominate distressed areas and propose strategic plans to stimulate economic and social revitalization. By the June 30, 1994 application deadline, over 500 communities had submitted applications.

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

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

Reasons for Change

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

Proposal

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

Second, technical changes would be made to the OBRA '93 tax-exempt private activity bond provisions and "enterprise zone business" definition. The purpose of these changes is to allow a broader range of businesses in empowerment zones and enterprise communities to borrow the proceeds of the tax-exempt bonds and, in empowerment zones, to qualify for the additional section 179 expensing. Unchanged are the requirements that at least 35 percent of the business's employees be zone residents and the bonds be applied against the State volume

caps. These changes would be effective for bonds issued after the date of enactment and, with respect to expensing, for taxable years beginning on or after the date of enactment.

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

The eligibility criteria for these new zones and communities would be modified slightly. For example, the nominated areas would be allowed to include an additional 2,000 acres for zones and 1,000 acres for communities beyond the square mileage limitations. This additional acreage would not be subject to the poverty criteria. In addition, the first-round requirement that half of the nominated area consist of census tracts with poverty rates of 35 percent or more would not be applicable. Thus, the poverty rate in 90 percent of the census tracts would have to be 25 percent or more, and the remaining tracts would have to have a poverty rate of 20 percent or more. The Secretary of Agriculture would be authorized to designate up to one rural empowerment zone and five rural enterprise communities based on specified emigration criteria without regard to minimum poverty rates.

The additional zones would have available a different combination of tax incentives than those available to existing zones. The current-law wage credit would not be available in the new zones. However, the additional section 179 expensing, as modified above, and the proposed "brownfield" remediation tax incentive (described below) would be available in the new zones. In addition, the new zones would qualify for private-activity bonds (with the modifications proposed for the existing zones, described above), subject to separate per-zone caps that would be outside of the current-law State volume caps. Any new zones in rural areas would be authorized to issue up to $60 million of bonds, urban zones with populations under 100,000 would be subject to a bond cap of $130 million, and urban zones with populations of 100,000 or more would be subject to a bond cap of $230 million.

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

These new zones and communities would be required to be designated before 1999, and the designations would generally be effective for 10 years.

CURRENT DEDUCTION FOR CERTAIN ENVIRONMENTAL CLEANUP EXPENSES

Current Law

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

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

Reasons for Change

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

Proposal

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

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

The geographic requirement would be satisfied if the property is located in (i) any census tract that has a poverty rate of 20 percent or more, (ii) any other census tract (a) that has a population under 2,000, (b) 75 percent or more of which is zoned for industrial or commercial use, and (c) that is contiguous to one or more census tracts with a poverty rate of 20 percent or more, (iii) an area designated as a federal Empowerment Zone or Enterprise Community, or (iv) an area subject to one of the 76 Environmental Protection Agency (EPA) Brownfields Pilots announced prior to February 1997. Both urban and rural sites may qualify. Superfund National Priority listed sites would be excluded.

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

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

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

The proposal would be effective for eligible expenses incurred after the date of enactment.

TAX CREDIT FOR EQUITY INVESTMENTS IN COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS

Current Law

The Community Development Banking and Financial Institutions Act of 1994 created the Community Development Financial Institutions (CDFI) Fund, now housed within the Department of the Treasury, to provide equity investments, grants, loans, and technical assistance to qualifying organizations. For FY 1997, the CDFI Fund was appropriated $50 million for its programs to assist the various CDFI qualified institutions. CDFIs are financial institutions that have community development as their primary mission and that develop a range of programs and methods to carry out that mission. Currently, CDFIs and their investors are not eligible for special tax incentives.

Reasons for Change

Extending tax incentives to encourage investment in CDFIs will leverage additional private investment in distressed areas and stimulate the economic revitalization of those areas.

Proposal

A total amount of $100 million in nonrefundable tax credits would be made available to the CDFI Fund to allocate among equity investors in qualified CDFIs between 1997 and 2006. The allocation of credits would be determined by the CDFI Fund using a competitive process similar to the one used to allocate $37.5 million in assistance last year. The maximum amount of credit allocable to a particular investment would be 25 percent of the amount invested, though the CDFI Fund could negotiate a lower percentage. The amount of the credit would be available when the contribution is made (e.g., a 25 percent credit would be claimed in the year the investment is made). The investor's tax basis in the equity interest would be reduced by the amount of the credit, which would increase any capital gain or reduce capital loss in the event the investor sells his interest in the CDFI. In addition, the credit would be subject to full recapture if the equity interest is sold or redeemed within 5 years.

WELFARE-TO-WORK TAX CREDIT

Current Law

Section 51 of the Code provides a work opportunity tax credit (WOTC) for hiring individuals from certain targeted groups. The credit equals 35 percent of qualified wages paid during the first year of employment with the employer up to $6,000 (for a maximum credit of $2,100 per year). The credit expires after September 30, 1997. The targeted groups include members of families receiving assistance (AFDC or its successor program) for at least a 9-month period ending on the hiring date, or for at least a 9-month period ending during the 12-month period ending on the hiring date in the case of a qualified veteran.

Reasons for Change

The goal of the Welfare Reform Act of 1996 is to move individuals from welfare to work. It is anticipated that the process of moving some welfare recipients to work may be more difficult for a variety of reasons, including a recipient's lack of prior work experience and skills relevant to the demands of a changing labor market. A new welfare-to-work credit would serve as an inducement for employers to hire longer-term welfare recipients, invest in training and provide certain benefits and more permanent employment.

Proposal

A new welfare-to-work credit would enable employers to claim a 50-percent credit on the first $10,000 of annual wages paid to certain long-term family assistance recipients for both the first and second years of employment. Thus, the maximum credit would be $5,000 per year.

The long-term family assistance recipient targeted group would be 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) the cost to the health plan for coverage of 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 would be effective for individuals hired from the date of enactment through September 30, 2000.

EXPANSION OF ESTATE TAX EXTENSION PROVISIONS FOR CLOSELY HELD BUSINESSES

Current Law

Estate tax attributable to certain interests in closely held businesses may be paid in installments over 14 years (interest only for four years followed by no more than ten annual installments of principal and interest). A special four-percent interest rate is provided for the tax deferred on the first $1 million of value. The regular IRS rate on tax underpayments applies to values over $1 million. An estate is eligible for the installment payment provision if the value of the business interest included in the estate equals at least 35 percent of the value of the adjusted gross estate. Eligible business interests include those operated as proprietorships, partnerships or corporations, but partnerships and corporations qualify only if they have 15 or fewer owners, or the estate owns 20 percent or more of the value of the entity.

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

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

Reasons for Change

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

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

Some businesses find it difficult to obtain the credit needed for day-to-day operations when business property is subject to an IRS tax lien.

Proposal

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

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

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

The proposal would be effective for decedents dying after December 31, 1997. However, estates deferring estate tax under current law may make a one-time election to use lower interest rates and forego the interest deduction.

EQUITABLE TOLLING

Current Law

Section 6511 of the Internal Revenue Code 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 3 years of the date of filing the return or 2 years of the date of payment, whichever is later. A refund claim that is not filed within these specified time periods is rejected as untimely. There is a split among the courts as to whether these limitations periods can be extended, or "tolled," for equitable reasons. The Supreme Court recently granted certiorari on this issue in Brockamp v. United States, 67 F.3d 260 (9th Cir. 1995).

Reason for Change

The law at times may reach harsh results for some taxpayers, particularly when they fail to seek a refund because of a well-documented disability or similar compelling circumstance that 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 tax years ending after the date of enactment.

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

Limitations on the credit were enacted in 1993, 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, 1997, and (3) removing the income cap.

EXTEND FOREIGN SALES CORPORATION BENEFITS TO LICENSES OF COMPUTER SOFTWARE FOR REPRODUCTION ABROAD

Current Law

The Foreign Sales Corporation ("FSC") rules provide an export benefit for U.S. corporations. If a U.S. corporation uses a FSC to export goods, a portion of the export trade income of the FSC will be exempt from U.S. tax. The FSC benefit is available only for an export transaction involving "export property," which is defined to *exclude* most intangible property including copyrights such as computer software. A special statutory exception does, however, allow FSC benefits for "films, tapes, records, and similar reproductions." FSC benefits are currently available for copyrighted articles exported without the right of reproduction, such as "shrink-wrapped" computer software manufactured in the United States.

Reasons for Change

As a result of developments in technology, such as CD-ROMs, computer software is increasingly indistinguishable from films, tapes, and records, which currently obtain FSC benefits. It is therefore seemingly inconsistent to provide FSC benefits for licenses of films, tapes, and records without extending the incentive to other, virtually identical categories of property.

Proposal

The proposal would amend the definition of "export property" qualifying for FSC benefits to include computer software licensed for reproduction abroad.

The proposal would be effective for software licenses granted after the date of enactment.

DISTRICT OF COLUMBIA TAX INCENTIVE

To encourage employment of disadvantaged residents and to revitalize those areas of the District of Columbia where development has been inadequate, tax incentives are proposed.

RESEARCH TAX CREDIT

Current Law

The research tax credit generally applies on an incremental basis to a taxpayer's "qualified research expenditures" for a taxable year. The credit is generally equal to 20 percent of the amount by which the taxpayer's qualified research expenditures 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 expenditures for the taxable year.

The credit expired on June 30, 1995, and was subsequently extended (in modified form) by the Small Business Job Protection Act of 1996 to apply to expenditures generally incurred between July 1, 1996 and May 31, 1997.

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 one tool that 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 one year, from June 1, 1997, through May 31, 1998.

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 on May 31, 1997. 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 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 June 1, 1997, through May 31, 1998, the provision allowing a full fair market value deduction for gifts of publicly traded stock to private foundations.

WORK OPPORTUNITY TAX CREDIT

Current Law

Section 51 of the Code provides a work opportunity tax credit (WOTC) for hiring individuals from certain targeted groups. The credit equals 35 percent of qualified wages paid during the first year of employment with the employer up to $6,000. The credit expires after September 30, 1997. The targeted groups include: (1) members of families receiving assistance (AFDC or successor program); (2) qualified ex-felons; (3) high-risk youth 18-24 years old who reside in an empowerment zone (EZ) or enterprise community (EC); (4) vocational rehabilitation referrals; (5) qualified summer youth employees 16 or 17 years old who reside in an EZ or EC; (6) qualified veterans; (7) qualified food stamp recipients who are 18 to 24 years.

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 and expanded wage credit would serve as an inducement for employers to hire these individuals and invest in their training. In addition, the current wage credit does not provide employers an incentive to hire certain long-term food stamp recipient adults.

Proposal

The current Work Opportunity Tax Credit would be modified in two ways. First, it would be extended an additional one year, through September 30, 1998, for all current targeted groups. Second, a new qualified food stamp targeted group category would be added for adults 18-50 who are subject to the time limits for food stamp receipt under the Administration's legislative proposal (but who have not become ineligible by refusing to work or failing to comply with work requirements). This group would be eligible for a 12-month period beginning on the date the time limit is reached. The WOTC would be effective for this targeted group for individuals hired from the date of enactment through September 30, 2000.

ORPHAN DRUG CREDIT

Current Law

A 50-percent nonrefundable tax credit is allowed for qualified clinical expenses incurred in testing certain drugs for rare diseases or conditions, generally referred to as "orphan drugs." The orphan drug credit was originally enacted in 1983 and was extended on several occasions. The credit expired on December 31, 1994, and was reinstated by the Small Business Job Protection Act of 1996 for the period July 1, 1996, through May 31, 1997. The Small Business Act also allowed taxpayers to carry back unused credits to three years preceding the year the credit is earned and to carry forward unused credits to 15 years following the year the credit is earned.

Reasons for Change

The credit should be extended because of the continuing need to provide an incentive for the development of orphan drugs.

Proposal

The orphan drug credit would be extended for one year, from, June 1, 1997, through May 31, 1998.

DENY INTEREST DEDUCTION ON CERTAIN DEBT INSTRUMENTS

Current Law

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

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

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

Reasons for Change

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

Proposal

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

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

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

The proposal would also clarify that for purposes of section 385(c), an issuer will be treated as having characterized an instrument as equity if the instrument (i) has a maximum term of more than 15 years, and (ii) is not shown as indebtedness on the separate balance sheet of the issuer. For this purpose, in the case of an instrument with a maximum term of more than 15 years issued to a related party (other than a corporation) that is eliminated in the consolidated balance sheet that includes the issuer and holder, the issuer will be treated as having characterized the instrument as equity if the holder or some other related party issues a related instrument that is not shown as indebtedness on the consolidated balance sheet. For this purpose, an instrument would not be treated as shown as indebtedness on a balance sheet just because it is described as such in footnotes or other narrative disclosures. This proposal would apply only to corporations that file annual financial statements with the Securities and Exchange Commission (SEC), and the relevant balance sheet is the balance sheet filed with the SEC. In addition, this proposal would not apply to leveraged leases.

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

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

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

DEFER DEDUCTION FOR ACCRUED BUT UNPAID INTEREST ON CONVERTIBLE DEBT

Current Law

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

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

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

Reasons for Change

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

Proposal

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

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

REDUCE DIVIDENDS-RECEIVED DEDUCTION TO 50 PERCENT

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.

Reasons for Change

The 70-percent dividends-received deduction is too generous for corporations that cannot be considered an alter ego of the distributing corporation because they do not have a sufficient ownership interest in that corporation. The 70-percent dividends-received deduction creates tax arbitrage opportunities that undermine the separate corporate income tax. Complex rules intended to stem the ability of corporations to eliminate their corporate tax through the use of the dividends-received deduction are complex and very difficult to administer. A simpler method of ensuring the integrity of the corporate income tax base is necessary.

Proposal

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

MODIFY HOLDING PERIOD FOR DIVIDENDS-RECEIVED DEDUCTION

Current Law

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 unless the taxpayer satisfies a 46-day holding period for the stock (or a 91-day period for certain preferred stock). 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.

Reasons for Change

No deduction for a distribution on stock should be allowed when the owner of stock does not bear the risk of loss otherwise inherent in the ownership of an equity interest at a time proximate to the time the distribution is made. The proposal would prevent a taxpayer from obtaining a dividends-received deduction for the return on an investment that is the equivalent of a bond.

Proposal

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

DENY DIVIDENDS-RECEIVED DEDUCTION FOR PREFERRED STOCK WITH CERTAIN NON-STOCK CHARACTERISTICS

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 unless the taxpayer satisfies a 46-day holding period for the stock (or a 91-day period for certain preferred stock). 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.

Reasons for Change

There are many instances in which holders of stock take advantage of the dividends-received deduction when they essentially anticipate an investment in an instrument that is economically more like debt than like stock: it has an enhanced likelihood of recovery of principal or of maintaining a dividend over the term of the instrument, or both, or certain other non-stock characteristics.

Proposal

Except in the case of "qualifying dividends", the dividends-received deduction would be eliminated for dividends on limited term preferred stock. For this purpose, preferred stock includes only stock that is limited and preferred as to dividends and that does not participate (through a conversion privilege or otherwise) in corporate growth to any significant extent. Stock is only treated as having a limited term 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 the likelihood of the redemption or purchase remote.

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

The proposal would apply to dividends on stock issued more than 30 days after the date of enactment.

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

Current Law

No income tax deduction is allowed for interest on debt used directly or indirectly to acquire or hold investments that yield tax-exempt income on which is tax-exempt. The determination of whether debt is used to acquire or hold tax-exempt investments differs depending on the holder of the instrument. For financial institutions and dealers in tax-exempt investments, debt generally is treated as financing all of the taxpayer's assets proportionately. For corporations, other than financial institutions and dealers, and for individuals, however, a tracing rule is employed. Under this approach, deductions are disallowed only when indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt investments. One court has applied the tracing rule across members of the same consolidated group, but no statutory related-party rule specifically applies.

Reasons for Change

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

Proposal

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

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

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

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

The proposal would be effective for taxable years beginning after the date of enactment with respect to obligations acquired after the date of first committee action.

REQUIRE AVERAGE COST BASIS FOR SECURITIES

Current Law

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

Reasons for Change

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

Proposal

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

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

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

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

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

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

REQUIRE RECOGNITION OF GAIN ON CERTAIN APPRECIATED POSITIONS IN PERSONAL PROPERTY

Current Law

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

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

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

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

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

Reasons for Change

It is inappropriate for taxpayers to be able to dispose of the economic risks and rewards of owning appreciated property without realizing income for tax purposes. For example, in a short sale against the box the taxpayer has no risk of loss and no opportunity for gain on the stock sold short, but for tax purposes is not treated as having disposed of the stock.

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

Proposal

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

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

If the taxpayer makes a constructive sale of less than all of his or her appreciated positions in a particular property, the proposal would trigger gain recognition in the order the positions were acquired or entered into under the average cost basis proposal described above. If the taxpayer actually disposed of a position previously constructively sold, the offsetting positions creating the constructive sale still held by the taxpayer would be treated as causing a

new constructive sale of appreciated positions in substantially identical property, if any, the taxpayer holds at that time.

The proposal would not apply to any contract for the sale of any stock, debt instrument or partnership interest that is not a marketable security (as defined under the rules that apply to installment sales) if the sale is reasonably expected to occur within one year of the date the contract is entered into. Nor would the proposal generally treat a sales contract subject to normal terms and conditions as a constructive sale. In addition, the proposal would not treat a transaction as a constructive sale if the taxpayer is required to mark to market the appreciated financial position under section 475 (mark to market for securities dealers) or section 1256 (mark to market for futures contracts, options and currency contracts).

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

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

ELIMINATE THE EXTINGUISHMENT DOCTRINE

Current Law

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

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

Reasons for Change

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

Proposal

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

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

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

REQUIRE REASONABLE PAYMENT ASSUMPTIONS FOR INTEREST ACCRUALS ON CERTAIN DEBT INSTRUMENTS

Current Law

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

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

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

Reasons for Change

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

Proposal

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

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

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

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

REQUIRE GAIN RECOGNITION FOR CERTAIN EXTRAORDINARY DIVIDENDS

Current Law

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

In general, a distribution in redemption of stock is treated as a dividend, rather than as a sale of the stock, if it is essentially equivalent to a dividend. A redemption of the stock of a shareholder generally is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. The determination whether a redemption is essentially equivalent to a dividend includes reference to the constructive ownership rules of section 318, including the option attribution rules of section 318(a)(4). The rules relating to treatment of other property received in a reorganization contain a similar reference (section 356(a)(2)).

Reasons for Change

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

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

Proposal

The extraordinary dividend rules of section 1059 would be amended to provide that a corporate shareholder will recognize gain immediately with respect to any redemption treated as a dividend (in whole or in part) when the nontaxed portion of the dividend exceeds the basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership. In addition, immediate gain recognition is required whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero. Reorganizations or other exchanges involving amounts that are treated as dividends under section 356 of the Code are treated as redemptions for purposes of applying the rules relating to redemptions under section 1059(e).

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

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

Current Law

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

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

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

The 1872 mining act has allowed investors to acquire mining rights on Federal lands at the cost of $5.00 per acre or less.

Reasons for Change

The percentage depletion provisions under present law generally are viewed as an incentive for mineral production rather than as a normative rule for recovering the taxpayer's investment in the property. This incentive, however, is excessive with respect to minerals acquired under the 1872 mining act, in light of the minimal costs of acquiring these mining rights. In addition, the measurement of income in the affected industries will be improved by the repeal of these percentage depletion provisions.

Proposal

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

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

Current Law

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

Reasons for Change

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

Proposal

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

TREAT CERTAIN PREFERRED STOCK AS "BOOT"

Current Law

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

Reasons for Change

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

Proposal

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

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

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

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

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

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

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

REPEAL SECTION 1374 FOR LARGE CORPORATIONS

Current Law

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

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

Reasons for Change

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

Proposal

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

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

The proposal would be effective for subchapter S elections that are first effective for a taxable year beginning after January 1, 1998. The proposal also would apply to acquisitions (e.g., the merger of a C corporation into an S corporation) after December 31, 1997. Thus, C corporations would continue to be permitted to elect S corporation status effective for taxable years beginning in 1997 or on January 1, 1998.

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

REQUIRE GAIN RECOGNITION ON CERTAIN DISTRIBUTIONS OF CONTROLLED CORPORATION STOCK

Current Law

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

Reasons for Change

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

Proposal

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

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

distribution it is subject to various conditions, such as the approval of shareholders or a regulatory body.

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

REFORM THE TREATMENT OF CERTAIN CORPORATE STOCK TRANSFERS

Current Law

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

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

Reasons for Change

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

In international cases, a U.S. corporation owned by a foreign corporation may inappropriately claim foreign tax credits from a section 304 transaction. For example, if a foreign-controlled domestic corporation sells the stock of a subsidiary to a foreign sister corporation, the domestic corporation may take the position that it is entitled to credit foreign taxes that were paid by the foreign sister corporation. See Rev. Rul. 92-86, 1992-2 C.B. 199; Rev. Rul. 91-5, 1991-1 C.B. 114. However, if the foreign sister corporation had actually

distributed its earnings and profits to the common foreign parent, no foreign tax credits would have been available to the domestic corporation.

Proposal

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

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

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

MODIFY THE EXTENSION OF THE SECTION 29 CREDIT FOR BIOMASS AND COAL FACILITIES

Current Law

Section 29 of the Internal Revenue Code generally allows a credit for certain fuels produced from nonconventional sources. The credit equals $3 per barrel of oil equivalent ("BOE"), adjusted for inflation; in 1995 (the last year for which data is available) the credit was $5.83 per BOE.

For synthetic fuels produced from coal, and for gas produced from biomass, the credit is available only for production from facilities that are (1) placed in service by a fixed date (2) pursuant to a binding written contract entered before another fixed date. See IRC § 29(g)(1)(A). The "placed in service" and "binding contract" dates have been extended several times, most recently by the Small Business Job Protection Act of 1996. That act extended the "placed in service" date by 18 months, from January 1, 1997 to July 1, 1998. It also extended the "binding contract" date by one year, from January 1, 1996 to January 1, 1997.

Reasons for Change

This credit has been growing extremely fast, and the extensions benefit only a handful of taxpayers. The "placed in service" and "binding contract" dates have been extended several times. The first extension in 1992 was intended as a temporary transition rule for taxpayers with facilities that were soon to be placed into service. That transition period is long over, and the additional extensions are unwarranted.

Proposal

The proposal would shorten the "placed in service" date to July 1, 1997, in effect repealing 12 months of the recent 18-month extension. (The current-law "binding contract" date, however, would not be changed.)

REIMPOSE SUPERFUND CORPORATE ENVIRONMENTAL INCOME TAX

Current Law

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

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

Reasons for Change

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

Proposal

The corporate environmental income tax would be reinstated for taxable years beginning after December 31, 1996, and before January 1, 2008.

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

Current Law

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

Reasons for Change

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

Proposal

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

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

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

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

REFORM TREATMENT OF CAPTIVE "INSURANCE" ARRANGEMENTS

Current Law

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

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

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

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

Reasons for Change

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

Proposal

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

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

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

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

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

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

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

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

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

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

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

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

MODIFY FOREIGN TAX CREDIT CARRYOVER RULES

Current Law

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

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

Reasons for Change

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

Proposal

The proposal would limit foreign tax credit carrybacks to one year and extend foreign tax credit carryforwards to seven years. The proposal would be effective for foreign taxes paid or accrued or deemed paid or accrued in taxable years beginning after December 31, 1997.

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

Current Law

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

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

Foreign oil and gas extraction income (FOGEI) generally is not included in subpart F income, but foreign oil related income (FORI) generally is so included. There is no separate section 904 foreign tax credit "basket" for oil and gas income. However, under section 907, the amount of creditable foreign taxes imposed on FOGEI is limited in any year to the applicable U.S. tax on that income.

Reasons for Change

The purpose of the foreign tax credit is to avoid double taxation of income by both the United States and a foreign jurisdiction. When a payment to a foreign government is made as compensation for a specific economic benefit, there is no incidence of double taxation. Current law recognizes the distinction between creditable taxes and non-creditable payments for a specific economic benefit but fail to achieve the appropriate split between the two in a

case where a foreign country imposes a levy on, for example, oil and gas income only, but has no generally imposed income tax.

Proposal

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

The proposal would treat foreign oil and gas income (including both FOGEI and FORI) as subpart F income. It also would convert the special foreign tax credit limitation rules of present-law section 907 into a new foreign tax credit basket within section 904 for foreign oil and gas income.

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

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.

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

Current Law

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

Reasons for Change

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

Proposal

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

* This description of the proposal reflects a correction of the effective date in the OMB analytical materials relating to this proposal.

REPEAL LOWER OF COST OR MARKET INVENTORY ACCOUNTING METHOD

Current Law

Taxpayers required to maintain inventories are permitted to use a variety of methods to determine the cost of their ending inventories, including the last-in, first-out ("LIFO") method, the first-in, first-out ("FIFO") method, and the retail method. Taxpayers not using a LIFO method may determine the carrying values of their inventories by applying the lower of cost or market ("LCM") method and by writing down the cost of goods that are unsalable at normal prices or unusable in the normal way because of damage, imperfection or other causes (the "subnormal goods" method).

Reasons for Change

The allowance of write-downs under the LCM and subnormal goods methods is an inappropriate exception from the realization principle and is essentially a one-way mark-to-market method that understates taxable income.

Proposal

The proposal would repeal the LCM and subnormal goods methods. Appropriate wash-sale rules would also be included. The proposal would be treated as a change in the method of accounting for inventories, and any resulting section 481(a) adjustment would be included in income ratably over a four-year period beginning with the year of change. These changes would not apply to taxpayers with average annual gross receipts over a three-year period of $5 million or less, with appropriate aggregation rules.

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

REPEAL COMPONENTS OF COST INVENTORY ACCOUNTING METHOD

Current Law

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

Reasons for Change

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

Proposal

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

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

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

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

Current Law

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

Reasons for Change

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

Proposal

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

FURTHER RESTRICT LIKE-KIND EXCHANGES INVOLVING FOREIGN PERSONAL PROPERTY

Current Law

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

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

Reasons for Change

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

Proposal

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

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

REQUIRE REGISTRATION OF CERTAIN CONFIDENTIAL CORPORATE TAX SHELTERS

Current Law

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

Reasons for Change

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

Proposal

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

REQUIRE REPORTING OF PAYMENTS TO CORPORATIONS RENDERING SERVICES TO FEDERAL AGENCIES

Current Law

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

Reasons for Change

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

Proposal

The proposal would generally require reporting of payments of $600 or more made to corporations for services rendered to Federal executive agencies. However, the Treasury Secretary would be authorized to prescribe regulations to except reporting in appropriate circumstances. The proposal would be effective for returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment of the proposal.

INCREASE PENALTIES FOR FAILURE TO FILE CORRECT INFORMATION RETURNS

Current Law

Any person 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.

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

Current Law

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

Reasons for Change

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

Proposal

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

EXTEND WITHHOLDING TO CERTAIN GAMBLING WINNINGS

Current Law

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

Reasons for Change

Withholding on gambling winnings would improve compliance and enforcement.

Proposal

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

REQUIRE TAX REPORTING FOR PAYMENTS TO ATTORNEYS

Current Law

Tax information reporting is required for persons engaged in a trade or business making payments of $600 or more during the year in the course of the trade or business of rent, salaries, wages, or other fixed or determinable income. Treasury regulations require a payor to report payments of attorney's fees if the payments are made in the course of a trade or business. If, however, a payment to an attorney is a gross amount and it cannot be determined what portion is the attorney's fee (as is the case with payments of lump-sum judgments or settlements made payable to a lawyer and plaintiff jointly), no reporting is required. In general, a payor is not required to report payments made to corporations.

Reasons for Change

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

Proposal

The proposal would require any person making a payment in the course of a trade or business to a lawyer (as sole or joint payee) to report the payment to the IRS. A payment to a law firm would be a payment to a lawyer for this purpose. When the portion that constitutes fees cannot be determined, the amount paid would be reported as gross proceeds. These reporting requirements would not apply to the extent provided in regulations if their application would result in double reporting (e.g., if the payor knows a payment does not include attorneys fees because the payor has made, and reports, a separate payment of fees to the attorney). In addition, the exception from reporting for payments made to corporations would not apply to payments of legal fees under the proposal. A lawyer receiving a payment would be required to provide his or her taxpayer identification number to the payor or be subject to applicable penalties and backup withholding. The proposal would be effective for payments made after December 31, 1997.

MODIFY THE SUBSTANTIAL UNDERSTATEMENT PENALTY

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 then "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.

ESTABLISH IRS CONTINUOUS LEVY AND IMPROVE DEBT COLLECTION

Current Law

Under section 6331, certain kinds of non-means tested, recurring Federal payments are subject to levy by the IRS to collect taxes, but the levy must be served repeatedly by the IRS in order to intercept each (or part of each) payment. Also, certain Federal payments are exempt from levy: Federal workers' compensation payments, currently exempt under section 6334(a)(7); and annuity or pension payments under the Railroad Retirement Act and benefits under the Railroad Unemployment Insurance Act, both currently exempt under section 6443(a)(6). Finally, the exempt amount of wages, salary and other income under sections 6334(a)(9) and 6334(d) is determined by reference to the taxpayer's standard deduction and personal exemptions.

Reasons for Change

Improving the Government's ability to recover delinquent debts is a high priority of the Administration. These proposals will make it easier to collect delinquent Federal tax debts from taxpayers to whom the Federal Government is also making payments. In particular, the "continuous" levy authority and the simple 85% exemption for Federal wages, salary, and other income will reduce IRS paperwork burdens.

Proposal

The proposal would provide for "continuous" levy on non-means tested, recurring Federal payments. Second, the proposal would change the exemptions from levy. Federal workers' compensation payments, annuity or pension payments under the Railroad Retirement Act, and benefits under the Railroad Unemployment Insurance Act would no longer be fully exempt from levy. Finally, the proposal would change the exempt amount of Federal wages, salary, and other income under sections 6334(a)(9) and 6334(d), to a flat 85% exemption.

TAX KEROSENE IN THE SAME MANNER AS DIESEL FUEL

Current Law

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

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

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

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

Reasons for Change

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

conditions make it necessary to add clear kerosene to heating oil after removal from the terminal and should not impose unnecessary burdens on feedstock uses of kerosene.

Proposal

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

The changes would be effective on July 1, 1998, with appropriate floor stocks taxes imposed on kerosene held on that date.

EXTEND THE FUTA SURCHARGE AND REQUIRE MONTHLY DEPOSITS

Current Law

The Federal Unemployment Tax Act (FUTA) currently imposes a Federal payroll tax on employers of 6.2 percent of the first $7,000 paid annually to each employee. The tax funds a portion of the Federal/State unemployment benefits system. This 6.2 percent rate includes a temporary surtax of 0.2 percent. States also impose an unemployment tax on employers. Employers in States that meet certain Federal requirements are allowed a credit for State unemployment taxes of up to 5.4 percent, making the minimum net Federal tax rate 0.8 percent. Generally, Federal and State unemployment taxes are collected quarterly and deposited in Federal trust fund accounts.

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8 percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The surtax has been extended several times, the most recently through 1998, to build up reserves in the Federal trust accounts and thus to help avoid future funding problems in these accounts. If the Federal trust accounts are funded to the statutory limits and there are no outstanding advances from the general fund, excess funds are distributed to state trust fund accounts.

Reasons for Change

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

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

Proposal

The proposal would extend the 0.2 percent surtax through December 31, 2007. The proposal will also increase the Federal Unemployment Account statutory limit to 0.5 percent from 0.25 percent of total wages in covered employment in the preceding year.

The proposal would also require an employer to pay Federal and State unemployment taxes on a monthly basis in a given year if the employer's FUTA tax liability in the prior year was $1,100 or more (reflecting approximately 20 employees earning at least $7,000.) A safe

harbor would be provided for the required deposits for the first two months of each calendar quarter. For the first month in each quarter, the payment would be required to be the lesser of 30 percent of the actual FUTA liability for the quarter or 90 percent of the actual FUTA liability for the month. The cumulative deposits paid in the first two months of each quarter would be required to be the lesser of 60 percent of the actual FUTA liability for the quarter or 90 percent of the actual FUTA liability for the two months. The employer must pay the balance of the actual FUTA liability for each quarter by the last day of the month following the quarter. States would be permitted to adopt a similar mechanism for paying State unemployment taxes. This proposal would be effective for months beginning after December 31, 2001.

REIMPOSE AIRPORT AND AIRWAY TRUST FUND EXCISE TAXES

Current Law

Before January 1, 1996, and from August 27 through December 31, 1996, the Airport and Airway Trust Fund was supported by taxes on air passenger transportation, domestic air freight transportation, and noncommercial aviation fuel. The tax on domestic air passenger transportation was 10 percent of the amount paid for the transportation, the tax on international departures was $6 per person, the tax on domestic air freight transportation was 6.25 percent of the amount paid for the transportation, and the tax on noncommercial aviation fuel, to the extent dedicated to the Trust Fund, was 17.5 cents per gallon (15 cents per gallon in the case of gasoline). The taxes on air passenger and air freight transportation, and the dedicated taxes on noncommercial aviation fuel expired on December 31, 1996. The authority to transfer tax revenues to the Trust Fund also expired on December 31, 1996.

Reason for Change

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

Proposal

The aviation excise taxes would be reinstated for the period beginning seven days after the date of enactment and ending September 30, 2007.* The Administration will propose legislation to completely replace these taxes, effective October 1, 1998, with cost-based user fees, as part of the Administration's effort to create a more business-like Federal Aviation Administration.

* This description of the proposal reflects a correction of the effective date in the OMB analytical materials relating to this proposal.

REIMPOSE LEAKING UNDERGROUND STORAGE TANK TRUST FUND TAX

Current Law

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

Reason for Change

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

Proposal

The LUST Trust Fund tax would be reinstated for the period after the date of enactment and before October 1, 2007.

REIMPOSE SUPERFUND EXCISE TAXES

Current Law

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

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

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

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

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

Reason for Change

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

Proposal

The three Superfund excise taxes would be reinstated for the period after the date of enactment and before October 1, 2007.

REIMPOSE OIL SPILL LIABILITY TRUST FUND EXCISE TAX

Current Law

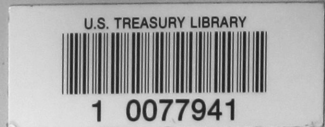
Before January 1, 1995, a five-cents-per-barrel excise tax was imposed on domestic crude oil and imported petroleum products. The tax was dedicated to the Oil Spill Liability Trust Fund to finance the cleanup of oil spills and pay other costs associated with oil pollution. The tax was not imposed for a calendar quarter if the unobligated balance in the Trust Fund exceeded $1 billion at the close of the preceding quarter.

Reasons for Change

It is essential that the Oil Spill Liability Trust Fund remain funded because of the continuing potential for oil spills and the magnitude of damages such spills can cause. Moreover, the full funding level was last changed by the Omnibus Budget Reconciliation Act of 1989 and is no longer adequate. After the enactment of the current $1 billion limitation, the Oil Pollution Act of 1990 permitted the use of amounts in the Trust Fund for additional expenditure purposes and doubled the limits on Trust Fund expenditures with respect to a single incident (increasing the overall limit from $500 million to $1 billion and the limit for natural resource damages payments from $250 million to $500 million). In addition, the Treasury Department's authority to advance up to $1 billion to the Trust Fund expired in 1994.

Proposal

The Oil Spill Liability Trust Fund excise tax would be reinstated for the period after the date of enactment and before October 1, 2007. In addition, the full funding limitation would be increased from $1 billion to $2.5 billion, effective on the date of enactment.



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