House Rpt. 280 Volume II

104 H. Rpt. 280; V.2 (Section 9 of 9;Due to its size, this report has been broken into 9 sections)

PROVIDING FOR RECONCILIATION PURSUANT TO SECTION 105 OF THE CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1996

**DATE:** October 17, 1995. Ordered to be printed

**SPONSOR:** Mr. Kasich submitted the following Report together with Minority, Additional, and Dissenting Views (Including cost estimate of the Congressional Budget Office)

**COMMITTEE:** from the Committee on the Budget

(To accompany H.R. 2491)

**TEXT:**

The Committee on the Budget, to whom reconciliation recommendations were submitted pursuant to section 105 of House Concurrent Resolution 67, the concurrent resolution on the budget for fiscal year 1996, having considered the same, report the bill without recommendation.

Although the legislative history of the 1932 Act indicated a concern with outbound transfers, the statutory standard for determining that a transaction did not have as one of its principal purposes tax avoidance evolved through administrative interpretation into a requirement that, in the case of transfers into the United States by a foreign corporation, tax-free treatment generally would be permitted only if the U.S. tax on accumulated earnings and profits was paid. For example, in 1968, the IRS issued guidelines (Rev. Proc. 680923, 1968091 C.B. 821) as to when favorable rulings "ordinarily" would be issued. As a condition of obtaining a favorable ruling with respect to certain transactions, the section 367 guidelines required the taxpayer to agree to include certain items in income (the amount to be included was called the section 367 toll charge). For example, if the transaction involved the liquidation of a foreign corporation into a domestic parent corporation, a favorable ruling was issued if the domestic parent agreed to include in its income as a dividend for the taxable year in which the liquidation occurred the portion of the accumulated earnings and profits of the foreign corporation which was properly attributable to the domestic corporations stock interest in the foreign corporation (Rev. Proc. 680923, sec. 3.01(1); see also sec. 3.03(1)(b)).

Absence of a toll charge on accumulated earnings of a foreign corporation upon liquidation or asset reorganization into a U.S. corporation clearly would permit avoidance of tax. For example, if a U.S. corporation owns 100 percent of the stock of a U.S. subsidiary, no tax is imposed either on a dividend from the subsidiary to the parent (sec. 243) or the liquidation of the subsidiary into the parent (secs. 332 and 337). In each case, the earnings of the subsidiary already have been subject to U.S. tax jurisdiction, and the liquidation provisions allow nonrecognition of gain inherent in appreciated property of the subsidiary. On the other hand, if a U.S. corporation owns 100 percent of the stock of a foreign subsidiary, earnings of the subsidiary generally are not subject to current U.S. tax. Instead, tax generally is imposed on a dividend from the subsidiary to the parent, net of creditable foreign taxes. If a liquidation of the subsidiary could be accomplished tax-free under the code, U.S. tax on its earnings would be avoided; more generally, the parent would be able to succeed to the basis and other tax attributes of the foreign corporation without having subjected to U.S. tax jurisdiction the earnings that gave rise to those tax attributes.

For purposes of the transactions described above, section 367 (and its predecessors) remained largely unchanged between 1932 and 1976. In 1976, however, a number of problems caused Congress to revise section 367. One result of the 1976 revision was to separate the provision into two sets of rules: one set dealing with outbound transfers, where the statutory aim is to prevent the removal of appreciated assets or inventory from U.S. tax jurisdiction prior to their sale (sec. 367(a)), and the other set dealing with both transfers into the United States and those which are exclusively foreign (sec. 367(b)).

Section 367(b) now provides, in part, that in the case of certain exchanges in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation will be considered to be a corporation except to the extent provided in regulations which are necessary or appropriate to prevent the avoidance of Federal income taxes.

Although it is clear that absence of a toll charge on accumulated earnings of a foreign corporation upon liquidation or reorganization into a U.S. corporation leads to avoidance of tax, and Congress in 1976 noted without disapproval the adoption of IRS positions that would prevent the avoidance of tax in these cases,5134 neither section 367(b) as revised in 1976, nor its predecessors, were drafted in such a way that directly causes tax to be imposed on foreign earnings.

 134 1AE.g., Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., "General Explanation of the Tax Reform Act of 1976," at 264 (1976).

For example, assume that a U.S. corporation owns 100 percent of the stock of a liquidating foreign corporation, and, pursuant to regulations under section 367(b), the foreign corporation is not treated as a corporation for purposes of section 332. In that case, the U.S. corporation would be required under the code to recognize the difference between the basis and the value of its stock in the foreign corporation. That gain, however, may be more or less than the accumulated earnings of the foreign corporation attributable to the period when the U.S. corporation owned the stock of the foreign corporation.

Perhaps as a result, neither the present temporary regulations nor the proposed regulations under section 367(b) mandate a tax based on the accumulated earnings of a foreign corporation that liquidates or reorganizes into a U.S. corporation. The temporary regulations allow the taxpayer to elect treatment of the foreign corporation as a corporation if the tax on earnings is paid. If the taxpayer chooses not to make the election, the foreign corporation is not treated as a corporation under the relevant nonrecognition provision (e.g., sec. 332, 354), but is treated as a corporation for other purposes, such as for purposes of the basis rules (secs. 334, 358, 362), and carryover provisions (sec. 381) (Temp. Treas. Reg. secs. 7.367(b)-5(b) and 7.367(b)-7(c)(2)). The proposed regulations generally require that the foreign corporation be treated as a corporation, and permit the taxpayer to elect either to pay the tax on earnings, or to pay tax on the gain; but if the latter option is chosen, adjustments must be made to either net operating loss carryovers, capital loss carryovers, or asset bases (Proposed Treas. Reg. sec. 1.367(b)-3(b)(2)).Reasons for ChangeOutbound transfers

The excise tax was intended to prevent U.S. taxpayers from transferring appreciated property to foreign entities in attempts to avoid the payment of a capital gains tax. During the 60 years since its enactment, the excise tax potentially due on a transfer has only roughly approximated the income tax consequences that would have flowed from gain recognition. In some cases the excise tax has been much harsher than that income tax.5135 Nevertheless, it is and has been the case that any taxpayer could properly avoid the excise tax by subjecting itself to the income tax. The committee understands that in some cases taxpayers are subject to the excise tax only because of inadvertent failure to elect to be subject to income tax. The committee understands that in order to defeat the tax avoidance possibilities of outbound transfers, in appropriate cases taxpayers should be subject to income tax on transfers of appreciated property to foreign entities, but not an excise tax.

 135 1AWhen the excise tax was enacted, the income tax on capital gains of individuals was 12.5 percent; the excise tax was 25 percent (Revenue Act of 1932, secs. 101 and 901).

Some have argued that partnership and trust provisions added to the code since 1932 generally obviate any need for either the excise tax or any new alternative provision. The committee does not agree. Implementation of many of those provisions requires regulations that may or may not exist, and may or may not adequately prevent the tax avoidance that prompted enactment of the excise tax. The committee believes that other statutes, while representing an improvement over pre-1932 law from the standpoint of preventing abuses, do not in all cases represent an adequate backstop where there is a failure to elect gain recognition or application of section 367 principles.Inbound transfers

The committee believes that the uncertainty surrounding the IRS authority to impose conditions on the treatment of a foreign corporation as a corporation, in cases other than outbound transfers, is not suited to prevent the avoidance of tax through the use of foreign corporations in the most straightforward fashion.

For example, assume that a U.S. corporation establishes a 100 percent-owned foreign corporation with capital of $100 cash. Assume that the foreign corporation spends $50 on operating assets and $50 on investment assets, and that the operating assets generate $100 of earnings and profits. Assume that the value and tax basis of operating assets maintained by the company remains at $50, while the value of the investment assets declines to $25, so that the stock in the foreign corporation is worth $175. Upon liquidation of the foreign corporation, assume that the taxpayer could avail itself of a gain limitation. Potentially, the taxpayer might achieve a double deduction of the $25 loss on the investment; once by sheltering $25 of earnings from taxation on repatriation, and again when the loss on the investment asset is realized upon disposition of that asset.5136

 136 1ACf. Tech. Advice Memo. 9003005 (Sept. 28, 1989).

The committee understands that the ambiguity of the statute in this case may foster complexity. For example, in the absence of regulations, the statute authorizes treatment of the foreign corporation as a corporation, and nontaxation of any earnings of the foreign corporation. To prevent this clear avoidance of tax, the IRS is authorized to provide for a different treatment of the foreign corporation by regulations. On one hand, it could be argued that the most the IRS can do in this case is to treat the transaction as if section 332 did not exist (resulting in gain recognition to the parent of $75). On the other hand, it could be argued that the Secretary is authorized to mandate the treatment of the foreign corporation as a corporation, subject to whatever regulations are necessary or appropriate to prevent the avoidance of tax on the repatriated earnings. One result of the ambiguity is a recently proposed regulation under which $75 of the earnings are taxed upon the liquidation, with the remaining $25 of earnings subject to future tax through a mandatory reduction of certain tax attributes, such as bases in the operating assets. The committee believes that requiring full taxation of the repatriated earnings is reasonable as a matter of the historic function of section 367 to prevent tax avoidance in inbound cases, and that such tax-avoidance can be prevented more directly and simply by explicitly authorizing the IRS to dispense with the gain limitation in appropriate cases.Explanation of ProvisionOutbound transfers

The bill repeals the excise tax on outbound transfers. In its place, the bill requires the full recognition of gain on a transfer of property by a U.S. person to a foreign corporation as either paid-in surplus or a contribution to capital, or to a foreign estate, trust, or partnership. Under the bill, the Secretary of the Treasury may, however, provide regulations under which principles similar to the principles of section 367 would apply to any such transfer in lieu of the application of the full recognition rule. Moreover, the Secretary may provide rules under which recognition of gain would not be triggered by section 1491 in cases where the Secretary is satisfied that application of other code rules (such as those relating to partnerships or trusts) would prevent the avoidance of tax consistent with the purposes of the bill. Full recognition of gain is also avoided in the case of a transfer described in section 367. It is anticipated that, prior to the promulgation of regulations, the Secretary generally will continue to permit taxpayers to elect the application of principles similar to the principles of section 367, provided the election is made by the time for filing the income tax return for the taxable year of the transfer.Inbound transfers

The bill provides that in the case of certain corporate organizations, reorganizations, and liquidations described in section 332, 351, 354, 355, 356, or 361 in which the status of a foreign corporation as a corporation is a condition for nonrecognition by a party to the transaction, income is recognized to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes. This provision is limited in its application, under the bill, so as not to apply to a transaction in which the foreign corporation is not treated as a corporation under section 367(a)(1). Thus, the bill permits the Secretary to provide by regulations for recognition of income, without regard to the amount of gain that would be recognized in the absence of the relevant nonrecognition provision listed above. As under current law, such regulations will be subject to normal court review as to whether they are necessary or appropriate for the prevention of avoidance of Federal income taxes.

In addition, the bill clarifies that rules for income recognition under section 367(b) may also be applied in a case involving a transfer literally described in section 367(a)(1), where necessary or appropriate to prevent the avoidance of Federal income taxes.Effective Date

The provision applies to transfers after December 31, 1995.4. Modification of reporting threshold for stock ownership of a foreign corporation (sec. 14425 of the bill and sec. 6046 of the code) Present Law

 Several provisions of the code require U.S. persons to report information with respect to a foreign corporation in which they are shareholders or act as officers or directors. Sections 6038 and 6035 generally require every U.S. citizen or resident who is an officer, director or who owns at least 10 percent of the stock of a foreign corporation that is a controlled foreign corporation (as defined in sec. 957(a)) or a foreign personal holding company (as defined in sec. 552(a)), respectively, to file form 5471 annually. These provisions require the U.S. filer to furnish certain ownership data as well as financial information of the foreign corporation.

Section 6046 mandates the filing of information returns on behalf of a foreign corporation by certain U.S. persons upon the occurrence of certain events. U.S. persons required to file these information returns are those who own or acquire 5 percent or more of the value of the stock of a foreign corporation, others who become U.S. persons while owning that percentage of the stock of a foreign corporation, and U.S. citizens and residents who are officers or directors of foreign corporations with such U.S. ownership. Information that is required to be furnished includes the items pertaining to the organization, acquisition or reorganization of the foreign corporation. When the predecessor of Section 6046 was enacted, Congress required information to be reported by several sources because of concerns that imposing a reporting requirement on only one party might not be sufficient to allow enforcement of the tax laws.

A failure to file the required information return could result in monetary penalties or reduction of foreign tax credit benefits under section 6038. Such a failure could result in monetary penalties under sections 6035 or 6046. Reasons for Change

The committee believes that because the annual reporting requirements applicable to controlled foreign corporations and foreign personal holding companies under sections 6035 and 6038 continue to apply, a liberalization of the filing requirements under section 6046 will not significantly impair the ability of the IRS to determine the U.S. tax liabilities associated with the activities of the relevant foreign corporations. The committee believes that it is appropriate to make the threshold at which reporting is required under section 6046 generally parallel to the thresholds that apply under sections 6035 and 6038. Doing so will reduce the compliance burdens on taxpayers.Explanation of Provision

The bill increases the reporting threshold for stock ownership of a foreign corporation under section 6046 from 5 percent (based on value) to 10 percent (based on vote or value).Effective Date

The provision is effective for reportable transactions occurring after December 31, 1995.5. Application of uniform capitalization rules to foreign persons (sec. 14426 of the bill and sec. 263A(c) of the code) Present LawIn general

For purposes of computing a taxpayers taxable income and earnings and profits, certain costs reduce net income as they are incurred (e.g., ordinary and necessary business expenses); other costs reduce net income only to the extent that the income-producing assets with which those costs are associated generate income. Pursuant to the code, Treasury Regulations prescribe a comprehensive set of rules for this purpose (the "uniform capitalization rules") which require certain costs including both direct and indirect costs allocable to property to be capitalized or included in inventory. The uniform capitalization rules generally apply to property produced by a taxpayer or acquired by a taxpayer for resale.

In the case of interest expense, the uniform capitalization rules apply to interest paid or incurred during the propertys production period that is allocable to property produced by the taxpayer or acquired for resale which first, is either real property or property with a class life of at least 20 years, second, has an estimated production period exceeding 2 years, or third, has an estimated production period exceeding 1 year and a cost exceeding $1,000,000 (sec. 263A(f)).Application to foreign persons

The uniform capitalization rules apply to foreign persons, whether or not engaged in business in the United States. In the case of a foreign corporation carrying on a U.S. trade or business, for example, the uniform capitalization rules apply for purposes of computing the corporations U.S. effectively connected taxable income, as well as its effectively connected earnings and profits for purposes of the branch profits tax.

If a foreign corporation is not engaged in business in the United States, its taxable income and earnings and profits may nonetheless be relevant under the code. For example, the pro-rata share of the subpart F income of a controlled foreign corporation is currently includible as income by its U.S. shareholders under section 951(a)(1)(A). And whether or not a foreign corporation is U.S.-controlled, its accumulated earnings and profits must be computed in order to determine the indirect foreign tax credit carried by distributions from the foreign corporation to any domestic corporation that owns at least 10 percent of its voting stock.

The code provides that the earnings and profits or deficit in earnings and profits of any foreign corporation, for any taxable year, shall be determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary of the Treasury (sec. 964(a)). Thus, foreign persons generally are required to capitalize costs in accordance with the uniform capitalization rules.

Eligible foreign persons may elect to use an alternative approach (the "U.S. ratio method") to apply the uniform capitalization rules to expenses other than interest (see Notice 88091041A5137). To apply the U.S. ratio method, there must be a similar U.S. trade or business carried on by the foreign person, or by a related party. All expenses that the foreign person otherwise treats as deductible are decreased ratably, to reflect the amount of the increase in costs capitalized under the U.S. ratio method for the taxable year. The appropriate ratio is applied to the costs of property produced or property acquired for resale incurred by the foreign person for each taxable year. A separate ratio is required to be computed for each taxable year for properties related to each separate trade or business.

 137 1A1988092 C.B. 443.Reasons for Change

The committee believes that the requirement to maintain separate records to compute inventory accounts solely for U.S. tax purposes is unduly burdensome for foreign corporations whose activities do not give rise to current U.S. income taxation. Therefore, the committee believes that it is appropriate to ease the compliance burdens of foreign taxpayers that are not engaging in a U.S. trade or business and that do not engage in activities that give rise to current taxation to their U.S. shareholders under the subpart F provisions. Explanation of Provision

The bill reduces the number of foreign corporations that are required to apply the uniform capitalization rules under section 263A of the code. Under the bill, a foreign corporation is subject to the uniform capitalization rules only with respect to the determination of first, its tax liability with respect to its U.S. trade or business and second, the tax liability of its U.S. shareholders under the subpart F provisions of the code. However, the committee intends that a foreign corporation that is not required to apply the uniform capitalization rules under the bill may nevertheless continue to apply such rules. Exemption from uniform capitalization rules under the bill constitutes a change of the accounting method of the foreign corporation adopted with the consent of the Secretary of Treasury. No section 481(a) adjustment will arise in connection with such change; instead, the "cut-off method" is applicable. Under the cut-off method, the value of the beginning inventory of an affected taxpayer includes amounts properly capitalized in a previous year under the uniform capitalization rules and the taxpayer would not apply the uniform capitalization rules with respect to inventory acquired or produced during the year for which the election is in effect.Effective Date

The provision is effective for taxable years of the foreign corporation beginning after December 31, 1995.6. Prizes and awards received by a nonresident alien relating to amateur sports competitions held in the United States (sec. 14427 of the bill and sec. 863(f) of the code)Present Law

Amounts received as prizes or awards are generally included in gross income under section 74 of the code. The code and Treasury regulations, however, contain no specific rules addressing the source and character of income from prizes and awards received by a nonresident alien. Prizes and awards associated with athletic competitions held in the United States are generally treated as services income. Services income earned by a nonresident alien from sources within the United States is generally subject to U.S. income tax. The source of income generally follows the location where the services are performed. A limited exception is available for U.S. source compensation income not exceeding $3,000 if certain criteria are satisfied (sec. 861(a)(3)).

Income tax treaties generally contain more generous provisions to exempt personal services income from U.S. taxation. Under many U.S. income tax treaties, an unlimited amount of dependent or independent services income may be exempt from U.S. income tax if the person performing the services is present in the United States for a period of 183 days or less provided certain conditions are met. However, a number of U.S. income tax treaties also contain a special "Artistes and Athletes" provision that limits this exemption. For example, under Article XVI of the U.S.-Canada income tax treaty, a Canadian athlete is subject to U.S. tax on the income derived from athletic activities conducted within the United States unless the amount of such income, including expenses reimbursed and expenses borne on behalf of the athlete, does not exceed $15,000 for the tax year in question.Reasons for Change

The committee believes that it is useful to provide specific statutory guidance with respect to the source of income from prizes and awards received by nonresident aliens that result from amateur sports competitions in the United States. The committee also believes that it is inappropriate to impose U.S. tax on prizes and awards received with respect to amateur sports competitions held in the United States, provided that the nonresident athlete does not perform any services in the United States for such prize or award. Explanation of Provision

The bill treats prizes and awards received by a nonresident alien with respect to his or her participation in an amateur sports competition held within the United States as foreign source income if the recipient does not perform any services for the payor for the prize or award. Thus, the value of the prize or award would be exempt from U.S. income tax. For this purpose, amateur sports competition means any competition in which the only prizes awarded by the sponsors are of nominal value. The committee intends that medals that are awarded in athletic competitions and that contain small amounts of precious or semi-precious metals, such as Olympic medals, be considered to be of nominal value for purposes of this provision. The operation of this provision is illustrated by the examples below.

Example 1. Assume that a nonresident alien athlete, A, is a resident of a country that does not have an income tax treaty with the United States, X. A is the first place finisher in an amateur athletic competition held in the United States. The only award that A receives from the sponsor of the competition is a blue ribbon. As a result of her accomplishment in such competition, a civic association of Country X names A its "Outstanding Athlete of 1995" and presents her with a new sports car. The civic association did not announce in advance that it would provide any prize to the winner of the event in which A competed. Thus, A does not have any contractual right to the car. In addition, due to her outstanding performance in the competition, the government of Country X believes that A has brought special honor to the country and grants a special award to A of $500. Country X does not have any continuous program in place to grant awards to athletes who win in sports competitions held abroad. As under present law, the value of the sports car and the $500 special prize do not constitute U.S. source income to A.

Example 2. Assume the same facts as Example 1, but instead of the $500 special award, the government of Country X has a long-standing program to award every first-place finisher from that country the equivalent of $10,000 in local currency as an incentive to all athletes from that country. The cash award does not qualify for the exception provided by the bill, and thus is treated as U.S. source income to A.

Example 3. Assume the same facts as Example 1, but in addition an athletic equipment manufacturer donates all of the equipment to the athletes of Country X for use in connection with the competition held in the United States. A uses this equipment during the competition but does not receive any other prize or award from the manufacturer. The value of the equipment does not constitute U.S. source income.

Example 4. Assume the same facts as Example 1, but in addition A has an endorsement contract with an athletic clothing manufacturer. The contract requires A to wear the manufacturers clothing during all competitions and provides that the athlete will receive a $15,000 bonus for every blue ribbon received in the competition. The $15,000 paid under the contract does not qualify for the exception provided by the bill, and thus is treated as U.S. source income to A.

Example 5. Assume the same facts as Example 1, but in addition an athletic shoe manufacturer enters into an arrangement with the athletes national sports federation under which the manufacturer provides the sports federation with all of the footwear required by its athletes. The athletes wear this footwear during the competition. The manufacturer also donates $100,000 to the sports federation, with the condition that this amount be divided among all of the countrys recipients of blue ribbons who actually wear the footwear during the competition. As share of the $100,000 award does not qualify for the exception provided by the bill, and thus is treated as U.S. source income.

Example 6. Assume the same facts as Example 2, but in addition the sponsor of the athletic competition has established a related foundation, the Blue Ribbon Foundation. Winners of each competition are named Blue Ribbon Athletes and are awarded $20,000 each by the Foundation. The contest is not an amateur competition as defined by the bill. The $20,000 award from the Foundation constitutes U.S. source income to the athlete.Effective Date

The provision is effective for prizes and awards received on or after the date of enactment.7. Treatment for estate tax purposes of short-term obligations held by nonresident aliens (sec. 14428 of the bill and sec. 2105 of the code) Present Law

The United States generally taxes nonresident aliens and foreign corporations on their U.S. source income or income which is effectively connected with a business conducted by them in the United States. Where a nonresident alien or foreign corporation receives interest, dividends, or other fixed or determinable annual or periodic gains, profits, and income and that income is not effectively connected with the conduct of a trade or business by the taxpayer within the United States, the United States generally imposes a 30-percent tax on the gross amount paid (code secs. 871(a) and 881).

Certain statutory exemptions from the 30-percent tax are applicable. In the case of interest, amounts that are derived from bank deposits, portfolio debt instruments and certain short-term original issue discount (OID) obligations are exempt from U.S. income taxation. A reason for such exemption is to enhance the ability of U.S. borrowers to raise capital from foreign persons. For example, in enacting the portfolio interest exemption, the Congress acknowledged that international bond issues are often exempt from withholding taxes and estate taxes imposed by foreign governments.5138 Section 2105(b) contains similar rules to exempt certain debt obligations from the U.S. estate tax imposed on nonresident aliens. Under present law, however, the income and estate tax exemptions for interest income received and debt instruments held by nonresident aliens are not in complete conformity.

51381ASee, e.g., Staff of the Joint Committee on Taxation, 98th Cong., 1st Sess. General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 391 et seq.

The United States imposes estate tax on assets of noncitizen nonresidents that are situated in the United States at the time of the individuals death. Debt obligations of a U.S. person, the United States, a political subdivision of a State, or the District of Columbia are considered property located within the United States if held by a nonresident not a citizen of the United States (sec. 2014(c)).

Special rules apply to treat certain bank deposits and debt instruments the income from which qualifies for the bank deposit interest exemption or the portfolio interest exemption as property from without the United States despite the fact that such items are obligations of a U.S. person, the United States, a political subdivision of a State, or the District of Columbia (sec. 2105(b)). Income from such items is exempt from U.S. income tax in the hands of the nonresident recipient (secs. 871(h) and 871(i)(2)(A)). The effect of the special rules is to exclude these items from the U.S. gross estate of a nonresident not a citizen of the United States. However, no equivalent exemption is available from the U.S. estate tax for obligations held by a noncitizen nonresident that generate short-term OID income despite the fact that such income also is exempt from U.S. income tax in the hands of the nonresident recipient (sec. 871(g)(1)(B)(i)).Reasons for Change

The committee believes that it is appropriate to conform the income and estate tax treatments of short-term OID obligations held by nonresident aliens. A purpose of exempting short-term OID income derived by nonresident aliens from U.S. income tax is to enhance the ability of U.S. borrowers to raise funds from foreign lenders, and such purpose is hindered by the lack of a corresponding exemption for U.S. estate tax. Moreover, to the extent the interest from such an obligation is exempt from U.S. income tax, the inclusion of the instrument in the nonresident noncitizens U.S. estate is a trap for the unwary. Explanation of Provision

The bill treats any debt obligation the income from which would be eligible for the exemption for short-term OID under section 871(g)(1)(B)(i) held by a decedent on the date of his death as property situated outside of the United States in determining the U.S. estate tax liability of a nonresident not a U.S. citizen. However, a short-term OID obligation the income from which is effectively connected with a U.S. trade or business conducted by the decedent is not subject to this rule.Effective Date

The provision is effective for estates of decedents dying after the date of enactment.

Subtitle E. Other Income Tax Simplification ProvisionsA. Provisions Relating to S Corporations1. S corporations permitted to have 75 shareholders (sec. 14501 of the bill and sec. 1361 of the code) Present Law

The taxable income or loss of an S corporation is taken into account by the corporations shareholders, rather than by the entity, whether or not such income is distributed. A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have first, more than 35 shareholders, second, as a shareholder, a person (other than certain trusts or estates) who is not an individual, third, a nonresident alien as a shareholder, and fourth, more than one class of stock. For purposes of the 35-shareholder limitation, a husband and wife are treated as one shareholder.Reasons for Change

The committee believes that increasing the number of eligible shareholders of an S corporation will facilitate corporate ownership by additional family members, employees and capital investors without damaging the intended simplified nature of subchapter S.Explanation of Provision

The provision increases maximum number of eligible shareholders from 35 to 75.Effective Date

The provision applies to taxable years beginning after December 31, 1995.2. Electing small business trusts (sec. 14502 of the bill and sec. 1361 of the code)Present Law

Under present law, trusts other than grantor trusts, voting trusts, certain testamentary trusts and "qualified subchapter S trusts" may not be shareholders in a S corporation. A "qualified subchapter S trust" is a trust which, under its terms, first, is required to have only one current income beneficiary (for life), second, any corpus distributed during the life of the beneficiary must be distributed to the beneficiary, third, the beneficiarys income interest must terminate at the earlier of the beneficiarys death or the termination of the trust, and fourth, if the trust terminates during the beneficiarys life, the trust assets must be distributed to the beneficiary. All the income (as defined for local law purposes) must be currently distributed to that beneficiary. The beneficiary is treated as the owner of the portion of the trust consisting of the stock in the S corporation.Reasons for Change

The committee believes that a trust that provides for income to be distributed to (or accumulated for) a class of individuals should be allowed to hold S corporation stock. This would allow an individual to establish a trust to hold S corporation stock and "spray" income among family members (or others) who are beneficiaries of the trust. The committee believes allowing such an arrangement will facilitate family financial planning. Explanation of ProvisionIn general

The provision allows stock in an S corporation to be held by certain trusts ("electing small business trusts"). In order to qualify for this treatment, all beneficiaries of the trust must be individuals or estates eligible to be S corporation shareholders, except that charitable organizations may hold contingent remainder interests. No interest in the trust may be acquired by purchase. For this purpose, "purchase" means any acquisition of property with a cost basis (determined under sec. 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc.

A trust must elect to be treated as an electing small business trust. An election applies to the taxable year for which made and could be revoked only with the consent of the Secretary of the Treasury or his delegate.

Each potential current beneficiary of the trust is counted as a shareholder for purposes of the proposed 75 shareholder limitation (or if there were no potential current beneficiaries, the trust would be treated as the shareholder). A potential current income beneficiary means any person, with respect to the applicable period, who is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. Where the trust disposes of all the stock in an S corporation, any person who first became so eligible during the 60 days before the disposition is not treated as a potential current beneficiary.

A qualified subchapter S trust with respect to which an election is in effect or an exempt trust is not eligible to qualify as an electing small business trust.Treatment of items relating to S corporation stock

The portion of the trust which consists of stock in one or more S corporations is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. The trust is taxed at the highest individual rate (currently, 39.6 percent on ordinary income and 28 percent on net capital gain) on this portion of the trusts income. The taxable income attributable to this portion includes first, the items of income, loss, or deduction allocated to it as an S corporation shareholder under the rules of subchapter S, second, gain or loss from the sale of the S corporation stock, and third, to the extent provided in regulations, any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock. Otherwise allowable capital losses are allowed only to the extent of capital gains.

In computing the trusts income tax on this portion of the trust, no deduction is allowed for amounts distributed to beneficiaries, and no deduction or credit is allowed for any item other than the items described above. This income is not included in the distributable net income of the trust, and thus is not included in the beneficiaries income. No item relating to the S corporation stock could be apportioned to any beneficiary.

On the termination of all or any portion of an electing small business trust the loss carryovers or excess deductions referred to in section 642(h) is taken into account by the entire trust, subject to the usual rules on termination of the entire trust.Treatment of remainder of items held by trust

In determining the tax liability with regard to the remaining portion of the trust, the items taken into account by the subchapter S portion of the trust are disregarded. Although distributions from the trust are deductible in computing the taxable income on this portion of the trust, under the usual rules of subchapter J, the trusts distributable net income does not include any income attributable to the S corporation stock.Termination of trust and conforming amendment applicable to all trusts

Where the trust terminates before the end of the S corporations taxable year, the trust takes into account its pro rata share of S corporation items for its final year. The bill makes a conforming amendment applicable to all trusts and estates clarifying that this is the present-law treatment of trusts and estates that terminate before the end of the S corporations taxable year.Effective Date

The provision applies to taxable years beginning after December 31, 1995.3. Expansion of post-death qualification for certain trusts (sec. 14503 of the bill and sec. 1361 of the code)Present Law

Under present law, trusts other than grantor trusts, voting trusts, certain testamentary trusts and "qualified subchapter S trusts" may not be shareholders in an S corporation. A grantor trust may remain an S corporation shareholder for 60 days after the death of the grantor. The 60-day period is extended to 2 years if the entire corpus of the trust is includible in the gross estate of the deemed owner. In addition, a trust may be an S corporation shareholder for 60 days after the transfer of S corporation pursuant to a will. Reasons for Change

The committee believes that the 60-day holding period applicable to certain testamentary trusts should be expanded to facilitate estate administration.Explanation of Provision

The provision expands the post-death holding period to 2 years for all testamentary trusts.Effective Date

The provision applies to taxable years beginning after December 31, 1995.4. Financial institutions permitted to hold safe harbor debt (sec. 14504 of the bill and sec. 1361 of the code)Present Law

A small business corporation eligible to be an S corporation may not have more than one class of stock. Certain debt ("straight debt") is not treated as a second class of stock so long as such debt is an unconditional promise to pay on demand or on a specified date a sum certain in money if: First, the interest rate (and interest payment dates) are not contingent on profits, the borrowers discretion, or similar factors; second, there is no convertibility (directly or indirectly) into stock, and third, the creditor is an individual (other than a nonresident alien), an estate, or certain qualified trusts. Reasons for Change

The committee can think of no reason why bona fide debt should not be treated as within the safe harbor simply because the debt is held by a financial institution. Explanation of Provision

The definition of "straight debt" is expanded to include debt held by creditors, other than individuals, that are actively and regularly engaged in the business of lending money. Effective Date

The provision applies to taxable years beginning after December 31, 1995.5. Rules relating to inadvertent terminations and invalid elections (sec. 14505 of the bill and sec. 1362 of the code)Present Law

Under present law, if the Internal Revenue Service ("IRS") determines that a corporations Subchapter S election is inadvertently terminated, the IRS can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and shareholders agree to be treated as if the election had been in effect for that period. Such waivers generally are obtained through the issuance of a private letter ruling. Present law does not grant the IRS the ability to waive the effect of an inadvertent invalid Subchapter S election.

In addition, under present law, a small business corporation must elect to be an S corporation no later than the 15th day of the third month of the taxable year for which the election is effective. The IRS may not validate a late election.Reasons for Change

The committee believes that the Secretary of the Treasury should have the same authority to validate inadvertently defective subchapter S elections as it has for inadvertent subchapter S terminations.Explanation of Provision

Under the provision, the authority of the IRS to waive the effect of an inadvertent termination is extended to allow the Service to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (including elections regarding qualified subchapter S trusts), or both. The provision also allows the IRS to treat a late Subchapter S election as timely where the Service determines that there was reasonable cause for the failure to make the election timely. It is intended that the IRS be reasonable in exercising this authority and apply standards that are similar to those applied under present law to inadvertent subchapter S terminations and other late or invalid elections.Effective Date

The provision applies to taxable years beginning after December 31, 1982.5139

51391AThis is the effective date of the present-law provision regarding inadvertent terminations.6. Agreement to terminate year (sec. 14506 of the bill and sec. 1377 of the code)Present Law

In general, each item of S corporation income, deduction and loss is allocated to shareholders on a per-share, per-day basis. However, if any shareholder terminates his or her interest in an S corporation during a taxable year, the S corporation, with the consent of all its shareholders, may elect to allocate S corporation items by closing its books as of the date of such termination rather than apply the per-share, per-day rule.Reasons for Change

The committee believes that the election to close the books of an S corporation does not need the consent of shareholders whose tax liability is unaffected by the election.Explanation of Provision

The provision provides that, under regulations to be prescribed by the Secretary of the Treasury, the election to close the books of the S corporation upon the termination of a shareholders interest is made by all affected shareholders and the corporation, rather than by all shareholders. The closing of the books applies only to the affected shareholders. For this purpose, "affected shareholders" means any shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the year. If a shareholder transferred shares to the corporation, "affected shareholders" includes all persons who were shareholders during the year.Effective Date

The provision applies to taxable years beginning after December 31, 1995.7. Expansion of post-termination transition period (sec. 14507 of the bill and secs. 1377 and 6037 of the code)Present Law

Distributions made by a former S corporation during its post-termination period are treated in the same manner as if the distributions were made by an S corporation (e.g., treated by shareholders as nontaxable distributions to the extent of the accumulated adjustment account). Distributions made after the post-termination period are generally treated as made by a C corporation (i.e., treated by shareholders as taxable dividends to the extent of earnings and profits).

The "post-termination period" is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: First, a date that is 1 year later, or second, the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporations S corporation election had terminated for a previous taxable year.

In addition, the audit procedures adopted by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) with respect to partnerships also apply to S corporations. Thus, the tax treatment of items is determined at the corporate, rather than individual level.Reasons for Change

The committee believes that the current scope of the "post-termination period" is insufficient under present law. In addition, the committee believes that the TEFRA audit procedures should be inapplicable to entities with a limited number of owners.Explanation of Provision

The present-law definition of post-termination period is expanded to include the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporations election and that adjusts a subchapter S item of income, loss or deduction of the S corporation during the S period. In addition, the definition of "determination" is expanded to include a final disposition of the Secretary of the Treasury of a claim for refund and, under regulations, certain agreements between the Secretary and any person, relating to the tax liability of the person.

In addition, the provision repeals the TEFRA audit provisions applicable to S corporations and would provide other rules to require consistency between the returns of the S corporation and its shareholders.Effective Date

The provision applies to taxable years beginning after December 31, 1995.8. S corporations permitted to hold subsidiaries (sec. 14508 of the bill and secs. 1361 and 1362 of the code)Present Law

A small business corporation may not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). Thus, an S corporation may not own 80 percent or more of the stock of another corporation (whether an S corporation or a C corporation).

In addition, a small business corporation may not have as a shareholder another corporation (whether an S corporation or a C corporation).Reasons for Change

The committee understands that there are situations where taxpayers may wish to separate different trades or businesses in different corporate entities. The committee believes that, in such situations, shareholders should be allowed to arrange these separate corporate entities under parent-subsidiary arrangements as well as brother-sister arrangements. Explanation of ProvisionC corporation subsidiaries

An S corporation is allowed to own 80 percent or more of the stock of a C corporation. The C corporation subsidiary could elect to join in the filing of a consolidated return with its affiliated C corporations. An S corporation is not allowed to join in such election. Dividends received by an S corporation from a C corporation in which the S corporation has an 80 percent or greater ownership stake is not treated as passive investment income for purposes of sections 1362 and 1375 to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.S corporation subsidiaries

In addition, an S corporation is allowed to own a qualified subchapter S subsidiary. The term "ualified subchapter S subsidiary" means a domestic corporation that is not an ineligible corporation (i.e., a corporation that would be eligible to be an S corporation if the stock of the corporation were held directly by the shareholders of its parent S corporation) if first, 100 percent of the stock of the subsidiary were held by its S corporation parent and second, for which the parent elects to treat as a qualified subchapter S subsidiary. If a subsidiary ceases to be a qualified S corporation subsidiary (either because the subsidiary fails to qualify or the parent revokes the election) another such election may not be made for the subsidiary by the parent for 5 years without the consent of the Secretary of the Treasury.

Under the election, the qualified subchapter S subsidiary is not treated as a separate corporation and all the assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as the assets, liabilities, and items of income, deduction, and credit of the parent S corporation. Thus, transactions between the S corporation parent and qualified S corporation subsidiary are not taken into account and items of the subsidiary (including accumulated earnings and profits, passive investment income, built-in gains, etc.) are considered to be items of the parent. In addition, if a subsidiary ceases to be a qualified subchapter S subsidiary (e.g., fails to meet the wholly-owned requirement), the subsidiary will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before such cessation from the parent S corporation in exchange for its stock.5140

 140 1ASimilar rules apply with respect to wholly owned subsidiaries of real estate investment trusts (REITs) under section 856(i) of present law.

Under the provision, if an election is made to treat an existing corporation (whether or not its stock was acquired from another person or previously held by the S corporation) as a qualified subchapter S subsidiary, the subsidiary will be deemed to have liquidated under sections 332 and 337 immediately before the election is effective. The built-in gains tax under section 1374 and the LIFO recapture tax under section 1363(d) may apply where the subsidiary was previously a C corporation. Where the stock of the subsidiary was acquired by the S corporation in a qualified stock purchase, an election under section 338 with respect to the subsidiary may be made.

Because the parent and each subsidiary corporation that is a qualified subchapter S subsidiary are treated for Federal income tax purposes as a single corporation, debt issued by a subsidiary to a shareholder of the parent corporation will be treated as debt of the parent for purposes of determining the amount of losses that may flow through to shareholders of the parent corporation under section 1366(d)(1)(B). The Secretary of the Treasury may prescribe rules as to the order that losses pass through where debt of both the parent and subsidiary corporations are held by shareholders of the parent. To the extent a shareholder of the parent S corporation is not at-risk with respect to losses of a subsidiary, the at-risk rules of section 465 may cause losses of the subsidiary to be suspended.Effective Date

The provision applies to taxable years beginning after December 31, 1995.9. Treatment of distributions during loss years (sec. 14509 of the bill and secs. 1366 and 1368 of the code) Present Law

Under present law, the amount of loss an S corporation shareholder may take into account for a taxable year cannot exceed the sum of the shareholders adjusted basis in his or her stock of the corporation and the adjusted basis in any indebtedness of the corporation to the shareholder. Any excess loss is carried forward.

Any distribution to a shareholder by an S corporation generally is tax-free to the shareholder to the extent of the shareholders adjusted basis of his or her stock. The shareholders adjusted basis is reduced by the tax-free amount of the distribution. Any distribution in excess of the shareholders adjusted basis is treated as gain from the sale or exchange of property.

Under present law, income (whether or not taxable) and expenses (whether or not deductible) serve, respectively, to increase and decrease an S corporation shareholders basis in the stock of the corporation. These rules require that the adjustments to basis for items of both income and loss for any taxable year apply before the adjustment for distributions applies.5141

 141 1ASee section 1368(d)(1); H. Rept. 9709826, p. 17; S. Rept. 9709640, p. 18; Treas. reg. sec. 1.1367091(e).

These rules limiting losses and allowing tax-free distributions up to the amount of the shareholders adjusted basis are similar in certain respects to the rules governing the treatment of losses and cash distributions by partnerships. Under the partnership rules (unlike the S corporation rules), for any taxable year, a partners basis is first increased by items of income, then decreased by distributions, and finally is decreased by losses for that year.5142

 142 1ATreas. reg. sec. 1.704091(d)(2); Rev. Rul. 660994, 1966091 C.B. 166.

In addition, if the S corporation has accumulated earnings and profits,5143 any distribution in excess of the amount in an "accumulated adjustments account" will be treated as a dividend (to the extent of the accumulated earnings and profits). A dividend distribution does not reduce the adjusted basis of the shareholders stock. The "accumulated adjustments account" generally is the amount of the accumulated undistributed post-1982 gross income less deductions.

 143 1AAn S corporation may have earnings and profits from years prior to its subchapter S election or from pre-1983 subchapter S years.Reasons for Change

The committee believes that the rules regarding the treatment of distributions by S corporations during loss years should be the same as the rules applicable to partnerships.Explanation of Provision

The provision provides that the adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year. Thus, distributions during a year reduce the adjusted basis for purposes of determining the allowable loss for the year, but the loss for a year does not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.

The provision also provides that in determining the amount in the accumulated adjustment account for purposes of determining the tax treatment of distributions made during a taxable year by an S corporation having accumulated earnings and profits, net negative adjustments (i.e., the excess of losses and deductions over income) for that taxable year are disregarded.

The following examples illustrate the application of these provisions:

Example 1. X is the sole shareholder of corporation A, a calendar year S corporation with no accumulated earnings and profits. Xs adjusted basis in the stock of A on January 1, 1996, is $1,000 and X holds no debt of A. During 1996, A makes a distribution to X of $600, recognizes a capital gain of $200 and sustains an operating loss of $900. Under the bill, Xs adjusted basis in the A stock is increased to $1,200 ($1,000 plus $200 capital gain recognized) pursuant to section 1368(d) to determine the effect of the distribution. Xs adjusted basis is then reduced by the amount of the distribution to $600 ($1,200 less $600) to determine the application of the loss limitation of section 1366(d)(1). X is allowed to take into account $600 of As operating loss, which reduces Xs adjusted basis to zero. The remaining $300 loss is carried forward pursuant to section 1366(d)(2).

Example 2. The facts are the same as in Example 1, except that on January 1, 1996, A has accumulated earnings and profits of $500 and an accumulated adjustments account of $200. Under the bill, because there is a net negative adjustment for the year, no adjustment is made to the accumulated adjustments account before determining the effect of the distribution under section 1368(c).

As to A, $200 of the $600 distribution is a distribution of As accumulated adjustments account, reducing the accumulated adjustments account to zero. The remaining $400 of the distribution is a distribution of accumulated earnings and profits (E&P) and reduces As E&P to $100. As accumulated adjustments account is then increased by $200 to reflect the recognized capital gain and reduced by $900 to reflect the operating loss, leaving a negative balance in the accumulated adjustment account on January 1, 1997, of $700 (zero plus $200 less $900).

As to X, $200 of the distribution is applied against Xs adjusted basis of $1,200 ($1,000 plus $200 capital gain recognized), reducing Xs adjusted basis to $1,000. The remaining $400 of the distribution is taxable as a dividend and does not reduce Xs adjusted basis. Because Xs adjusted basis is $1,000, the loss limitation does not apply to X, who may deduct the entire $900 operating loss. Xs adjusted basis is then decreased to reflect the $900 operating loss. Accordingly, Xs adjusted basis on January 1, 1997, is $100 ($1,000 plus $200 less $200 less $900).Effective Date

The provision applies to taxable years beginning after December 31, 1995.10. Treatment of S corporations under subchapter C (sec. 14510 of the bill and sec. 1371 of the code)Present Law

Present law contains several provisions relating to the treatment of S corporations as corporations generally for purposes of the Internal Revenue Code.

First, under present law, the taxable income of an S corporation is computed in the same manner as in the case of an individual (sec. 1363(b)). Under this rule, the provisions of the code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction, do not apply to S corporations.

Second, except as otherwise provided by the Internal Revenue Code and except to the extent inconsistent with subchapter S, subchapter C (i.e., the rules relating to corporate distributions and adjustments) applies to an S corporation and its shareholders (sec. 1371(a)(1)). Under this second rule, provisions such as the corporate reorganization provisions apply to S corporations. Thus, a C corporation may merge into an S corporation tax-free.

Finally, an S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C (sec. 1371(a)(2)). In 1988, the Internal Revenue Service took the position that this rule prevents the tax-free liquidation of a C corporation into an S corporation because a C corporation cannot liquidate tax-free when owned by an individual shareholder.5144 In 1992, the Internal Revenue Service reversed its position, stating that the prior ruling was incorrect.5145

 144 1APLR 8818049, (Feb. 10, 1988).

 145 1APLR 9245004, (July 28, 1992).Reasons for Change

The committee wishes to provide that the position taken by the Internal Revenue Service in 1992 that allows the tax-free liquidation of a C corporation into an S corporation represents the proper policy.Explanation of Provision

The provision repeals the rule that treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the provision clarifies that the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules, including the provisions of sections 332 and 337 allowing the tax-free liquidation of a corporation into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax under section 1374 upon a subsequent disposition. An S corporation also will be eligible to make a section 338 election (assuming all the requirements are otherwise met), resulting in immediate recognition of all the acquired C corporations gains and losses (and the resulting imposition of a tax).

The repeal of this rule does not change the general rule governing the computation of income of an S corporation. For example, it does not allow an S corporation, or its shareholders, to claim a dividends received deduction with respect to dividends received by the S corporation, or to treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers.Effective Date

The provision applies to taxable years beginning after December 31, 1995.11. Elimination of certain earnings and profits (sec. 14511 of the bill and secs. 1362 and 1375 of the code)Present Law

Under present law, the accumulated earnings and profits of a corporation are not increased for any year in which an election to be treated as an S corporation is in effect. However, under the subchapter S rules in effect before revision in 1982, a corporation electing subchapter S for a taxable year increased its accumulated earnings and profits if its earnings and profits for the year exceeded both its taxable income for the year and its distributions out of that years earnings and profits. As a result of this rule, a shareholder may later be required to include in his or her income the accumulated earnings and profits when it is distributed by the corporation. The 1982 revision to subchapter S repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.Reasons for Change

The committee believes that the existence of pre-1983 earnings and profits of an S corporation unnecessarily complicates corporate recordkeeping and constitutes a potential trap for the unwary. Explanation of Provision

The provision provides that if a corporation is an S corporation for its first taxable year beginning after December 31, 1995, the accumulated earnings and profits of the corporation as of the beginning of that year is reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Thus, such a corporations accumulated earnings and profits are solely attributable to taxable years for which an S election was not in effect. This rule is generally consistent with the change adopted in 1982 limiting the S shareholders taxable income attributable to S corporation earnings to his or her share of the taxable income of the S corporation.Effective Date

The provision applies to taxable years beginning after December 31, 1995.12. Carryover of disallowed losses and deductions under at-risk rules allowed (sec. 14512 of the bill and sec. 1366 of the code)Present Law

Under section 1366, the amount of loss an S corporation shareholder may take into account cannot exceed the sum of the shareholders adjusted basis in his or her stock of the corporation and the unadjusted basis in any indebtedness of the corporation to the shareholder. Any disallowed loss is carried forward to the next taxable year. Any loss that is disallowed for the last taxable year of the S corporation may be carried forward to the post-termination period. The "post-termination period" is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: First, a date that is 1 year later, or second, the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporations S corporation election had terminated for a previous taxable year.

In addition, under section 465, a shareholder of an S corporation may not deduct losses that are flowed through from the corporation to the extent the shareholder is not "at-risk" with respect to the loss. Any loss not deductible in one taxable year because of the at-risk rules is carried forward to the next taxable year. Reasons for Change

The committee believes that losses suspended by the at-risk rules should be conformed to the treatment of losses suspended by the subchapter S basis rules.Explanation of Provision

Losses of an S corporation that are suspended under the at-risk rules of section 465 are carried forward to the S corporations post-termination period. Effective Date

The provision applies to taxable years beginning after December 31, 1995.13. Adjustments to basis of inherited S stock to reflect certain items of income (sec. 14513 of the bill and sec. 1367 of the code)Present Law

Income in respect to a decedent (IRD) generally consists of items of gross income that accrued during the decedents lifetime but were not includible in the decedents income before his or her death under his or her method of accounting. IRD is includible in the income of the person acquiring the right to receive such item. A deduction for the estate tax attributable to an item of IRD is allowed to such person (sec. 691(c)). The cost or basis of property acquired from a decedent is its fair market value at the date of death (or alternate valuation date if that date is elected for estate tax purposes). This basis is often referred to as a "stepped-up basis." Property that constitutes a right to receive IRD does not receive a stepped-up basis.

The basis of a partnership interest or corporate stock acquired from a decedent generally is stepped-up at death. Under Treasury regulations, the basis of a partnership interest acquired from a decedent is reduced to the extent that its value is attributable to items constituting IRD (Treas. reg. sec. 1.742091). This rule insures that the items of IRD held by a partnership are not later offset by a loss arising from a stepped-up basis. Although S corporation income is taxed to its shareholders in a manner similar to the taxation of a partnership and its partners, no comparable regulation requires a reduction in the basis of stock in an S corporation acquired from a decedent where the S corporation holds items of IRD.Reasons for Change

The committee believes that the present-law treatment of IRD items of an S corporation is unclear and that the treatment of such items should be similar to the treatment of identical items held by a partnership.Explanation of Provision

The provision provides that a person acquiring stock in an S corporation from a decedent would treat as IRD his or her pro rata share of any item of income of the corporation that would have been IRD if that item had been acquired directly from the decedent. Where an item is treated as IRD, a deduction for the estate tax attributable to the item generally will be allowed under the provisions of section 691(c). The stepped-up basis in the stock in an S corporation acquired from a decedent is reduced by the extent to which the value of the stock is attributable to items consisting of IRD. This basis rule is comparable to the present-law partnership rule.Effective Date

The provision applies with respect to decedents dying after the date of enactment.14. S corporations eligible for rules applicable to real property subdivided for sale by noncorporate taxpayers (sec. 14514 of the bill and sec. 1237 of the code)Present Law

Under present-law section 1237, a lot or parcel of land held by a taxpayer other than a corporation generally is not treated as ordinary income property solely by reason of the land being subdivided if first, such parcel had not previously been held as ordinary income property and if in the year of sale, the taxpayer did not hold other real property; second, no substantial improvement has been made on the land by the taxpayer, a related party, a lessee, or a government; and third, the land has been held by the taxpayer for 5 years.Reasons for Change

The committee believes that rules generally applicable to individuals should be applicable to S corporations.Explanation of Provision

The provision allows the present-law capital gains presumption in the case of land held by an S corporation. It is expected that rules similar to the attribution rules for partnerships will apply to S corporation (Treas. reg. sec. 1.1237091(b)(3)).Effective Date

The provision is effective for sales in taxable years beginning after December 31, 1995.15. Effective date (sec. 14515 of the bill and sec. 1362 of the code)Present Law

A small business corporation that terminates its subchapter S election (whether by revocation or otherwise) may not make another election to be an S corporation for 5 taxable years unless the Secretary of the Treasury consents to such election.Reasons for Change

The committee believes that, given the changes made by the committee to subchapter S, it is appropriate to allow corporations that terminated their elections under subchapter S within the last 5 years to reelect subchapter S status without the consent of the Secretary. Explanation of Provision

For purposes of the 5-year rule, any termination of subchapter S status in effect immediately before the date of enactment of the proposal is not be taken into account. Thus, any small business corporation that had terminated its S corporation election within the 5-year period before the date of enactment may re-elect subchapter S status upon enactment of the bill without the consent of the Secretary of the Treasury.Effective Date

The provision is effective upon the date of enactment.B. Provisions Relating to Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs)1. Repeal the short-short test for regulated investment companies (sec. 14521 of the bill and sec. 851(b)(3) of the code)Present Law

 A regulated investment company ("RIC") generally is treated as a conduit for Federal income tax purposes. The code provides conduit treatment by permitting a RIC to deduct dividends paid to its shareholders in computing its taxable income. In order to qualify for conduit treatment, the RIC must be a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (sec. 851(a)). In addition, a corporation must elect such status and must satisfy certain tests (sec. 851(b)). In particular, a corporation must derive less than 30 percent of its gross income from the sale or disposition of certain investments (including stock, securities, options, futures, and forward contracts) held less than 3 months (the "short-short test") (sec. 851(b)(3)).Reasons for Change

The short-short test restricts the investment flexibility of RICs. The test can, for example, limit a RICs ability to "hedge" its investment (e.g., to use options to protect against adverse market moves).

The test also burdens a RIC with significant recordkeeping, compliance, and administration costs. The RIC must keep track of the holding periods of assets and the relative percentages of short-term and long-term gain that it realizes throughout the year.Explanation of Provision

The bill repeals the short-short test.Effective Date

The provision is effective for taxable years beginning after the date of enactment. 2. Modifications of rules for real estate investment trusts (sec. 145310914543 of the bill and secs. 856 and 857 of the code)Present LawOverview

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that receives conduit treatment for income that is distributed to shareholders. If an entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level; the REIT generally is subject to a corporate tax only on the income that it retains and on certain income from property that qualifies as foreclosure property. Election to be treated as a REIT

In order to qualify as a REIT, and thereby receive conduit treatment, an entity must elect REIT status. A newly-electing entity generally cannot have earnings and profits accumulated from any year in which the entity was in existence and not treated as a REIT (sec. 857(a)(3)). To satisfy this requirement, the entity must distribute, during its first REIT taxable year, any earnings and profits that were accumulated in non-REIT years. For this purpose, distributions by the entity generally are treated as being made from the most recently accumulated earnings and profits.Taxation of REITsOverview

In general, if an entity qualifies as a REIT by satisfying the various requirements described below, the entity is taxable as a corporation on its "real estate investment trust taxable income" ("REITTI"), and also is taxable on certain other amounts (sec. 857). REITTI is the taxable income of the REIT with certain adjustments (sec. 857(b)(2)). The most significant adjustment is a deduction for dividends paid. The allowance of this deduction is the mechanism by which the REIT becomes a conduit for income tax purposes.Capital gains

A REIT that has a net capital gain for a taxable year generally is subject to tax on such capital gain under the capital gains tax regime generally applicable to corporations (sec. 857(b)(3)). However, a REIT may diminish or eliminate its tax liability attributable to such capital gain by paying a "capital gain dividend" to its shareholders (sec. 857(b)(3)(C)). A capital gain dividend is any dividend or part of a dividend that is designated by the payor REIT as a capital gain dividend in a written notice mailed to shareholders. Shareholders who receive capital gain dividends treat the amount of such dividends as long-term capital gain regardless of their holding period of the stock (sec. 857(b)(3)(C)).

A regulated investment company ("RIC"), but not a REIT, may elect to retain and pay income tax on net long-term capital gains it received during the tax year. If a RIC makes this election, the RIC shareholders must include in their income as long-term capital gains their proportionate share of these undistributed long-term capital gains as designated by the RIC. The shareholder is deemed to have paid the shareholders share of the tax, which can be credited or refunded to the shareholder. Also, the basis of the shareholders shares is increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the RIC) included in the shareholders long-term capital gains.Income from foreclosure property

In addition to tax on its REITTI, a REIT is subject to tax at the highest rate of tax paid by corporations on its net income from foreclosure property (sec. 857(b)(4)). Net income from foreclosure property is the excess of the sum of gains from foreclosure property that is held for sale to customers in the ordinary course of a trade or business and gross income from foreclosure property (other than income that otherwise would qualify under the 75-percent income test described below) over all allowable deductions directly connected with the production of such income.

Foreclosure property is any real property or personal property incident to such real property that is acquired by a REIT as a result of default or imminent default on a lease of such property or indebtedness secured by such property, provided that (unless acquired as foreclosure property), such property was not held by the REIT for sale to customers (sec. 856(e)). A property generally may be treated as foreclosure property for a period of 2 years after the date the property is acquired by the REIT. The IRS may grant extensions of the period for treating the property as foreclosure property if the REIT establishes that an extension of the grace period is necessary for the orderly liquidation of the REITs interest in the property. The grace period cannot be extended beyond 6 years from the date the property is acquired by the REIT.

Property will cease to be treated as foreclosure property if, after 90 days after the date of acquisition, the REIT operates the foreclosure property in a trade or business other than through an independent contractor from whom the REIT does not derive or receive any income (sec. 856(e)(4)(C)).Income or loss from prohibited transactions

In general, a REIT must derive its income from passive sources and not engage in any active trade or business. Accordingly, in addition to the tax on its REITTI and on its net income from foreclosure property, a 100 percent tax is imposed on the net income of a REIT from "prohibited transactions" (sec. 857(b)(6)). A prohibited transaction is the sale or other disposition of property described in section 1221(1) of the code (property held for sale in the ordinary course of a trade or business) other than foreclosure property. Thus, the 100 percent tax on prohibited transactions helps to ensure that the REIT is a passive entity and may not engage in ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project. A safe harbor is provided for certain sales that otherwise might be considered prohibited transactions (sec. 857(b)(6)(C)). The safe harbor is limited to seven or fewer sales a year or, alternatively, any number of sales provided that the aggregate adjusted basis of the property sold does not exceed 10 percent of the aggregate basis of all the REITs assets at the beginning of the REITs taxable year.Requirements for REIT Status

A REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. These tests are intended to allow conduit treatment in circumstances in which a corporate tax otherwise would be imposed, only if there really is a pooling of investment arrangement that is evidenced by its organizational structure, if its investments are basically in real estate assets, and if its income is passive income from real estate investment, as contrasted with income from the operation of business involving real estate. In addition, substantially all of the entitys income must be passed through to its shareholders on a current basis.Organizational structure requirements

To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees (sec. 856(a)). The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership. Except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons, and the entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income. A REIT is disqualified for any year in which it does not comply with regulations to ascertain the actual ownership of the REITs outstanding shares.Income requirementsOverview

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the "95-percent test"). In addition, at least 75 percent of its income generally must be from certain real estate sources (the "75-percent test"), including rents from real property.

In addition, less than 30 percent of the entitys gross income may be derived from gain from the sale or other disposition of stock or securities held for less than 1 year, real property held less than 4 years (other than foreclosure property, or property subject to an involuntary conversion within the meaning of sec. 1033), and property that is sold or disposed of in a prohibited transaction (sec. 856(c)(4)).Definition of rents

For purposes of the income requirements, rents from real property generally include rents from interests in real property, charges for services customarily rendered or furnished in connection with the rental of real property, whether or not such charges are separately stated, and rent attributable to personal property that is leased under or in connection with a lease of real property, but only if the rent attributable to such personal property does not exceed 15 percent of the total rent for the year under the lease (sec. 856(d)(1)).

Services provided to tenants are regarded as customary if, in the geographic market within which the building is located, tenants in buildings that are of a similar class (for example, luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance, and of janitorial and cleaning services, the collection of trash, the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard service, parking facilities and swimming pool facilities are examples of services that are customarily furnished to tenants of a particular class of buildings in many geographical marketing areas (Treas. Reg. sec. 1.856094(b)).

In addition, amounts are not treated as qualifying rent if received from certain parties in which the REIT has an ownership interest of 10 percent or more (sec. 856(d)(2)(B)). For purposes of determining the REITs ownership interest in a tenant, the attribution rules of section 318 apply, except that 10 percent is substituted for 50 percent where it appears in subparagraph (C) of section 318(a)(2) and 318(a)(3) (sec. 856(d)(5)).

Finally, where a REIT furnishes or renders services to the tenants of rented property, amounts received or accrued with respect to such property generally are not treated as qualifying rents unless the services are furnished through an independent contractor (sec. 856(d)(2)(C)). A REIT may furnish or render a service directly, however, if the service would not generate unrelated business taxable income under section 512(b)(3) if provided by an organization described in section 511(a)(2). In general, an independent contractor is a person who does not own more than a 35 percent interest in the REIT, and in which no more than a 35 percent interest is held by persons with a 35 percent or greater interest in the REIT (sec. 856(d)(3)).Hedging instruments

Interest rate swaps or cap agreements that protect a REIT from interest rate fluctuations on variable rate debt incurred to acquire or carry real property are treated as securities under the 30-percent test and payments under these agreements are treated as qualifying under the 95-percent test (sec. 856(c)(6)(G)).Treatment of shared appreciation mortgages

For purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transaction provisions, any income derived from a "shared appreciation provision" is treated as gain recognized on the sale of the "secured property." For these purposes, a shared appreciation provision is any provision that is in connection with an obligation that is held by the REIT and secured by an interest in real property, which provision entitles the REIT to receive a specified portion of any gain realized on the sale or exchange of such real property (or of any gain that would be realized if the property were sold on a specified date). Secured property for these purposes means the real property that secures the obligation that has the shared appreciation provision.

In addition, for purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transactions provisions, the REIT is treated as holding the secured property for the period during which it held the shared appreciation provision (or, if shorter, the period during which the secured property was held by the person holding such property), and the secured property is treated as property described in section 1221(1) if it is such property in the hands of the obligor on the obligation to which the shared appreciation provision relates (or if it would be such property if held by the REIT). For purposes of the prohibited transaction safe harbor, the REIT is treated as having sold the secured property at the time that it recognizes income on account of the shared appreciation provision, and any expenditures made by the holder of the secured property are treated as made by the REIT.Asset requirements

To satisfy the asset requirements to qualify for treatment as a REIT, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and government securities (sec. 856(c)(5)(A)). Moreover, not more than 25 percent of the value of the entitys assets can be invested in securities of any one issuer (other than government securities and other securities described in the preceding sentence). Further, these securities may not comprise more than 5 percent of the entitys assets or more than 10 percent of the outstanding voting securities of such issuer (sec. 856(c)(5)(B)). The term real estate assets is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs (sec. 856(c)(6)(B)).REIT subsidiaries

Under present law, all the assets, liabilities, and items of income, deduction, and credit of a "qualified REIT subsidiary" are treated as the assets, liabilities, and respective items of the REIT that owns the stock of the qualified REIT subsidiary. A subsidiary of a REIT is a qualified REIT subsidiary if and only if 100 percent of the subsidiarys stock is owned by the REIT at all times that the subsidiary is in existence. If at any time the REIT ceases to own 100 percent of the stock of the subsidiary, or if the REIT ceases to qualify for (or revokes an election of) REIT status, such subsidiary is treated as a new corporation that acquired all of its assets in exchange for its stock (and assumption of liabilities) immediately before the time that the REIT ceased to own 100 percent of the subsidiarys stock, or ceased to be a REIT as the case may be.Distribution requirements

To satisfy the distribution requirement, a REIT must distribute as dividends to its shareholders during the taxable year an amount equal to or exceeding (i) the sum of 95 percent of its REITTI other than net capital gain income and 95 percent of the excess of its net income from foreclosure property over the tax imposed on that income minus (ii) certain excess noncash income (described below).

Excess noncash items include (a) the excess of the amounts that the REIT is required to include in income under section 467 with respect to certain rental agreements involving deferred rents, over the amounts that the REIT otherwise would recognize under its regular method of accounting, second, in the case of a REIT using the cash method of accounting, the excess of the amount of original issue discount and coupon interest that the REIT is required to take into account with respect to a loan to which section 1274 applies, over the amount of money and fair market value of other property received with respect to the loan, and third, income arising from the disposition of a real estate asset in certain transactions that failed to qualify as like-kind exchanges under section 1031.Reasons for Change

The REIT serves as a means whereby numerous small investors can have a practical opportunity to invest in a diversified portfolio of real estate assets and have the benefit of professional management. The committee believes that the asset requirements of present law ensure that a REIT acts as a pass-through entity for taxpayers wishing to invest in real estate. Therefore, the committee finds the 30-percent gross income test unnecessary and administratively burdensome. The committee further finds that financial markets have changed over the past decade such that interest risk can be managed by many strategies other than swaps and caps. Recognizing these developments in the financial markets, the committee believes it necessary to modify the classification of income from certain hedging instruments to provide flexibility to REITs in managing risk for their shareholders. The committee also believes that, as a pass-through entity, REITs should be permitted to retain the proceeds of realized capital gains in a manner comparable to that accorded to RICs.Explanation of ProvisionOverview

The bill modifies many of the provisions relating to the requirements for qualification as, and the taxation of, a REIT. In particular, the modifications relate to the general requirements for qualification as a REIT, the taxation of a REIT, the income requirements for qualification as a REIT, and certain other provisions.Election to be treated as a REIT

The bill changes the ordering rule for purposes of the requirement that newly-electing REITs distribute earnings and profits that were accumulated in non-REIT years. Under the provision, distributions of accumulated earnings and profits generally would be treated as made from the entitys earliest accumulated earnings and profits, rather than the most recently accumulated earnings and profits. These distributions would not be treated as distributions for purposes of calculating the dividends paid deduction.Taxation of REITsCapital gains

The bill permits a REIT to elect to retain and pay income tax on net long-term capital gains it received during the tax year, just as a RIC is permitted under present law. Thus, if a REIT made this election, the REIT shareholders would include in their income as long-term capital gains their proportionate share of the undistributed long-term capital gains as designated by the REIT. The shareholder would be deemed to have paid the shareholders share of the tax, which could be credited or refunded to the shareholder. Also, the basis of the shareholders shares would be increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the REIT) included in the shareholders long-term capital gains.Income from foreclosure property

The bill lengthens the original grace period for foreclosure property until the last day of the third full taxable year following the election. The grace period also could be extended for an additional 3 years by filing a request to the IRS. Under the bill, a REIT could revoke an election to treat property as foreclosure property for any taxable year by filing a revocation on or before its due date for filing its tax return.

In addition, the bill conforms the definition of independent contractor for purposes of the foreclosure property rule (sec. 856(e)(4)(C)) to the definition of independent contractor for purposes of the general rules (sec. 856(d)(2)(C)).Income or loss from prohibited transactions

The bill also excludes from the prohibited sales rules property that was involuntarily converted.Organizational structure requirements

The bill replaces the rule that disqualifies a REIT for any year in which the REIT failed to comply with regulations to ascertain its ownership, with an intermediate penalty for failing to do so. The penalty would be $25,000 ($50,000 for intentional violations) for any year in which the REIT did not comply with the ownership regulations. The REIT also would be required, when requested by the IRS, to send curative demand letters.

In addition, a REIT that complied with the regulations for ascertaining its ownership, and which did not know, or have reason to know, that it was so closely held as to be classified as a personal holding company, would not be treated as a personal holding company.Income requirementsOverview

The bill repeals the rule that requires less than 30 percent of a REITs gross income be derived from gain from the sale or other disposition of stock or securities held for less than 1 year, certain real property held less than 4 years, and property that is sold or disposed of in a prohibited transaction.Definition of rents

The bill permits a REIT to render a de minimis amount of impermissible services to tenants, or in connection with the management of property, and still treat amounts received with respect to that property as rent. The value of the impermissible services could not exceed 1 percent of the gross income from the property. For these purposes, the services could not be valued at less than 150 percent of the REITs direct cost of the services.

In addition, the bill modifies the application of section 318(a)(3)(A) (attribution to partnerships) for purposes of defining rent in section 856(d)(2), so that attribution would occur only when a partner owns a 25 percent or greater interest in the partnership.Hedging instruments

The bill treats income from all hedges that reduce the interest rate risk of REIT liabilities, not just from interest rate swaps and caps, as qualifying income under the 95-percent test. Thus, payments to a REIT under an interest rate swap, cap agreement, option, futures contract, forward rate agreement or any similar financial instrument entered into by the REIT to hedge its indebtedness incurred or to be incurred (and any gain from the sale or other disposition of these instruments) would be treated as qualifying income for purposes of the 95-percent test.Asset requirementsREIT subsidiaries

The bill permits any wholly-owned corporation of a REIT to be treated as a qualified subsidiary, regardless of whether the corporation had always been owned by the REIT. The bill treats any such subsidiary as being liquidated as of the time of acquisition by the REIT and then reincorporated (thus, any of the subsidiarys pre-REIT built-in gain would be subject to tax under the normal rules of section 337). In addition, any pre-REIT earnings and profits of the subsidiary must be distributed before the end of the REITs taxable year.Distribution requirements

The bill first, expands the class of excess noncash items to include income from the cancellation of indebtedness and second, extends the treatment of original issue discount and coupon interest as excess noncash items to REITs that use an accrual method of taxation.Effective Date

The provisions are effective for taxable years beginning after the date of enactment. C. Accounting Provisions1. Modifications to the look-back method for long-term contracts (sec. 14551 of the bill and sec. 460 of the code) Present Law

Taxpayers engaged in the production of property under a long-term contract generally must compute income from the contract under the percentage of completion method. Under the percentage of completion method, a taxpayer must include in gross income for any taxable year an amount that is based on the product of first, the gross contract price and second, the percentage of the contract completed as of the end of the year. The percentage of the contract completed as of the end of the year is determined by comparing costs incurred with respect to the contract as of the end of the year with estimated total contract costs.

Because the percentage of completion method relies upon estimated, rather than actual, contract price and costs to determine gross income for any taxable year, a "look-back method" is applied in the year a contract is completed in order to compensate the taxpayer (or the Internal Revenue Service) for the acceleration (or deferral) of taxes paid over the contract term. The first step of the look-back method is to reapply the percentage of completion method using actual contract price and costs rather than estimated contract price and costs. The second step generally requires the taxpayer to recompute its tax liability for each year of the contract using gross income as reallocated under the look-back method. If there is any difference between the recomputed tax liability and the tax liability as previously determined for a year, such difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily. The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments.

 146 146 1AThe overpayment rate equals the applicable Federal short-term rate plus 2 percentage points. This rate is adjusted quarterly by the IRS. Thus, in applying the look-back method for a contract year, a taxpayer may be required to use five different interest rates.

The look-back method must be reapplied for any item of income or cost that is properly taken into account after the completion of the contract.

The look-back method does not apply to any contract that is completed within two taxable years of the contract commencement date and if the gross contract price does not exceed the lesser of first, $1 million or second, 1 percent of the average gross receipts of the taxpayer for the preceding 3 taxable years. In addition, a simplified look-back method is available to certain pass-through entities and, pursuant to Treasury regulations, to certain other taxpayers. Under the simplified look-back method, the hypothetical underpayment or overpayment of tax for a contract year generally is determined by applying the highest rate of tax applicable to such taxpayer to the change in gross income as recomputed under the look-back method. Reasons for Change

Present law may require multiple applications of the look-back method with respect to a single contract or may otherwise subject contracts to the look-back method even though amounts necessitating the look-back calculations are de minimis relative to the aggregate contract income. In addition, the use of multiple interest rates complicates the mechanics of the look-back calculation. The committee wishes to address these concerns. Explanation of ProvisionElection not to apply the look-back method for de minimis amounts

The provision provides that a taxpayer may elect not to apply the look-back method with respect to a long-term contract if for each prior contract year, the cumulative taxable income (or loss) under the contract as determined using estimated contract price and costs is within 10 percent of the cumulative taxable income (or loss) as determined using actual contract price and costs.

Thus, under the election, upon completion of a long-term contract, a taxpayer would be required to apply the first step of the look-back method (the reallocation of gross income using actual, rather than estimated, contract price and costs), but is not required to apply the additional steps of the look-back method if the application of the first step resulted in de minimis changes to the amount of income previously taken into account for each prior contract year.

The election applies to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 1. A taxpayer enters into a 3-year contract and upon completion of the contract, determines that annual net income under the contract using actual contract price and costs is $100,000, $150,000, and $250,000, respectively, for years 1, 2, and 3 under the percentage of completion method. An electing taxpayer need not apply the look-back method to the contract if it had reported cumulative net taxable income under the contract using estimated contract price and costs of between $90,000 and $110,000 as of the end of year 1; and between $225,000 and $275,000 as of the end of year 2.Election not to reapply the look-back method

The provision provides that a taxpayer may elect not to reapply the look-back method with respect to a contract if, as of the close of any taxable year after the year the contract is completed, the cumulative taxable income (or loss) under the contract is within 10 percent of the cumulative look-back income (or loss) as of the close of the most recent year in which the look-back method was applied (or would have applied but for the other de minimis exception described above). In applying this rule, amounts that are taken into account after completion of the contract are not discounted.

Thus, an electing taxpayer need not apply or reapply the look-back method if amounts that are taken into account after the completion of the contract are de minimis.

The election applies to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 2. A taxpayer enters into a 3-year contract and reports taxable income of $12,250, $15,000 and $12,750, respectively, for years 1 through 3 with respect to the contract. Upon completion of the contract, cumulative look-back income with respect to the contract is $40,000, and 10 percent of such amount is $4,000. After the completion of the contract, the taxpayer incurs additional costs of $2,500 in each of the next three succeeding years (years 4, 5, and 6) with respect to the contract. Under the provision, an electing taxpayer does not reapply the look-back method for year 4 because the cumulative amount of contract taxable income ($37,500) is within 10 percent of contract look-back income as of the completion of the contract ($40,000). However, the look-back method must be applied for year 5 because the cumulative amount of contract taxable income ($35,000) is not within 10 percent of contract look-back income as of the completion of the contract ($40,000). Finally, the taxpayer does not reapply the look-back method for year 6 because the cumulative amount of contract taxable income ($32,500) is within 10 percent of contract look-back income as of the last application of the look-back method ($35,000).Interest rates used for purposes of the look-back method

The provision provides that for purposes of the look-back method, only one rate of interest is to apply for each accrual period. An accrual period with respect to a taxable year begins on the day after the return due date (determined without regard to extensions) for the taxable year and ends on such return due date for the following taxable year. The applicable rate of interest is the overpayment rate in effect for the calendar quarter in which the accrual period begins. Effective Date

The provision applies to contracts completed in taxable years ending after the date of enactment.2. Application of mark to market accounting method to traders in securities (sec. 14552 of the bill and sec. 475 of the code) Present LawMethods of accounting, in general

In general, a taxpayer must compute its taxable income under a method of accounting on the basis of which the taxpayer regularly keeps its books so long as, in the opinion of the Secretary of the Treasury, such method clearly reflects the taxpayers income. A taxpayer may change its method of accounting with the consent of the Secretary. Dealers in securities

A dealer in securities must compute its income pursuant to a "mark-to-market" method of accounting prescribed by section 475. Under section 475, any security that is inventory in the hands of a dealer must be included in inventory at its fair market value and any security that is not inventory in the hands of a dealer and that is held at year end shall be treated as sold for its fair market value. For this purpose, a "dealer in securities" is any person who first, regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or second, regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. For this purpose, "security" means any stock in a corporation; any partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; any note, bond, debenture, or other evidence of indebtedness; any interest rate, currency or equity notional principal contract; any evidence of an interest in, or a derivative financial instrument of, any security described above; and any position identified as a hedge of any of the above (other than a section 1256(a) contract). Section 475 generally does not apply to any security identified as held for investment (or a hedge of such security). Any gain or loss taken into account under section 475 generally is treated as ordinary gain or loss (sec. 475(d)(3)).Traders in securities

Traders in securities generally are taxpayers who derive their income principally from the active sale or exchange of securities on the market (rather than to customers, as in the case of a dealer in securities). Section 475 does not explicitly apply to traders in securities. In fact, there are no specific statutory provisions that mandate the use of an overall method of accounting by traders.5147 Thus, traders generally account for gains and losses on trading securities when the securities are sold, rather than marking the securities to market, for Federal income tax purposes.

 147 1AHowever, under section 1256 certain regulated futures contracts, foreign currency contracts, and nonequity options of traders must be marked to market for Federal income tax purposes.Reasons for Change

The committee believes that in certain instances the mark-to-market method of accounting more accurately reflects the income of a trader in securities and that it may be appropriate to extend the use of that method in those cases. The committee believes, at this time, that the determination of whether the mark-to-market method of accounting is appropriate for a particular trader in securities should be made on a case-by-case basis, subject to the discretion of the Secretary of the Treasury.Explanation of Provision

The provision provides that a trader in securities may, with the consent of the Secretary of the Treasury, elect to change its method of accounting to adopt a mark-to-market method for its trading activities. Such method may be based on the provisions of present-law section 475, modified to clearly reflect the income of the taxpayer. The adoption of a mark-to-market method of accounting may not change the character of the gain or loss with respect to the securities (i.e., sec. 475(d)(3) could not apply). In determining whether a trader should be allowed to adopt a mark-to-market method of accounting, the Secretary shall take into account all relevant facts and circumstances, including transaction entered into, and accounting methods used, by parties related to the trader. As under present law, the accounting method change is subject to such conditions and procedures as the Secretary of the Treasury may prescribe. In addition, the Secretary may prescribe conditions and procedures under which a taxpayer may adopt a mark-to-market method of accounting without first seeking the consent of the Secretary. For this purpose, a trader in securities is a taxpayer who is actively engaged in trading securities.

No inference is intended whether the Secretary of the Treasury has the authority under present law to allow taxpayers that are not dealers in securities to use a mark-to-market method of accounting. Effective Date

The provision is effective for taxable years ending on or after December 31, 1995.3. Modification of ruling amounts for nuclear decommissioning costs (sec. 14553 of the bill and sec. 468A of the code)Present Law

Under the economic performance rules, a deduction for accrual basis taxpayers generally is deferred until there is economic performance for the item for which the deduction is claimed (sec. 461(h)). Present law contains an exception to the economic performance rules under which a taxpayer responsible for nuclear power plant decommissioning may elect to deduct contributions made to a qualified nuclear decommissioning fund (sec. 468A).5148 Taxpayers who do not elect this provision are subject to the general economic performance rules.

 148 1AAs originally enacted in 1984, the fund paid tax on its earnings at the top corporate rate and, as a result, there would be no present value tax benefit of making deductible contributions to the fund. Also, as originally enacted, the funds in the trust could be invested only in certain relatively safe investments. Subsequent amendments to the provision have reduced the rate of tax on the fund to 20 percent and removed the restrictions on the types of permitted investment that the fund can make.

A qualified decommissioning fund is a segregated fund established by the taxpayer that is used exclusively for the payment of decommissioning costs, taxes on fund income, payment of management costs of the fund, and investment in certain types of investments. The fund is prohibited from dealing with the taxpayer that established the fund.

Contributions to the fund are deductible in the year made to the extent that these amounts were collected as part of the cost of service to ratepayers. Withdrawals of funds by the taxpayer to pay for decommissioning expenses are included in income at that time, but the taxpayer also is entitled to a deduction at that time for decommissioning expenses as economic performance for those costs occurs.

In order to prevent accumulations of funds over the remaining life of the plant in excess of those required to pay future decommissioning costs and to ensure that contributions to the funds are not deducted more rapidly than level funding, taxpayers are required to obtain a ruling from the IRS to establish the maximum contribution that may be made to the fund. The IRS is directed to review the ruling amount at least once during the plants life, but may do so more frequently at the request of the taxpayer. The existing Treasury regulations provide that there is one required request per reactor, even where there are sites on which there are multiple reactors. Changes in the initial ruling amount may be warranted as a result of changes in the estimated cost of decommissioning a reactor, changes to the investment return on assets held in the fund, or changes brought about by ratemaking orders. Taxpayers are required to obtain subsequent rulings to reflect changes in the ruling amount in certain instances (Treas. reg. sec. 1.468A093(i)).

If the decommissioning fund fails to comply with the qualification requirements, or when the decommissioning is substantially completed, the funds qualification may be terminated in which case the amounts in the fund must be included in the income of the taxpayer.Reasons for Change

The committee believes that it is appropriate to require a taxpayer to obtain an initial ruling from the IRS in order to determine the maximum deduction that can be obtained for contributions to a nuclear decommissioning fund. However, the committee also believes that it is burdensome for the taxpayer to obtain subsequent rulings whenever the underlying facts change so that the initial ruling amount is no longer appropriate, so long as the new ruling amount can be readily determined by the application of a method or formula set out in the initial ruling to the new facts.Explanation of Provision

The provision deletes the requirement that a taxpayer obtain certain rulings from the IRS in order to deduct contributions to a nuclear decommissioning fund. Under the provision, a taxpayer is required to obtain an initial ruling to determine its maximum deduction for contributions to a fund, but is not required to obtain subsequent rulings if such amounts are not substantially modified. The taxpayer is required to notify the Secretary of the Treasury if the ruling amount is modified. The Secretary of the Treasury is expected to issue appropriate guidance as to what constitutes a substantial modification under the provision and how the taxpayer is to inform the Secretary that the ruling amount has been modified.Effective Date

The provision applies to modifications after the date of enactment4. Election of alternative taxable years by partnerships and S corporations (sec. 14554 of the bill and sec. 444 and new sec. 6654A of the code)Present Law

The taxable income of a partnership or an S corporation (a "flow-thru entity") generally is reported by the partnerships partners or the corporations shareholders (the "owners") in the taxable year within which the taxable year of the flow-thru entity ends. As a result, if a flow-thru entity uses a taxable year that is the same as the taxable year of its owners, the owners will report income earned by the entity in the year that the income is earned. If a flow-thru entity uses a taxable year that is different than the taxable year of its owners, the owners will defer reporting a portion of the income earned by the entity until the year following the year the income was earned.5149 Thus, in order to avoid this deferral, under present law, a flow-through entity generally must use a taxable year that corresponds to the taxable years of its owners (i.e., generally, the calendar year in the case of an entity owned by individuals).

 149 1AFor example, assume that an individual using a calendar year wholly owns the stock of an S corporation using a fiscal year ending January 31. If for its fiscal year beginning February 1, 1994, and ending January 31, 1995, the corporation earned $1,000 a month, the individual would report the $12,000 of aggregate corporate in his calendar year ending December 31, 1995, even though $11,000 had been earned by the corporation during 1994.

However, under certain circumstances, deferral through use of a fiscal year is permitted (sec. 444). A flow-thru entity may use a fiscal year that it used prior to 1987 or a fiscal year that provides up to a 3-month deferral so long as it makes a payment equal to the income attributable to the deferral period times the highest individual tax rate plus 1 percentage point (currently, 40.6 percent). Such payments remain on deposit and may be refunded if the income of the entity for the deferral period diminishes or the entity abandons its fiscal year (sec. 7519). Under Treasury regulations, the 3-month deferral rule and the payment rule described above are not required for a fiscal year for which the entity establishes a business purpose to the satisfaction of the IRS (Treas. Reg. sec. 1.444091T(a)(3)(i)).

The due date for the tax return of a partnership is the 15th day of the 4th month following the taxpayers yearend. The due date for the tax return of an S corporation is the 15th day of the 3d month following the taxpayers yearend. Reasons for Change

The committee believes there are valid business reasons for a flow-thru entity to use a fiscal year and, in such instances, the entity should be allowed to adopt such a year for Federal income tax purposes. On the other hand, the committee recognizes that the use of a fiscal year may provide owners of a flow-thru entity with an unwarranted deferral of the income generated by the entity.

The committee also believes the present-law provisions that allow the use of a fiscal year are limited in scope and, in certain circumstances, overly burdensome. As result, under present law, many flow-thru entities have adopted calendar years. The unextended due dates of the tax returns of calendar-year flow-thru entities and individuals all fall between March 15 and April 15 of the year, causing a workload compression for tax return preparers.

In balancing these concerns, the committee provides a new set of rules under which a flow-thru entity may adopt a fiscal year without providing its owners with the opportunity for significant tax deferral.Explanation of ProvisionEstimated tax payments by flow-thru entities

The provision allows any flow-thru entity to use a fiscal year so long as the entity makes quarterly estimated tax payments at an applicable rate. These estimated tax payments are treated as estimated tax payments of the owners of the flow-thru entity for the owners taxable year in which the fiscal year ends. Quarterly installments are due on the 15th day of the 3d, 5th, 8th, and 12th months of the taxable year. An election to make quarterly estimated tax payments must be made on or before the 15th day of the 3d month of the first taxable year of 12 months under the election. Such election generally remains in effect until first, it is revoked by owners of more than half of the equity interests of the entity, second, there is a termination of the partnership or the subchapter S election of the corporation, or third, the entity becomes part of a tiered structure of entities with different fiscal years. An entity is not allowed to re-elect, without the consent of the Secretary of the Treasury, the application of the provision until 5 years after the termination of an election. Estimated tax payments are not required for a taxable year if the amount of aggregate payments otherwise due is $5,000 or less.

In determining its estimated tax payments for a taxable year, the flow-thru entity uses an applicable rate of 34 percent, unless the flow-thru entity is a "high income average entity," in which case the applicable rate is 39.6 percent. A "high average income entity" is one where the average applicable income of the 2-percent owners for the base year was at least $250,000 or, in the case of a partnership, the applicable income for the base year was at least $10,000,000. For this purpose, a "2-percent owner" is first, in the case of a partnership, any person who owns (or is considered as owning within the meaning of the attribution rules of sec. 318) on any day during the base year more than 2 percent of the capital interest of the partnership, and second, in the case of an S corporation, any shareholder who owns (or is considered as owning within the meaning of the attribution rules of sec. 318) on any day of the taxable year more than 2 percent of the outstanding stock of the corporation or more than 2 percent of the outstanding voting stock of the corporation. The base year is the most recent prior taxable year containing 12 months.

In determining its quarterly estimated tax payments, the entity may use first, the 100-percent method, second, the 110-percent method, or third, the annualization method. Under the 100-percent method, the required quarterly installment is one-quarter of the product of the entitys applicable income for the current year and the applicable rate. Under the 110-percent method, the required quarterly installment is one-quarter of 110 percent of the product of the entitys applicable income for the base year and the applicable rate. The 110-percent method is not available if the entitys current year applicable income exceeds its base year applicable income by more than $750,000, or if the entity fails to elect such method before the due date of the first quarterly installment. Once elected, the 110-percent method must be used for the entire taxable year. Under the annualization method, the required quarterly installment is one-quarter of the product of the entitys annualized applicable income and the applicable rate. The amount of the quarterly installment may be increased or decreased to the extent prior installments were overpaid or underpaid under the annualization method. The entity may elect the annualization method for any quarter on or before the due date for such quarter and once selected, must be applied for the remainder of the taxable year.

For this purpose, "applicable income" is determined by taking the entitys items into account under subchapter K or S, as the case may be, with the following adjustments: First, charitable contributions are deducted, second, foreign taxes are deducted rather than credited, third, various limitations determined at the partner or shareholder level are disregarded, fourth, guaranteed payments to partners are not deductible; and fifth, no deduction is allowed for disproportionate deferral period applicable payments. For this purpose, "disproportionate deferral period applicable payments" means the excess (if any) of: First, the product of the deferral ratio and the aggregate applicable payments made to owners during the taxable year over second, the aggregate applicable payments made to owners during the deferral period. For this purpose, first, "applicable payments" means amounts paid by the entity that are includible in the income of the owner (except for gains on the sale of property between the entity and the owner or dividends paid by an S corporation), second, "deferral period" means the months in the period beginning with the first day of the entitys taxable year and ending on December 31, and third, "deferral ratio" means the ratio of the number of months in the deferral period to the number of months in the taxable year.

If, by reason of the election, the entity has a short taxable year (i.e., a taxable year of less than 12 months), the entity is required to make an additional estimated tax payment on or before the due date of the election. Such additional tax payment is determined and treated in a manner similar to the determination and treatment of other estimated tax payments under the provision. Any net operating loss arising in such short year is spread ratably over 3 taxable years, beginning with the short year (unless the entity is a new entity).Underpayments of estimated tax

If a flow-thru entity has an underpayment of estimated tax under the provision, the entity is subject to an addition to tax determined by applying the underpayment rate established under section 6621 to the amount of the underpayment over the period of the underpayment. The period of the underpayment runs from the due date of the installment until the earlier of the date the entity pays the underpayment or the first April 15 more than 3 months after the close of the entitys taxable year. In addition, if, on the first April 15 more than 3 months after the close of the entitys taxable year, the entity has an underpayment of estimated tax, and the aggregate deposits made by the entity are less than the aggregate amount of allocable shares of estimated tax shown on the entitys return for the year, such shortfall is treated as a tax on the entity due on such April 15 (unless the owners had paid such shortfall). If the entity has an excess of deposits, such excess is treated as an overpayment of tax by the entity.Credit to owners for estimated tax

The estimated tax payments paid by a flow-thru entity are treated as estimated tax payments of the owners of the entity for the owners taxable years in which the fiscal year ends. An owners allocable share of estimated tax paid by a flow-thru entity is determined by applying first, the ratio of (a) the owners applicable income for the year to (b) the aggregate applicable income for all owners for the year to second, the aggregate estimated tax payments made by the entity during the taxable year. In the case of an entity that uses the annualization method, this determination is made on a quarterly basis.

An owner generally treats the estimated tax credit as being incurred ratably throughout the owners taxable year. However, if the flow-thru entity uses the annualization method for any quarter, the estimated tax credit is deemed to flow through to the owner in the same pattern as such payments were made by the flow-thru entity. The estimated tax payments of the flow-thru entity that are allocable to an owner of the entity will be treated as distributions to the owner at the times the entity makes the estimated tax payments.Treatment of current elections

A flow-thru entity is not allowed to make a new election under present-law section 444. An entity that currently has a section 444 election in effect may first, retain the election or second, revoke the election and receive a refund of its deposit, or third, make a new section 444 election and treat its deposit as a payment of estimated tax under the provision.Effective Date

The provision is effective for taxable years beginning after December 31, 1996.5. Special rule for crop insurance proceeds and disaster payments (sec. 14555 of the bill and sec. 451 of the code)Present Law

A taxpayer engaged in a farming business generally may use the cash receipts and disbursements method of accounting ("cash method") to report taxable income. A cash method taxpayer generally recognizes income in the taxable year in which cash is received, regardless of when the economic events that give rise to such income occur. Under a special rule (sec. 451(d) of the Internal Revenue Code), in the case of insurance proceeds received as a result of destruction or damage to crops, a cash method taxpayer may elect to defer the income recognition of the proceeds until the taxable year following the year of the destruction or damage, if the taxpayer establishes that under his practice, income from such crops would have been reported in a following taxable year. For this purpose, certain payments received under the Agricultural Act of 1949, as amended, or title II of the Disaster Assistance Act of 1988, are treated as insurance proceeds received as a result of destruction or damage to crops.Reasons for Change

The committee is aware of situations where calendar-year, cash-method farmers have received insurance proceeds or disaster assistance payments in one taxable year relating to the destruction of crops in a prior taxable year, where the income from such crop normally would have been reported in such prior year. The receipt of these payments in the subsequent year along with the recognition of the income from crops harvested or sold in that year will result in a "bunching" of income. This bunching of income may result in the loss of itemized deductions in the year of the disaster, a higher marginal income tax rate in the subsequent year, and the loss of several AGI-based deductions and exemptions in the subsequent year. The committee believes that it is appropriate to allow taxpayers to accelerate the recognition of insurance and disaster assistance payments in these and similar cases so that taxpayers may more closely replicate the tax effects that would have occurred had the destroyed crop been sold in the normal course of business.Explanation of Provision

The provision amends the special rule of section 451(d) to allow a cash method taxpayer to elect to accelerate (or defer) the recognition of certain disaster-related payments if the taxpayer establishes that, under the taxpayers practice, income from the crops lost in the disaster would have been reported in a prior (or the subsequent) taxable year. The provision expands the payments for which these elections are available to include disaster assistance received as a result of destruction or damage to crops caused by drought, flood, or other natural disaster, or the inability to plant crops because of such a disaster, under any Federal law (rather than only payments received under the Agricultural Act of 1949, as amended, or title II of the Disaster Assistance Act of 1988).

Thus, for example, the provision allows a calendar-year, cash-method taxpayer who has received disaster assistance payments in 1997 relating to the destruction of crops by a flood in 1996 to elect to treat such payments as received in 1996, so long as the taxpayer establishes that, under the taxpayers practice, income from such crops would have been reported in 1996. Effective Date

The provision is effective for payments received after December 31, 1995, as a result of destruction or damage occurring after such date. D. Tax-Exempt Bond ProvisionsOverview

Interest on State and local government bonds generally is excluded from gross income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units (code sec. 103).

Unlike the interest on governmental bonds, described above, interest on private activity bonds generally is taxable. A private activity bond is a bond issued by a State or local governmental unit acting as a conduit to provide financing for private parties in a manner violating either first, a private business use and payment test or second, a private loan restriction. However, interest on private activity bonds is not taxable if first, the financed activity is specified in the code and second, at least 95 percent of the net proceeds of the bond issue is used to finance the specified activity.

Issuers of State and local government bonds must satisfy numerous other requirements, including arbitrage restrictions (for all such bonds) and annual State volume limitations (for most private activity bonds) for the interest on these bonds to be excluded from gross income.1. Repeal of $100,000 limitation on unspent proceeds under 1-year exception from rebate (sec. 14561 of the bill and sec. 148 of code)Present Law

Subject to limited exceptions, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. No rebate is required if the gross proceeds of an issue are spent for the governmental purpose of the borrowing within 6 months after issuance.

This 6-month exception is deemed to be satisfied by issuers of governmental bonds (other than tax and revenue anticipation notes) and qualified 501(c)(3) bonds if first, all proceeds other than an amount not exceeding the lesser of 5 percent or $100,000 are so spent within 6 months and second, the remaining proceeds are spent within 1 year after the bonds are issued.Reasons for Change

Exemption of interest paid on State and local bonds from Federal income tax provides an implicit subsidy to State and local governments for their borrowing costs. The principal Federal policy concern underlying the arbitrage rebate requirement is to discourage the earlier and larger than necessary issuance of tax-exempt bonds to take advantage of the opportunity to profit by investing funds borrowed at low-cost tax-exempt rates in higher yielding taxable investments. If at least 95 percent of the proceeds of an issue is spent within 6 months, and the remainder is spent within 1 year, opportunities for such arbitrage profit are significantly limited.Explanation of Provision

The $100,000 limit on proceeds that may remain unspent after 6 months for certain governmental and qualified 501(c)(3) bonds otherwise exempt from the rebate requirement is deleted. Thus, if at least 95 percent of the proceeds of these bonds is spent within 6 months after their issuance, and the remainder is spent within 1 year, the 6-month exception is deemed to be satisfied.Effective Date

The provision applies to bonds issued after the date of enactment.2. Exception from rebate for earnings on bona fide debt service fund under construction bond rules (sec. 14562 of the bill and sec. 148 of the code)Present Law

In general, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. An exception is provided for certain construction bond issues if the bonds are governmental bonds, qualified 501(c)(3) bonds, or exempt-facility private activity bonds for governmentally-owned property.

This exception is satisfied only if the available construction proceeds of the issue are spent at minimum specified rates during the 24-month period after the bonds are issued. The exception does not apply to bond proceeds invested after the 24-month expenditure period as part of a reasonably required reserve or replacement fund, a bona fide debt service fund, or to certain other investments (e.g., sinking funds). Issuers of these construction bonds also may elect to comply with a penalty regime in lieu of rebating arbitrage profits if they fail to satisfy the exceptions spending requirements.Reasons for Change

Bond proceeds invested in a bona fide debt service fund generally must be spent at least annually for current debt service. The short-term nature of investments in such funds results in only limited potential for generating arbitrage profits. If the spending requirements of the 24-month rebate exception are satisfied, the administrative complexity of calculating rebate on these proceeds outweighs the other Federal policy concerns addressed by the rebate requirement.Explanation of Provision

The bill exempts earnings on bond proceeds invested in bona fide debt service funds from the arbitrage rebate requirement and the penalty requirement of the 24-month exception if the spending requirements of that exception are otherwise satisfied.Effective Date

The provision applies to bonds issued after the date of enactment.3. Repeal of debt service-based limitation on investment in certain nonpurpose investments (sec. 14563 of the bill and sec. 148 of the code)Present Law

Issuers of all tax-exempt bonds generally are subject to two sets of restrictions on investment of their bond proceeds to limit arbitrage profits. The first set requires that tax-exempt bond proceeds be invested at a yield that is not materially higher (generally defined as 0.125 percentage points) than the bond yield ("yield restrictions"). Exceptions are provided to this restriction for investments during any of several "temporary periods" pending use of the proceeds and, throughout the term of the issue, for proceeds invested as part of a reasonably required reserve or replacement fund or a "minor" portion of the issue proceeds.

Except for temporary periods and amounts held pending use to pay current debt service, present law also limits the amount of the proceeds of private activity bonds (other than qualified 501(c)(3) bonds) that may be invested at materially higher yields at any time during a bond year to 150 percent of the debt service for that bond year. This restriction affects primarily investments in reasonably required reserve or replacement funds. Present law further restricts the amount of proceeds from the sale of bonds that may be invested in these reserve funds to 10 percent of such proceeds.

The second set of restrictions requires generally that all arbitrage profits earned on investments unrelated to the governmental purpose of the borrowing be rebated to the Federal Government ("arbitrage rebate"). Arbitrage profits include all earnings (in excess of bond yield) derived from the investment of bond proceeds (and subsequent earnings on any such earnings).Reasons for Change

The 150-percent of debt service limit was enacted before enactment of the arbitrage rebate requirement and the ten-percent limit on the size of reasonably required reserve or replacement funds. It was intended to eliminate arbitrage-motivated activities available from investment of such reserve funds. Provided that comprehensive yield restriction and arbitrage rebate requirements and the present-law overall size limit on reserve funds are maintained, the 150-percent of debt service yield restriction limit is duplicative.Explanation of Provision

The bill repeals the 150-percent of debt service yield restriction.Effective Date

The provision applies to bonds issued after the date of enactment.4. Repeal of expired provisions (sec. 14564 of the bill and sec. 148 of the code)Present Law

Present law includes two special exceptions to the arbitrage rebate and pooled financing temporary period rules for certain qualified student loan bonds. These exceptions applied only to bonds issued before January 1, 1989.Explanation of Provision

These special exceptions are deleted as "deadwood."Effective Date

The provision applies to bonds issued after the date of enactment. It has no effect on bonds issued prior to the date of enactment. E. Insurance Provisions1. Treatment of certain insurance contracts on retired lives (sec. 14571 of the bill and sec. 817(d) of the code)Present Law

Life insurance companies are allowed a deduction for any net increase in reserves and are required to include in income any net decrease in reserves. The reserve of a life insurance company for any contract is the greater of the net surrender value of the contract or the reserve determined under Federally prescribed rules. In no event, however, may the amount of the reserve for tax purposes for any contract at any time exceed the amount of the reserve for annual statement purposes.

Special rules are provided in the case of a variable contract. Under these rules, the reserve for a variable contract is adjusted by first, subtracting any amount that has been added to the reserve by reason of appreciation in the value of assets underlying such contract, and second, adding any amount that has been subtracted from the reserve by reason of depreciation in the value of assets underlying such contract. In addition, the basis of each asset underlying a variable contract is adjusted for appreciation or depreciation to the extent the reserve is adjusted.

A variable contract generally is defined as any annuity or life insurance contract first, that provides for the allocation of all or part of the amounts received under the contract to an account that is segregated from the general asset accounts of the company, and second, under which, in the case of an annuity contract, the amounts paid in, or the amounts paid out, reflect the investment return and the market value of the segregated asset account, or, in the case of a life insurance contract, the amount of the death benefit (or the period of coverage) is adjusted on the basis of the investment return and the market value of the segregated asset account. A pension plan contract that is not a life, accident, or health, property, casualty, or liability insurance contract is treated as an annuity contract for purposes of this definition.Reasons for Change

The committee believes that certain contracts which provide insurance on retired lives should be treated as variable contracts in order to simplify the treatment of such contracts and to provide a more accurate measure of the income of life insurance companies with respect to such contracts.Explanation of Provision

The bill provides that a variable contract is to include a contract that provides for the funding of group term life or group accident and health insurance on retired lives if: First, the contract provides for the allocation of all or part of the amounts received under the contract to an account that is segregated from the general asset account of the company; and second, the amounts paid in, or the amounts paid out, under the contract reflect the investment return and the market value of the segregated asset account underlying the contract.

Thus, the reserve for such a contract is to be adjusted by first, subtracting any amount that has been added to the reserve by reason of appreciation in the value of assets underlying such contract, and second, adding any amount that has been subtracted from the reserve by reason of depreciation in the value of assets underlying such contract. In addition, the basis of each asset underlying the contract is to be adjusted for appreciation or depreciation to the extent that the reserve is adjusted.Effective Date

The provision applies to taxable years beginning after December 31, 1995.2. Treatment of modified guaranteed contracts (sec. 14572 of the bill and new sec. 817A of the code)Present Law

Life insurance companies are allowed a deduction for any net increase in reserves and are required to include in income any net decrease in reserves. The reserve of a life insurance company for any contract is the greater of the net surrender value of the contract or the reserve determined under Federally prescribed rules. The net surrender value of a contract is the cash surrender value reduced by any surrender penalty, except that any market value adjustment required on surrender is not taken into account. In no event, however, may the amount of the reserve for tax purposes for any contract at any time exceed the amount of the reserve for annual statement purposes.

In general, assets held for investment are treated as capital assets. Any gain or loss from the sale or exchange of a capital asset is treated as a capital gain or loss and is taken into account for the taxable year in which the asset is sold or exchanged.Reasons for Change

Life insurance companies have recently begun issuing annuity contracts, life insurance contracts, and pension plan contracts that provide for a guaranteed interest rate for a specified period of time and a market value adjustment in the event that the owner of the contract surrenders the contract for cash prior to the end of the guaranteed interest period. These contracts are commonly referred to as modified guaranteed contracts.

If the premium or other consideration received under a modified guaranteed contract is allocated to an account that is segregated from the general asset accounts of the life insurance company, then the reserve for the contract and the assets in the segregated account generally are required to be taken into account at market value for annual statement purposes. For Federal income tax purposes, the reserve for a modified guaranteed contract may reflect the market value adjustment, while the market fluctuations in the assets underlying the contract are not taken into account unless the assets are disposed of.

The committee considers it appropriate to conform the Federal income tax treatment of modified guaranteed contracts with the annual statement treatment of such contacts in order to simplify the accounting for such contracts and to provide a more accurate measure of the income of life insurance companies with respect to such contracts.Explanation of Provision

The bill generally applies a mark-to-market regime to assets held as part of a segregated account under a modified guaranteed contract issued by a life insurance company. Gain or loss with respect to such assets held as of the close of any taxable year are taken into account for that year (even though the assets have not been sold or exchanged),5150 and are treated as ordinary. If gain or loss is taken into account by reason of the mark-to-market requirement, then the amount of gain or loss subsequently realized as a result of sale, exchange, or other disposition of the asset, or as a result of the application of the mark-to-market requirement is appropriately adjusted to reflect such gain or loss. In addition, the reserve for a modified guaranteed contract is determined by taking into account the market value adjustment required on surrender of the contract.

 150 1AThe wash sale rules of section 1091 of the code are not to apply to any loss that is required to be taken into account solely by reason of the mark-to-market requirement.

A modified guaranteed contract is defined as any life insurance contract, annuity contract or pension plan contract1A5151 that is not a variable contract (within the meaning of code section 817), and that satisfies the following requirements. All or a part of the amounts received under the contract must be allocated to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company and is valued from time to time by reference to market values. The reserves for the contract must be valued at market for annual statement purposes. Further, a modified guaranteed contract includes only a contract that provides either for a net surrender value or for a policyholders fund (within the meaning of section 807(e)(1)). If only a portion of the contract is not described in section 817, that portion is treated as a separate contract for purposes of the provision.

 151 1AThe provision applies only to a pension plan contract that is not a life, accident or health, property, casualty, or liability contract.

The Treasury Department is authorized to issue regulations that provide for the application of the mark-to-market requirement at times other than the close of a taxable year or the last business day of a taxable year. The Treasury Department is also authorized to issue such regulations as may be necessary or appropriate to carry out the purposes of the provision and to provide for the treatment of modified guaranteed contracts under sections 72, 7702, and 7702A. In addition, the Treasury Department is authorized to determine the interest rates applicable under sections 807(c)(3), 807(d)(2)(B) and 812 with respect to modified guaranteed contracts annually, calculating such rates as appropriate for modified guaranteed contracts. For example, it may be appropriate to take into account the yield on the assets underlying the contract in determining such rates. The Treasury Department is also authorized, to the extent appropriate for such a contract, to modify or waive section 811(d).

The Treasury Department is also authorized to provide rules limiting the ordinary treatment provided under the provision to gain or loss on those assets properly taken into account in calculating the reserve for Federal tax purposes (and necessary to support such reserves) for modified guaranteed contracts, and to provide rules for limiting such treatment with respect to other assets (such as assets representing surplus of the company). Particular concern has been expressed about characterization of gain or loss as ordinary under the provision in transactions that would otherwise either first, have to meet the requirements of the hedging exception to the straddle rules to receive this treatment, or second, be treated as capital transactions under present law. It is intended that the mark-to-market treatment apply to all assets held as part of a segregated account established under the provision, even though ordinary treatment may not apply (pursuant to Treasury regulatory authority) to assets held as part of the segregated account that are not necessary to support the reserve for modified guaranteed contracts.

The bill authorizes the Treasury Department to prescribe regulations that provide for the treatment of assets transferred to or from a segregated account. This regulatory authority is provided because of concern that taxpayers may exercise selective ordinary loss (or income or gain) recognition by virtue of the ordinary treatment under the provision. One example of selective ordinary loss recognition could arise if assets are always marked to market when transferred out of the segregated account. For example, if at the beginning of the taxable year an asset in the segregated account is worth $1,000, but declines to $900 in July, the taxpayer might choose to recognize $100 of ordinary loss while continuing to own the asset, simply by transferring it out of the segregated account in July and replacing $1,000 of cash (for example) in the segregated account.

It is intended that the regulations relating to asset transfers will forestall opportunities for selective recognition of ordinary items. Prior to the issuance of these regulations, the following rules shall apply.

If an asset is transferred to a segregated account, gain or loss attributable to the period during which the asset was not in the segregated account is taken into account when the asset is actually sold, and retains the character (as ordinary or capital) properly attributable to that period. Appropriate adjustments are made to the basis of the asset to reflect gain or loss attributable to that period.

If an asset is transferred out of a segregated account, the transfer is deemed to occur on the last business day of the taxable year and gain or loss with respect to the transferred asset is taken into account as of that day. Loss with respect to such transferred asset is treated as ordinary to the extent of the lesser of first, the loss (if any) that would have been recognized if the asset had been sold for its fair market value on the last business day of the taxable year (or the date the asset was actually sold by the taxpayer, if earlier) or second, the loss (if any) that would have been recognized if the asset had been sold for its fair market value on the date of the transfer. A similar rule applies for gains. Proper adjustment is made in the amount of any gain or loss subsequently realized to reflect gain or loss under the provision.

For example, assume that a capital asset in the segregated account that is worth $1,000 at the beginning of the year is transferred out of the segregated account in July at a value of $900, is retained by the company and is worth $950 on the last business day of the taxable year. A $50 ordinary loss is taken into account with respect to the asset for the taxable year (the difference between $1,000 and $950). The asset is not marked to market in any subsequent year under the provision, provided that it is not transferred back to the segregated account.

As an additional example, assume that a capital asset in the segregated account that is worth $1,000 at the beginning of the year is transferred out of the segregated accounted in July at a value of $900, is retained by the company and continues to decline in value to $850 on the last business day of the taxable year. A $100 ordinary loss ($1,000 less $900) and a $50 capital loss ($900 less $850) is taken into account with respect to the asset for the taxable year.Effective Date

The provision applies to taxable years beginning after December 31, 1995. A taxpayer that is required to first, change its calculation of reserves to take into account market value adjustments and second, mark to market its segregated assets in order to comply with the requirements of the provision is treated as having initiated changes in method of accounting and as having received the consent of the Treasury Department to make such changes.

The section 481(a) adjustments required by reason of the changes in method of accounting are to be combined and taken into account as a single net adjustment for the taxpayers first taxable year beginning after December 31, 1995.3. Minimum tax treatment of certain property and casualty insurance companies (sec. 14573 of the bill and sec. 56(g) of the code)Present Law

Present law provides that certain property and casualty insurance companies may elect to be taxed only on taxable investment income for regular tax purposes (sec. 831(b)). Eligible property and casualty insurance companies are those whose net written premiums (or if greater, direct written premiums) for the taxable year exceed $350,000 but do not exceed $1,200,000.

Under present law, all corporations including insurance companies are subject to an alternative minimum tax. Alternative minimum taxable income is increased by 75 percent of the excess of adjusted current earnings over alternative minimum taxable income (determined without regard to this adjustment and without regard to net operating losses).Reasons for Change

The committee believes that property and casualty companies small enough to be eligible to simplify their regular tax computation by electing to be taxed only on taxable investment income should be accorded comparable simplicity in the calculation of their alternative minimum tax. Under present law, the simplicity under the regular tax is nullified because electing companies must calculate underwriting income for tax purposes under the alternative minimum tax. The provision thus simplifies the entire Federal income tax calculation for a limited group of small taxpayers whom Congress has previously determined merit a simpler tax calculation.Explanation of Provision

The bill provides that a property and casualty insurance company that elects for regular tax purposes to be taxed only on taxable investment income determines its adjusted current earnings under the alternative minimum tax without regard to any amount not taken into account in determining its gross investment income under section 834(b). Thus, adjusted current earnings of an electing company is determined without regard to underwriting income (or underwriting expense, as provided in sec. 56(g)(4)(B)(i)(II)).Effective Date

The provision is effective for taxable years beginning after December 31, 1995. F. Other Provisions1. Closing of partnership taxable year with respect to deceased partner, etc. (sec. 14581 of the bill and sec. 706(c) of the code)Present Law

The partnership taxable year closes with respect to a partner whose entire interest is sold, exchanged, or liquidated. Such year, however, generally does not close upon the death of a partner. Thus, a decedents entire share of items of income, gain, loss, deduction and credit for the partnership year in which death occurs is taxed to the estate or successor in interest rather than to the decedent on his or her final income tax return. See Estate of Hesse v. Commissioner, 74 T.C. 1307, 1311 (1980).Reasons for Change

The rule leaving open the partnership taxable year with respect to a deceased partner was adopted in 1954 to prevent the bunching of income that could occur with respect to a partnership reporting on a fiscal year other than the calendar year. Without this rule, as many as 23 months of income might have been reported on the partners final return. Legislative changes occurring since 1954 have required most partnerships to adopt a calendar year, reducing the possibility of bunching. Consequently, income and deductions are better matched if the partnership taxable year closes upon a partners death and partnership items are reported on the decedents last return.

Present law closes the partnership taxable year with respect to a deceased partner only if the partners entire interest is sold or exchanged pursuant to an agreement existing at the time of death. By closing the taxable year automatically upon death, the provision reduces the need for such agreements.Explanation of Provision

The bill provides that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation or otherwise. The provision is not intended to change present law with respect to the effect upon the partnership taxable year of a transfer of a partnership interest by a debtor to the debtors estate (under Chapters 7 or 11 of Title 11, relating to bankruptcy).Effective Date

The provision applies to partnership taxable years beginning after December 31, 1995.2. Credit for Social Security taxes paid with respect to employee cash tips (sec. 14582 of the bill and sec. 45B of the code)Present Law

Under present law, all employee tip income is treated as employer-provided wages for purposes of the Federal Insurance Contributions Act ("FICA") (sec. 3121(q)). Employees are required to report to the employer the amount of tips received (sec. 6053(a)).

The Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993") provided a business tax credit with respect to certain employer FICA taxes paid with respect to tips that are treated as paid by the employer. In determining the credit, tips are taken into account only if they are received from customers in connection with the provision of food or beverages for consumption on the premises of an establishment with respect to which the tipping of employees serving food or beverages by customers is customary. In addition, the credit only applies with respect to tips that exceed the amount by which the wages paid by the employer (excluding tips) are less than the amount of the minimum wage.

OBRA 1993 provides that the FICA tip credit is effective for taxes paid after December 31, 1993.

Temporary Treasury regulations provide that the tax credit is available only with respect to tips reported by the employee. The temporary regulations also provide that the credit is effective for FICA taxes paid by an employer after December 31, 1993, with respect to tips received for services performed after December 31, 1993.Reasons for Change

The committee believes it appropriate to clarify the effective date and scope of the credit for FICA taxes paid on employer cash tips.Explanation of Provision

The provision clarifies the credit with respect to employer FICA taxes paid on tips by providing that the credit is first, available whether or not the employee reported the tips on which the employer FICA taxes were paid pursuant to section 6053(a), and second, effective with respect to taxes paid after December 31, 1993, regardless of when the services with respect to which the tips are received were performed. Effective Date

The provision is effective as if included in OBRA 1993.3. Due date for first quarter estimated tax payments by private foundations (sec. 14583 of the bill and sec. 6655(g)(3) of the code) Present Law

Under section 4940, tax-exempt private foundations generally are required to pay an excise tax equal to 2 percent of their net investment income for the taxable year. Under section 6655(g)(3), private foundations are required to pay estimated tax with respect to their excise tax liability under section 4940 (as well as any unrelated business income tax (UBIT) liability under section 511).5152 Section 6655(c) provides that this estimated tax is payable in quarterly installments and that, for calendar-year foundations, the first quarterly installment is due on April 15. Under section 6655(i), foundations with taxable years other than the calendar year must make their quarterly estimated tax payments no later than the dates in their fiscal years that correspond to the dates applicable to calendar-year foundations.

 152 1AGenerally, the amount of the first quarter payment must be at least 25 percent of the lesser of first, the preceding years tax liability, as shown on the foundations form 99009PF, or second, 95 percent of the foundations current-year tax liability.Reasons for Change

Because a private foundations estimated tax payments are determined, in part, by reference to the foundations tax liability for the preceding year, the due date for a foundations first-quarter estimated tax payment should be the same date for filing the foundations annual return (form 99009PF) for the preceding year. Explanation of Provision

The bill amends section 6655(g)(3) to provide that a calendar-year foundations first-quarter estimated tax payment is due on May 15 (which is the same day that its annual return, form 99009PF, for the preceding year is due). As a result of the operation of present-law section 6655(i), fiscal-year foundations will be required to make their first-quarter estimated tax payment no later than the 15th day of the 5th month of their taxable year.Effective Date

The provision applies to taxable years beginning after 1995.4. Treatment of dues paid to agricultural or horticultural organizations (sec. 14584 of the bill and sec. 512 of the code)Present Law

Tax-exempt organizations generally are subject to the unrelated business income tax (UBIT) on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organizations tax-exempt functions (secs. 51109514). Dues payments made to a membership organization generally are not subject to the UBIT. However, several courts have held that, with respect to postal labor organizations, dues payments were subject to the UBIT when received from individuals who were not postal workers but who became "associate" members for the purpose of obtaining health insurance available to members of the organization. See National League of Postmasters of the United States v. Commissioner, No. 80320993, T.C. Memo (May 11, 1995); American Postal Workers Union, AFL09CIO v. United States, 925 F.2d 480 (D.C. Cir. 1991); National Association of Postal Supervisors v. United States, 944 F.2d 859 (Fed. Cir. 1991).

In Rev. Proc. 950921 (issued March 23, 1995), the IRS indicated its position regarding when associate member dues payments received by an organization described in section 501(c)(5) will be treated as subject to the UBIT. The IRS indicated that dues payments from associate members will not be treated as subject to UBIT unless, for the relevant period, "the associate member category has been formed or availed of for the principal purpose of producing unrelated business income." Thus, under Rev. Proc. 950921, the focus of the inquiry is upon the organizations purposes in forming the associate member category (and whether the purposes of that category of membership are substantially related to the organizations exempt purposes other than through the production of income), rather than upon the motive of the individuals who join as associate members.Reasons for Change

In order to reduce uncertainty and legal disputes involving the UBIT treatment of certain associate member dues, the committee believes that it is appropriate to provide a special rule exempting from the UBIT annual dues not exceeding $100 paid to a tax-exempt agricultural or horticultural organization.Explanation of Provision

Under the bill, if an agricultural or horticultural organization described in section 501(c)(5) requires annual dues not exceeding $100 to be paid in order to be a member of such organization, then in no event will any portion of such dues be subject to the UBIT by reason of any benefits or privileges to which members of such organization are entitled. For taxable years beginning after 1995, the $100 amount will be indexed for inflation. The term "dues" is defined as "any payment required to be made in order to be recognized by the organization as a member of the organization."5153

 153 1ANo inference is intended regarding the UBIT treatment of any dues payment not governed by the provision.Effective Date

The provision applies to taxable years beginning after December 31, 1994.

Subtitle F. Estate, Gifts, and TrustsA. Income Tax Provisions1. Certain revocable trusts treated as part of estate (sec. 14601 of the bill and secs. 646 and 2652(b)(1) of the code) Present Law

Both estates and revocable intervivos trusts can function to wind up the affairs of a decedent and distribute assets to heirs. In the case of revocable intervivos trusts, the grantor transfers property into a trust which is revocable during his or her lifetime. Upon the grantors death, the power to revoke ceases and the trustee then performs the winding up functions typically performed by the executor of an estate. While both estates and revocable trusts perform essentially the same function after the testator or grantors death, there are a number of ways in which an estate and a revocable trust operate in different ways. First, there can be only one estate per decedent while there can be more than one revocable trust. Second, estates are in existence only for a reasonable period of administration; revocable trusts can perform the same winding up functions as an estate, but may continue in existence thereafter as testamentary trusts.

Numerous differences presently exist between the income tax treatment of estates and revocable trusts, including: First, estates are allowed a charitable deduction for amounts permanently set aside for charitable purposes while post death revocable trusts are allowed a charitable deduction only for amounts paid to charities; second, the active participation requirement the passive loss rules under section 469 is waived in the case of estates (but not revocable trusts) for 2 years after the owners death; third, an estate is a qualified shareholder of an S corporation, while a revocable trust may not be; and fourth, estates can qualify for section 194 amortization of reforestation expenditures, while trusts do not.Reasons for Change

The use of revocable trusts may offer certain nontax advantages for estate planning as compared to a traditional estate plan. There are several differences, however, between the Federal tax treatment of revocable trusts and an estate. These differences may discourage individuals from utilizing revocable trusts for estate planning where they might otherwise be appropriate or efficient. Accordingly, in an effort to minimize these tax differences, the committee believes it is appropriate to allow an election to treat a revocable trust as part of the decedents estate during a reasonable period of administration. Explanation of Provision

The bill provides an irrevocable election to treat a qualified revocable trust as part of the decedents estate for Federal income tax purposes. This elective treatment is effective from the date of the decedents death until 2 years after his or her death (if no estate tax return is required) or 6 months after the final determination of estate tax liability (if an estate tax return is required). The election must be made by both the executor of the decedents estate and the trustee of the revocable trust no later than the time required for filing the income tax return of the estate for its first taxable year, taking into account any extensions. A conforming change is made to section 2652(b) for generation-skipping transfer tax purposes.

For this purpose, a qualified revocable trust is any trust all of which was treated under section 676 as owned by the decedent with respect to whom the election is being made.Effective Date

The provision applies to decedents dying after the date of enactment.2. Distributions during first 65 days of taxable year of estate (sec. 14602 of the bill and sec. 663(b) of the code)Present Law

In general, trusts and estates are treated as conduits for Federal income tax purposes; income received by a trust or estate that is distributed to a beneficiary in the trust or estates taxable year "ending with or within" the taxable year of the beneficiary is taxable to the beneficiary in that year; income that is retained by the trust or estate is initially taxable to the trust or estate. In the case of distributions of previously accumulated income by trusts (but not estates), there may be additional tax under the so-called throwback rules if the beneficiary to whom the distributions were made has marginal rates higher than those of the trust. Under the "65-day rule," a trust may elect to treat distributions paid within 65 days after the close of its taxable year as paid on the last day of its taxable year. The 65-day rule is not applicable to estates.Reasons for Change

In order to minimize the tax differences between estates and revocable trusts, the committee believes that the 65-day rule should be allowed to estates as well as to trusts.Explanation of Provision

The bill extends application of the 65-day rule to distributions by estates. Thus, an executor can elect to treat distributions paid within 65 days after the close of the estates taxable year as having been paid on the last day of such taxable year.Effective Date

The provision applies to taxable years beginning after the date of enactment.3. Separate share rules available to estates (sec. 14603 of the bill and sec. 663(c) of the code)Present Law

Trusts with more than one beneficiary must use the "separate share" rule in order to provide different tax treatment of distributions to different beneficiaries to reflect the income earned by different shares of the trusts corpus.5154 Treasury regulations provide that "(t)he application of the separate share rule \* \* \* will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. \* \* \* Separate share treatment will not be applied to a trust or portion of a trust subject to a power to distribute, apportion, or accumulate income or distribute corpus to or for the use of one or more beneficiaries within a group or class of beneficiaries, unless the payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made under the governing instrument so that substantially separate and independent shares exist." (Treas. Reg. sec. 1.663(c)093). The separate share rule presently does not apply to estates.

 154 1AApplication of the separate share rule is not elective; it is mandatory if there are separate shares in the trust.Reasons for Change

The committee understands that estates typically do not have separate shares. Nonetheless, where separate shares do exist in an estate, the inapplicability of the separate share rule to estates may result in one beneficiary or class of beneficiaries being taxed on income payable to, or accruing to, a separate beneficiary or class of beneficiaries. Accordingly, the committee believes that a more equitable taxation of an estate and its beneficiaries would be achieved with the application of the separate share rule to an estate where, under the provisions of the decedents will or applicable local law, there are separate shares in the estate.Explanation of Provision

The bill extends the application of the separate share rule to estates. There are separate shares in an estate when the governing instrument of the estate (e.g., the will and applicable local law) creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specified items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries. For example, a separate share in an estate would exist where the decedents will provides that all of the shares of a closely-held corporation are devised to one beneficiary and that any dividends paid to the estate by that corporation should be paid only to that beneficiary and any such dividends would not affect any other amounts which that beneficiary would receive under the will. As in the case of trusts, the application of the separate share rule is mandatory where separate shares exist.Effective Date

The provision applies to decedents dying after the date of enactment.4. Executor of estate and beneficiaries treated as related persons for disallowance of losses, etc. (sec. 14604 of the bill and secs. 267(b) and 1239(b) of the code) Present Law

Section 267 disallows a deduction for any loss on the sale of an asset to a person related to the taxpayer. For the purposes of section 267, the following parties are related persons: First, a trust and the trusts grantor, second, two trusts with the same grantor, third, a trust and a beneficiary of the trust, fourth, a trust and a beneficiary of another trust, if both trusts have the same grantor, and fifth, a trust and a corporation the stock of which is more than 50 percent owned by the trust or the trusts grantor.

Section 1239 disallows capital gain treatment on the sale of depreciable property to a related person. For purposes of section 1239, a trust and any beneficiary of the trust are treated as related persons, unless the beneficiarys interest is a remote contingent interest.

Neither section 267 or section 1239 presently treat an estate and a beneficiary of the estate as related persons.Reasons for Change

The committee believes that the disallowance rules under sections 267 and 1239 with respect to transactions between related parties should apply to an estate and a beneficiary of that estate for the same reasons that such rules apply to a trust and a beneficiary of that trust. Explanation of Provision

Under the bill, an estate and a beneficiary of that estate are treated as related persons for purposes of sections 267 and 1239, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.Effective Date

The provision applies to taxable years beginning after the date of enactment.5. Limitation on taxable year of estates (sec. 14605 of the bill and sec. 645 of the code)Present Law

The taxability of distributions from a trust or estate is based on the amount of income received by the trust or estate in the trust or estates taxable year "ending with or within" the taxable year of the beneficiary (typically a calendar year). Trusts are required to use a calendar year and, consequently, income of a trust that is distributed to a calendar-year beneficiary in the year earned is taxed to the beneficiary in the year earned. Estates, on the other hand, are allowed to use any fiscal year. Consequently, in the case of estates, the taxation of distributions to a calendar-year beneficiary in up to the last 11 months of the calendar year can be deferred until the next taxable year depending upon the fiscal year selected.Reasons for Change

The committee believes that allowing an estate to use a taxable year significantly different than the calendar year may result in an improper deferral of income by the beneficiaries of the estate. Thus, the committee believes that the choice of taxable years allowable to an estate should be appropriately limited. Explanation of Provision

The bill limits the taxable year of an estate to a year ending on October 31, November 30, or December 31.5155 Thus, the maximum deferral allowable to a calendar-year beneficiary is with respect to distributions made in the last 2 months of the calendar year.

 155 1AIf an election is made to treat a revocable trust as part of the estate under section 14601 of the bill, such trust would switch to the taxable year of the estate during the period that the election was effective.Effective Date

The provision applies to decedents dying after the date of enactment.6. Repeal of certain throwback rules applicable to domestic trusts (sec. 14606 of the bill and secs. 644(e) and 665)Present Law

A nongrantor trust is treated as a separate taxpayer for Federal income tax purposes. Such a trust generally is treated as a conduit with respect to amounts distributed currently1A5156 and taxed with respect to any income which is accumulated in the trust rather than distributed. A separate graduated tax rate structure applies to trusts which historically has permitted accumulated trust income to be taxed at lower rates than the rates applicable to trust beneficiaries. This benefit often was compounded through the creation of multiple trusts.

 156 1AThe conduit treatment is achieved by allowing the trust a deduction for amounts distributed to beneficiaries during the taxable year to the extent of distributable net income and by including such distributions in the beneficiaries income.

The Internal Revenue Code has several rules intended to limit the benefit that would otherwise occur from using the lower rates applicable to one or more trusts. Under the so-called throwback rules, the distribution of previously accumulated trust income to a beneficiary will be subject to tax (in addition to any tax paid by the trust on that income) where the beneficiarys average top marginal rate in the previous 5 years is higher than those of the trust.

Under section 643(f), two or more trusts are treated as one trust if first, the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and second, a principal purpose for the existence of the trusts is to avoid Federal income tax. For trusts that were irrevocable as of March 1, 1984, section 643(f) applies only to contributions to corpus after that date.

Under section 644, if property is sold within 2 years of its contribution to a trust, the gain that would have been recognized had the contributor sold the property is taxed at the contributors marginal tax rates. In effect, section 644 treats such gains as if the contributor had realized the gain and then transferred the net after-tax proceeds from the sale to the trust as corpus.Reasons for Change

The throwback rules and section 644 are intended to eliminate the potential tax reduction arising from taxation at the trust level, rather than the beneficiary or contributor level. When those provisions were enacted, a taxpayer could reduce his or her overall tax liability substantially by transferring property to one or more trusts, so that any income from the property would be taxed at lower income tax rates. In the Tax Reform Act of 1984, Congress curtailed the tax avoidance use of multiple trusts. Moreover, in the Tax Reform Act of 1986, Congress provided a new rate schedule for estates and trusts under which the maximum tax benefit of the graduated rate structure applicable to estates or trusts was reduced substantially to slightly more than $600 per year for a trust or estate. (Because of indexing of the rate brackets, that benefit has increased to $845 per year per trust or estate.) The committee has determined that the insignificant potential tax reduction available through the transfer of property to trust no longer warrants the complexity of the throwback rules and section 644.Explanation of Provision

The bill exempts from the throwback rules amounts distributed by a domestic trust after December 31, 1995. The provision also provides that precontribution gain on property sold by a domestic trust no longer is subject to section 644 (i.e., taxed at the contributors marginal tax rates).Effective Date

The provision with respect to the throwback rules is effective for distributions made in taxable years beginning after December 31, 1995. The modification to section 644 applies to sales or exchanges after December 31, 1995.7. Treatment of funeral trusts (sec. 14607 of the bill and sec. 684 of the code) Present Law

A pre-need funeral trust is an arrangement where an individual purchases funeral or burial services or merchandise from a funeral home or cemetery in advance of the individuals death. The individual enters into a contract with the provider of such services or merchandise whereby the individual selects the services or merchandise to be provided upon his or her death, and agrees to pay for them in advance of his or her death. Such amounts (or a portion thereof) are held in trust during the individuals lifetime and are paid to the seller upon the individuals death.

Under present law, pre-need funeral trusts generally are treated as grantor trusts, and the annual income earned by such trusts is taxed to the purchaser/grantor of the trust.5157 Amounts received from the trust by the seller are treated as payments for services and merchandise and are includible in the gross income of the seller.

 157 1ARev. Rul. 8709127, 1987092 C.B. 156.Reasons for Change

To the extent that pre-need funeral trusts are treated as grantor trusts under present law, numerous individual taxpayers are required to account for the earnings of such trusts on their tax returns, even though the earnings with respect to any one taxpayer may be small. The committee believes that this recordkeeping burden on individuals could be eased, and that compliance with the tax laws would be improved, if such trusts instead were taxed at the entity level, with one simplified annual return filed by the trustee reporting the aggregate income from all such trusts administered by the trustee. Explanation of Provision

The bill allows the trustee of a pre-need funeral trust to elect to have the trust essentially be treated as a nongrantor trust, to the extent the trust would otherwise be treated as a grantor trust. For purposes of this provision, if funds of more than one purchaser are commingled in, or transferred to, a single master trust (or other similar arrangement), each purchasers share of the trust is treated as a separate trust, and each of the following requirements is applied separately with respect to each purchasers trust. A qualified funeral trust is defined as one which meets the following requirements: First, the trust arises as the result of a contract between a person engaged in the trade or business of providing funeral or burial services or merchandise and one or more individuals (i.e., the trust beneficiaries) to have such services or property provided upon such individuals death; second, the only beneficiaries of the trust are individuals who have entered into contracts to have such services or merchandise provided upon their death; third, the only contributions to the trust are contributions by or for the benefit of the trust beneficiaries; fourth, the trusts only purpose is to hold and invest funds that will be used to make payments for funeral or burial services or merchandise for the trust beneficiaries; and fifth, the trust has not accepted contributions in excess of $5,000 by or for the benefit of any individual. For this purpose, "contributions" include all amounts transferred to the trust, regardless of how denominated in the contract. Contributions do not, however, include income or gain earned with respect to property in the trust. For purposes of applying the $5,000 limit, if a purchaser has more than one contract with a single trustee (or related trustees), all such trusts are treated as one trust. Similarly, if the Secretary of Treasury determines that a purchaser has entered into separate contracts with unrelated trustees to avoid the $5,000 limit described above, the Secretary may require that such trusts be treated as one trust. The $5,000 limit is indexed for inflation after 1995.

The trustees election to have this provision apply to a qualified funeral trust is to be made separately with respect to each purchasers trust. It is anticipated that the Department of Treasury will issue prompt guidance with respect to the simplified reporting requirements so that if the election is made, a single annual trust return may be filed by the trustee, separately listing the amount of income earned with respect to each purchaser. The amount of tax paid with respect to each purchasers trust is determined in accordance with the income tax rate schedule generally applicable to estates and trusts (code sec. 1(e)), but no deduction is allowed under section 642(b). The tax on the annual earnings of the trust is payable by the trustee.

As under present law, amounts received from the trust by the seller are treated as payments for services and merchandise and are includible in the gross income of the seller. No gain or loss is recognized to the beneficiary of the trust for payments from the trust to the beneficiary upon cancellation of the contract, and the beneficiary takes a carryover basis in any assets received from the trust upon cancellation.Effective Date

The provision is effective for taxable years beginning after the date of enactment.B. Estate and Gift Tax Provisions1. Clarification of waiver of certain rights of recovery (sec. 14611 of the bill and secs. 2207A and 2207B of the code)Present Law

For estate and gift tax purposes, a marital deduction is allowed for qualified terminable interest property (QTIP). Such property generally is included in the surviving spouses gross estate upon his or her death. The surviving spouses estate is entitled to recover the portion of the estate tax attributable to inclusion of QTIP from the person receiving the property, unless the spouse directs otherwise by will (sec. 2207A). For this purpose, a will provision specifying that all taxes shall be paid by the estate is sufficient to waive the right of recovery.

A decedents gross estate includes the value of previously transferred property in which the decedent retains enjoyment or the right to income (sec. 2036). The estate is entitled to recover from the person receiving the property a portion of the estate tax attributable to the inclusion (sec. 2207B). This right may be waived only by a provision in the will (or revocable trust) specifically referring to section 2207B.Reasons for Change

It is understood that persons utilizing standard testamentary language often inadvertently waive the right of recovery with respect to QTIP. Similarly, persons waiving a right to contribution are unlikely to refer to the code section granting the right. Accordingly, allowing the right of recovery (or right of contribution) to be waived only by specific reference should simplify the drafting of wills by better conforming with the testators likely intent. Explanation of Provision

The bill provides that the right of recovery with respect to QTIP is waived only to the extent that language in the decedents will or revocable trust specifically so indicates (e.g., by a specific reference to QTIP, the QTIP trust, section 2044, or section 2207A). Thus, a general provision specifying that all taxes be paid by the estate is no longer sufficient to waive the right of recovery.

The bill also provides that the right of contribution for property over which the decedent retained enjoyment or the right to income is waived by a specific indication in the decedents will or revocable trust, but specific reference to section 2207B is no longer required.Effective Date

The provision applies to decedents dying after the date of enactment.2. Adjustments for gifts within 3 years of decedents death (sec. 14612 of the bill and secs. 2035 and 2038 of the code)Present Law

The first $10,000 of gifts of present interests to each donee during any 1 calendar year are excluded from Federal gift tax.

The value of the gross estate includes the value of any previously transferred property if the decedent retained the power to revoke the transfer (sec. 2038). The gross estate also includes the value of any property with respect to which such power is relinquished during the 3 years before death (sec. 2035). This rule has been interpreted to include in the gross estate certain transfers made from a revocable trust within 3 years of death.5158 Such inclusion subjects gifts that would otherwise qualify under the annual $10,000 exclusion to estate tax.

 158 1ASee, e.g., Jalkut Estate v. Commissioner. 96 T.C. 675 (1991) (transfers from revocable trust to permissible beneficiaries of the trust includible in the grantors gross estate); LTR 9117003 (same).Reasons for Change

The inclusion of certain property transferred during the 3 years before death is directed at transfers that would otherwise reduce the amount subject to estate tax by more than the amount subject to gift tax, disregarding appreciation between the times of gift and death. Because all amounts transferred from a revocable trust are subject to the gift tax, the committee believes that inclusion of such amounts is unnecessary where the transferor has retained no power over the property transferred out of the trust. It is understood that repeal of such inclusion eliminates a principal tax disadvantage of funded revocable trusts, which are generally used for nontax purposes.Explanation of Provision

The bill provides that a transfer from a revocable trust (i.e., a trust described under section 676) is treated as if made directly by the grantor. Thus, an annual exclusion gift from such trust is not included in the gross estate. The provision is not intended to create an inference with respect to the treatment of transfers from revocable trusts under present law.

The provision also revises section 2035 to improve its clarity.Effective Date

The provision applies to decedents dying after the date of enactment.3. Clarification of qualified terminable interest rules (sec. 14613 of the bill and secs. 2044, 2056(b)(7), and 2523(f) of the code)Present Law

A marital deduction is allowed for qualified terminal interest property ("QTIP"). Property is QTIP only if the surviving spouse has a qualifying income interest for life (e.g., the spouse is entitled to all of the income from the property payable at least annually). QTIP generally is includible in the surviving spouses gross estate.

The U.S. Tax Court has held that, in order to satisfy the QTIP requirements, the income accumulating between the last distribution date and the date of the surviving spouses death (the "accumulated income") must be paid to the spouses estate or be subject to a power of appointment held by the spouse. See Estate of Howard v. Commissioner, 91 T.C. 329, 338 (1988), revd, 910 F.2d 633 (9th Cir. 1990). In contrast, proposed Treasury regulations presently provide that an income interest may constitute a qualifying income interest for life even if the accumulated income is not required to be distributed to the surviving spouse or the surviving spouses estate. See Treas. Reg. secs. 20.2056(b)097(d)(4), 25.2523(f)091(c)(1). Reasons for Change

The committee believes that an income interest may constitute a qualifying income interest for life even if the accumulated income is not required to be distributed to the surviving spouse or the surviving spouses estate. The provision will alleviate the uncertainty caused by the Tax Court opinion in Estate of Howard as to when a trust qualifies for the marital deduction. This uncertainty makes planning difficult and necessitates closing agreements designed to prevent the whipsaw that would occur if a deduction is allowed for property that is not subsequently included in the spouses estate. Explanation of Provision

Under the bill, an income interest does not fail to be a qualified income interest for life solely because the accumulated income is not required to be distributed to the surviving spouse. Such income is includible in the surviving spouses gross estate. The provision is not intended to create an inference regarding the definition of a qualified income interest for life under present law.Effective Date

The provision applies to decedents dying, and gifts made, after the date of enactment. However, the bill does not include in the surviving spouses gross estate property transferred before the date of enactment for which no marital deduction was claimed.4. Transitional rule under section 2056A (sec. 14614 of the bill and sec. 2056A of the code) Present Law

A "marital deduction" generally is allowed for estate and gift tax purposes for the value of property passing to a spouse. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) denied the marital deduction for property passing to an alien spouse outside a qualified domestic trust (QDT). An estate tax generally is imposed on corpus distributions from a QDT.

TAMRA defined a QDT as a trust that, among other things, required all trustees be U.S. citizens or domestic corporations. This provision was modified in the Omnibus Budget Reconciliation Acts of 1989 and 1990 to require that at least one trustee be a U.S. citizen or domestic corporation and that no corpus distribution be made unless such trustee has the right to withhold any estate tax imposed on the distribution (the "withholding requirement").Reasons for Change

Wills drafted under the TAMRA rules must be revised to conform with the withholding requirement, even though both the TAMRA rule and its successor ensure that a U.S. trustee is personally liable for the estate tax on a QDT. Reinstatement of the TAMRA rule for wills drafted in reliance upon it reduces the number of will revisions necessary to comply with statutory changes, thereby simplifying estate planning.Explanation of Provision

A trust created before the enactment of the Omnibus Budget Reconciliation Act of 1990 is treated as satisfying the withholding requirement if its governing instrument requires that all trustees be U.S. citizens or domestic corporations.Effective Date

The provision applies as if included in the Omnibus Budget Reconciliation Act of 1990.5. Opportunity to correct certain failures under section 2032A (sec. 14615 of the bill and sec. 2032A of the code)Present Law

For estate tax purposes, an executor may elect to value certain real property used in farming or other closely held business operations at its current use value rather than its highest and best use (sec. 2032A). A written agreement signed by each person with an interest in the property must be filed with the election.

Treasury regulations require that a notice of election and certain information be filed with the Federal estate tax return (Treas. Reg. sec. 20.2032A098). The administrative policy of the Treasury Department is to disallow current use valuation elections unless the required information is supplied.

Under procedures prescribed by the Treasury Department, an executor who makes the election and substantially complies with the regulations but fails to provide all required information or the signatures of all persons with an interest in the property may supply the missing information within a reasonable period of time (not exceeding 90 days) after notification by the Treasury Department.Reasons for Change

It is understood that executors commonly fail to include with the filed estate tax return a recapture agreement signed by all persons with an interest in the property or all information required by Treasury regulations. It is believed that allowing such signatures or information to be supplied later is consistent with the legislative intent of section 2032A and eases return filing.Explanation of Provision

The bill extends the procedures allowing subsequent submission of information to any executor who makes the election and submits the recapture agreement, without regard to compliance with the Treasury regulations. Thus, the bill allows the current use valuation election if the executor supplies the required information within a reasonable period of time (not exceeding 90 days) after notification by the IRS. During that time period, the bill also allows the addition of signatures to a previously filed agreement.Effective Date

The provision applies to decedents dying after the date of enactment.6. Unified credit of decedent increased by unified credit of spouse used on split gift included in decedents gross estate (sec. 14616 of the bill and sec. 2010 of the code)Present Law

A gift tax is imposed on transfers by gift during life and an estate tax is imposed on transfers at death. The gift and estate taxes are a unified transfer tax system in that one progressive tax is imposed on the cumulative transfers during lifetime and at death. The amount of gift tax payable for any taxable period generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative lifetime taxable transfers made by the taxpayer and then subtracting any gift taxes payable for prior taxable periods. This amount is reduced by any available unified credit (and other applicable credits) to determine the gift tax liability for the taxable period. Also, the first $10,000 of gifts of present interests to each donee during any 1 calendar year are excluded from Federal gift tax.

The amount of estate tax payable generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative post-1976 taxable transfers made by the taxpayer and then subtracting any transfer taxes payable for prior taxable periods. This amount is reduced by any remaining available unified credit (and other applicable credits) to determine the estate tax liability. The estate tax is imposed on all of the assets held by the decedent at his death, including the value of property previously transferred by the decedent in which the decedent had certain retained powers or interests (e.g., sections 2036 (relating to transfers with retained life estate), 2037 (relating to transfers taking effect at death), 2038 (relating to revocable trusts), or 2042 (relating to proceeds of life insurance)). Under section 2035, the estate tax also would apply with respect to property in which such a retained power or interest is transferred within 3 years of death.

Under section 2513, one spouse can elect to treat a gift made by the other spouse to a third person as made one-half by each spouse (i.e., "gift-splitting"). Reasons for Change

The ability to gift-split is intended to equalize the treatment of spouses in community property States and noncommunity property States. Gift-splitting effectively permits the transferor taxpayer to benefit from, among other things, any unified credit allowable to the nontransferor spouse. The benefit of the nontransferor spouses unified credit is lost, however, in circumstances where the split-gift property is subsequently included in the transferor spouses estate under sections 2035, 2036, 2037, or 2038 (e.g., where the transferor spouse had retained a life estate such that the value of the entire property, including the transferred remainder interest, is includible in the transferors estate under section 2036). The committee believes that it is inappropriate that the benefit of the nontransferor spouses unified credit be lost in such circumstances.Explanation of Provision

With respect to any split-gift property that is subsequently included in the estate of the transferor spouse under sections 2035, 2036, 2037 or 2038, the bill increases the unified credit allowable to the transferor spouses estate by the amount of the unified credit previously allowed to the nontransferor spouse with respect to the split gift. Effective Date

The provision applies to gifts made after the date of enactment.7. Reformation of defective bequests, etc. to spouse of decedent (sec. 14617 of the bill and secs. 2056(b) and 2523 of the code)Present Law

A "marital deduction" generally is allowed for estate and gift tax purposes for the value of property passing to a spouse. However, "terminable interest" property (i.e., an interest in property that will terminate or fail) transferred to a spouse generally will only qualify for the marital deduction under certain special rules designed to ensure that there will be an estate or gift tax to the transferee spouse on unspent transferred proceeds. Thus, the effect of a marital deduction with the terminable interest rule is to provide only a method of deferral of the estate or gift tax, not exemption. One of the special terminable interest rules (code sec. 2056(b)(5)) provides that the marital deduction is allowed where the decedent transfers property to a trust that is required to pay income to the surviving spouse and the surviving spouse has a general power of appointment at that spouses death (under this so-called power of appointment trust, the power of appointment both provides the surviving spouse with power to control the ultimate disposition of the trust assets and assures that the trust assets will be subject to estate or gift tax). Another special terminable interest rule called the "qualified terminable interest property" rule (QTIP) generally permits a marital deduction for transfers by the decedent to a trust that is required to distribute all of the income to the surviving spouse at least annually and an election is made to subject the transferee spouse to transfer tax on the trust property. To qualify for the marital deduction, a power of appointment trust or QTIP trust must meet certain specific requirements. If there is a technical defect in meeting those requirements, the marital deduction may be lost.Reasons for Change

The IRS generally has required strict compliance with the requirements for a qualified power of appointment trust under section 2056(b)(5) or for QTIP under section 2056(b)(7). As a result, taxpayers have been unable to qualify for the marital deduction due to inadvertent or unavoidable failure to meet those requirements. Accordingly, the committee believes it is appropriate to provide a reformation procedure to allow such failures to be cured in order that the marital deduction not be lost. Explanation of Provision

The bill allows the marital deduction with respect to a defective power of appointment or QTIP trust if there is a "qualified reformation" of the trust that corrects the defect. In order to qualify, the reformation must change the governing instrument in a manner that cures the defects to qualification of the trust for the marital deduction. In addition, where a reformation proceeding is commenced after the due date for the estate tax return (including extensions), the reformation would qualify only if, prior to reformation, the governing instrument provides first, that the surviving spouse is entitled to all of the income from the property for life, and second, no person other than the surviving spouse is entitled to any distributions during the surviving spouses life. With respect to QTIP, an election to qualify must be made by the executor on the estate tax return as required by section 2056(b)(7)(B)(v).

The determination of whether a marital deduction should be allowed (i.e., the reformation has cured the defects to qualification and otherwise qualifies under this provision) is made either as of the due date for filing the estate or gift tax return (including any extensions) or the time that changes are completed pursuant to a reformation proceeding. The statute of limitations is extended with respect to the estate or gift tax attributable to the trust property until 1 year after the date the Treasury Department is notified that a qualified reformation has been completed or that the reformation proceeding has otherwise terminated.Effective Date

The provision applies to decedents dying after the date of enactment.8. Gifts may not be revalued for estate tax purposes after expiration of statute of limitations (sec. 14618 of the bill and secs. 2001, 6501(c)(9) and 7477 of the code)Present Law

The Federal estate and gift taxes are unified so that a single progressive rate schedule is applied to an individuals cumulative gifts and bequests. The tax on gifts made in a particular year is computed by determining the tax on the sum of the taxable gifts made that year and all prior years and then subtracting the tax on the prior years taxable gifts and the unified credit. Similarly, the estate tax is computed by determining the tax on the sum of the taxable estate and prior taxable gifts and then subtracting the tax on taxable gifts and the unified credit. Under a special rule applicable to the computation of the gift tax (sec. 2504(c)), the value of gifts made in prior years is the value that was used to determine the prior years gift tax. There is no comparable rule in the case of the computation of the estate tax.

Generally, any estate or gift tax must be assessed within 3 years after the filing of the return. No proceeding in a court for the collection of an estate or gift tax can be begun without an assessment within the 3-year period. If no return is filed, the tax may be assessed, or a suit commenced to collect the tax without assessment, at any time. If an estate or gift tax return is filed, and the amount of unreported items exceeds 25 percent of the amount of the reported items, the tax may be assessed or a suit commenced to collect the tax without assessment, within 6 years after the return was filed (sec. 6501).

Commencement of the statute of limitations generally does not require that a particular gift be disclosed. A special rule, however, applies to certain gifts that are valued under the special valuation rules of Chapter 14. The gift tax statute of limitations runs for such a gift only if it is disclosed on a gift tax return in a manner adequate to apprise the Secretary of the Treasury of the nature of the item.

Most courts have permitted the Commissioner to redetermine the value of a gift for which the statute of limitations period for the gift tax has expired in order to determine the appropriate tax rate bracket and unified credit for the estate tax. See, e.g., Evanson v. United States, 74 AFTR 2d 94095128 (9th Cir. 1994); Stalcup v. United States, 946 F. 2d 1125 (5th Cir. 1991); Estate of Levin, 1991 T.C. Memo 199109208, affd 986 F. 2d 91 (4th Cir. 1993); Estate of Smith v. Commissioner, 94 T.C. 872 (1990). But see Boatmans First National Bank v. United States, 705 F. Supp. 1407 (W.D. Mo. 1988) (Commissioner not permitted to revalue gifts).Reasons for Change

Revaluation of lifetime gifts at the time of death requires the taxpayer to retain records for a potentially lengthy period. Rules that encourage a determination within the gift tax statute of limitations ease transfer tax administration by eliminating reliance on stale evidence and reducing the period for which retention of records is required.Explanation of Provision

The bill provides that a gift for which the limitations period has passed cannot be revalued for purposes of determining the applicable estate tax bracket and available unified credit. For gifts made in calendar years after the date of enactment, the bill also extends the special rule governing gifts valued under Chapter 14 to all gifts. Thus, the statute of limitations will not run on an inadequately disclosed transfer in calendar years after the date of enactment, regardless of whether a gift tax return was filed for other transfers in that same year.

It is intended that, in order to revalue a gift that has been adequately disclosed on a gift tax return, the IRS must issue a final notice of redetermination of value (a "final notice") within the statute of limitations applicable to the gift for gift tax purposes (generally, 3 years). This rule is applicable even where the value of the gift as shown on the return does not result in any gift tax being owed (e.g., through use of the unified credit). It is also anticipated that the IRS will develop an administrative appeals process whereby a taxpayer can challenge a redetermination of value by the IRS prior to issuance of a final notice.

A taxpayer who is mailed a final notice may challenge the redetermined value of the gift (as contained in the final notice) by filing a motion for a declaratory judgment with the Tax Court. The motion must be filed on or before 90 days from the date that the final notice was mailed. The statute of limitations is tolled during the pendency of the Tax Court proceeding. Effective Date

The provision generally applies to gifts made after the date of enactment. The extension of the special rule under chapter 14 to all gifts applies to gifts made in calendar years after the date of enactment. 9. Clarifications relating to disclaimers (sec. 14619 of the bill and sec. 2518 of the code)Present Law

Historically, there must be acceptance of a gift in order for the gift to be completed under State law and there is no taxable gift for Federal gift tax purposes unless there is a completed gift. Most States have rules that provide that, where there is a disclaimer of a gift, the property passes to the person who is entitled to the property had the disclaiming party died before the purported transfer.

In the Tax Reform Act of 1976, Congress provided a uniform disclaimer rule (section 2518) that specified how and when a disclaimer under State law must be made in order to be effective for Federal transfer tax purposes. Under section 2518, a State law type disclaimer is effective for Federal transfer tax purposes if it is an irrevocable and unqualified refusal to accept an interest in property and certain other requirements are satisfied. One of these other requirements is that the disclaimer generally must be made in writing not later than 9 months after the transfer creating the interest occurs. Section 2518 is not presently effective for Federal tax purposes other than transfer taxes.

In 1981, Congress added a rule to section 2518 that allowed certain transfers of property to be treated as a qualified disclaimer. In order to qualify, these transfer-type disclaimers must be a written transfer of the disclaimants "entire interest in the property" to persons who would have received the property had there been a valid disclaimer under State law (sec. 2518(c)(3)). Like other disclaimers, the transfer-type disclaimer generally must be made within 9 months of the transfer creating the interest.Reasons for Change

Under present law, a State law type disclaimer can be a qualified disclaimer even first, where it is only a partial disclaimer of the property interest, or second, where the disclaimant spouse retains an interest in the property. In contrast, it is presently unclear whether a transfer-type disclaimer can qualify under similar circumstances. Thus, in order to equalize the treatment of State law type disclaimers and transfer-type disclaimers, the committee believes it is appropriate to allow a transfer-type disclaimer of an undivided portion of property or a transfer-type disclaimer where the disclaimant spouse has retained an interest in the property to be treated as a qualified disclaimer for transfer tax purposes.

The committee also believes that qualified disclaimers should be effective for Federal income tax purposes, as well as transfer tax purposes.Explanation of Provision

The bill allows a transfer-type disclaimer of an "undivided portion" of the disclaimant transferors interest in property to qualify under section 2518. Also, the bill allows a spouse to make a qualified transfer-type disclaimer where the disclaimed property is transferred to a trust in which the disclaimant spouse has an interest (e.g., a credit shelter trust). Finally, the bill provides that a qualified disclaimer for transfer tax purposes under section 2518 is also effective for Federal income tax purposes (e.g., disclaimers of interests in annuities and income in respect of a decedent).

None of the foregoing provisions are intended to create an inference regarding the Federal tax treatment of disclaimers under present law.Effective Date

The provision applies to disclaimers made after the date of enactment.10. Clarification of treatment of survivor annuities under qualified terminable interest rules (sec. 14620 of the bill and sec. 2056(b)(7)(C) of the code)Present LawCommunity property

Under State community property laws, each spouse owns an undivided one-half interest in each community property asset. In community property States, a nonparticipant spouse may be treated as having a vested community property interest in his or her spouses qualified plan, individual retirement arrangement, or simplified employee pension plan.Transfer tax treatment of qualified plans

In the Retirement Equity Act of 1984 (REA), qualified retirement plans were required to provide automatic survivor benefits first, in the case of a participant who retires under the plan, in the form of a qualified joint and survivor annuity, and second, in the case of a vested participant who dies before the annuity starting date and who has a surviving spouse, in the form of a preretirement survivor annuity. A participant generally is permitted to waive such annuities, provided he or she obtains the written consent of his or her spouse.

The Tax Reform Act of 1986 repealed the estate tax exclusion, formerly contained in section 2039, for certain interests in qualified plans owned by a nonparticipant spouse attributable to community property laws and made certain other changes to conform the transfer tax treatment of qualified and nonqualified plans.

Also, under another change made by the Tax Reform Act of 1986, a survivorship interest in an annuity interest arising out of the decedents employment that is includible his or her estate (under section 2039) that passes to the nonparticipant spouse is treated as a deductible marital transfer (i.e., the annuity interest is treated as a qualifying income interest for purposes of the marital deduction under the Qualified Terminable Interest Property (QTIP)1A5159 rules unless the executor of the decedents estate elects otherwise) (sec. 2056(b)(7)(C)). Thus, in noncommunity property States, no estate tax generally is imposed on such survivor annuity interests in the nonsurviving spouses estate. In contrast, an interest of the nonparticipant spouse arising under community property laws in an annuity derived from the employment of his or her spouse is includible in his or her estate under section 2033 and, therefore, may not qualify as a deductible transfer to his or her surviving spouse under the QTIP rules.

 159 1AIn general, QTIP is property which passes from the decedent, in which the surviving spouse has a qualifying income interest for life, and which the executor elected to treat as QTIP. A surviving spouse generally has a qualifying income interest for life if he or she is entitled to all the income from the property payable at least annually, and no person has the power to appoint any part of the property to any person other than the surviving spouse.Reasons for Change

The committee believes that survivorship interests in annuities in community property States should be accorded similar treatment to the tax treatment of interests in such annuities in noncommunity property States. Accordingly, the bill would clarify that the transfer at death of a survivorship interest in an annuity to a surviving spouse will be a deductible marital transfer under the QTIP rules regardless of whether the decedents annuity interest arose out of his or her employment or arose under community property laws by reason of the employment of his or her spouse.Explanation of Provision

The bill clarifies that the marital deduction is available with respect to a nonparticipant spouses interest in an annuity attributable to community property laws where he or she predeceases the participant spouse. Under the bill, the nonparticipant spouses interest in an annuity arising under the community property laws of a State that passes to the surviving participant spouse may qualify for treatment as QTIP under section 2056(b)(7).

The provision is not intended to create an inference regarding the treatment under present law of a transfer to a surviving spouse of the decedent spouses interest in an annuity arising under community property laws. Effective Date

The provision applies to decedents dying, or waivers, transfers and disclaimers made, after the date of enactment.11. Treatment under qualified domestic trust rules of forms of ownership which are not trusts (sec. 14621 of the bill and sec. 2056A(c) of the code)Present Law

Trusts are not permitted in some countries (e.g., many civil law countries).5160 As a result, it is not possible to create a QDT in those countries.

 160 1ANote that in some civil law States (e.g., Louisiana) an entity similar to a trust, called a usufruct, exists.Reasons for Change

The estate of a decedent with a nonresident spouse should not be precluded from qualifying for the marital deduction in situations where the use of a trust is prohibited by another country. Accordingly, the committee believes it is appropriate to grant regulatory authority to allow qualification for the marital deduction in such situations where the Treasury Department determines that another similar arrangement allows the United States to retain jurisdiction and provides adequate security for the payment of U.S. transfer taxes on subsequent transfers by the surviving spouse of the property transferred by the decedent. Explanation of Provision

The bill provides the Treasury Department with regulatory authority to treat as trusts legal arrangements that have substantially the same effect as a trust. It is anticipated that such regulations, if any, would only permit a marital deduction with respect to nontrust arrangements under which the United States would retain jurisdiction and adequate security to impose U.S. transfer tax on transfers by the surviving spouse of the property transferred by the decedent. Possible arrangements could include the adoption of a bilateral treaty that provides for the collection of U.S. transfer tax from the noncitizen surviving spouse or a closing agreement process under which the surviving spouse waives treaty benefits, allows the U.S. to retain taxing jurisdiction and provides adequate security with respect to such transfer taxes.Effective Date

The provision applies to decedents dying after the date of enactment.12. Authority to waive requirement of U.S. trustee for qualified domestic trusts (sec. 14622 of the bill and sec. 2056A(a)(1)(A) of the code)Present Law

In order for a trust to be a QDT, a U.S. trustee must have the power to approve all corpus distributions from the trust. In some countries, trusts may be prohibited from having a U.S. trustee (e.g., some countries do not allow real property to be placed in trust if a U.S. trustee must approve distributions from the trust.) As a result, such trusts cannot qualify as a QDT.Reasons for Change

The estate of a decedent with a nonresident spouse should not be precluded from qualifying for the marital deduction in situations where the use of a U.S. trustee is prohibited by another country. Accordingly, the committee believes it is appropriate to grant regulatory authority to allow qualification for the marital deduction in such situations where the Treasury Department determines that the United States can retain jurisdiction and other adequate security has been provided for the payment of U.S. transfer taxes on subsequent transfers by the surviving spouse of the property transferred by the decedent. Explanation of Provision

In order to permit the establishment of a QDT in those situations where a country prohibits a trust from having a U.S. trustee, the bill provides the Treasury Department with regulatory authority to waive the requirement that a QDT have a U.S. trustee. It is anticipated that such regulations, if any, provide an alternative mechanism under which the United States would retain jurisdiction and adequate security to impose U.S. transfer tax on transfers by the surviving spouse of the property transferred by the decedent. For example, one possible mechanism would be a closing agreement process under which the surviving spouse waives treaty benefits, allows the U.S. to retain taxing jurisdiction and provides adequate security with respect to such transfer taxes.Effective Date

The provision applies to decedents dying after the date of enactment.C. Generation-Skipping Tax Provisions1. Severing of trusts holding property having an inclusion ratio of greater than zero (sec. 14631 of the bill and sec. 2642(a) of the code) Present Law

A generation-skipping transfer tax (GST tax) generally is imposed on transfers, either directly or through a trust or similar arrangement, to a skip person (i.e., a beneficiary in more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations and taxable distributions. An exemption of $1 million is provided for each person making generation-skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property .

If the value of the transferred property exceeds the amount of the GST exemption allocated to that property, the GST tax generally is determined by multiplying a flat tax rate equal to the highest estate tax rate (i.e., currently 55 percent) by the "inclusion percentage" and the value of the taxable property at the time of the taxable event. The "inclusion percentage" is the number one minus the "exclusion percentage". The exclusion percentage generally is calculated by dividing the amount of the GST exemption allocated to the property by the value of the property.Reasons for Change

The committee believes it is appropriate to provide flexibility for the severance of trusts to minimize the need for complicated governing documents and to remove a potential trap for poorly advised taxpayers. The committee understands that a similar result can already be obtained by creating separate trusts in the governing document. The flexibility of a severance should only be afforded, however, in situations where the Treasury Department believes there is no significant opportunity for tax avoidance as a result of the severance.Explanation of Provision

If a trust with an inclusion ratio of greater than zero is severed into two separate trusts, the bill allows the trustee to elect to treat one of the separate trusts as having an inclusion ratio of zero and the other separate trust as having an inclusion ratio of one. To qualify for this treatment, the separate trust with the inclusion ratio of one must receive an interest in each property held by the single trust (prior to severance) equal to the single trusts inclusion ratio, except to the extent otherwise provided by regulation. The remaining interests in each property will be transferred to the separate trust with the inclusion ratio of zero. The election must be made at a time and in a manner prescribed by the Treasury Department. It is intended that the time for making the election be reasonably soon after the transfer to the single trust.Effective Date

The provision is effective for severances of trusts occurring after the date of enactment.2. Clarification of who is transferor where subsequent gift by reason of power of appointment (sec. 14632 of the bill and sec. 2652(a)(1) of the code)Present Law

The exercise or release of a general power of appointment (e.g., a power of withdrawal) generally is treated as a transfer of property by the person who possesses such power (sec. 2514(b)). Under section 2514(e), the lapse of a general power of appointment also is treated as a taxable transfer except to the extent that the power does not exceed the greater of $5,000 or 5 percent of the fair market value of the property with respect to which the power could have been exercised. Example 5 of Prop. Treas. Reg. sec. 26.2652091(a)(5) involves a trust created by a parent that provided an income interest to his child for life, remainder to his grandchild with the child having a power to withdraw $10,000 within 60 days of the creation of the trust. The example states that the parent is the transferor with respect to the entire trust and the child is the transferor as to the excess of $10,000 over the greater of $5,000 or 5 percent of the trust.Reasons for Change

The committee wishes to resolve the uncertainty under present law regarding the identity of the transferor for GST tax purposes where a transfer is made of property with respect to which another person is granted a power of withdrawal or general power of appointment. Explanation of Provision

The bill provides that an individual cannot be treated as a "transferor" with respect to any portion of property with respect to which another person is treated as the "transferor" by reason of the exercise, release or lapse of a general power of appointment with respect to such property. Thus, for example, applying the same facts as contained in Example 5 of Prop. Treas. Reg. sec. 26.2652091(a)(5), the parent is not treated as the transferor with respect to any portion of the trust which the child is deemed to have transferred by reason of the childs power to withdraw.

The bill is not intended to create an inference regarding the identity of the transferor for GST tax purposes under present law.Effective Date

The provision applies to the exercise, release or lapse of a general power of appointment occurring after the date of enactment.3. Taxable termination not to include direct skips (sec. 14633 of the bill and sec. 2612(a)(1) of the code)Present Law

A generation-skipping transfer tax (GST tax) generally is imposed on transfers, either directly or through a trust or similar arrangement, to a skip person (i.e., a beneficiary in more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations and taxable distributions. For this purpose, a direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person (sec. 2612(c)(1)). A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a nonskip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person (sec. 2612(a)). A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or a direct skip)(sec. 2612(b)).

Direct skips are subject to less GST tax than taxable terminations and distributions since the GST tax on direct skips is paid by the transferor (sec. 2603(a)(3)) and, therefore, the tax base for a direct skip is tax exclusive (like the Federal gift tax), while the GST tax on taxable terminations and distributions is paid by the trust or beneficiary (secs. 2603(a)(1) & (2)) and, therefore, the tax base on taxable terminations and distributions is tax inclusive (like the Federal estate tax).Reasons for Change

Present law is unclear whether a transaction should be taxed as a direct skip or a taxable termination where the transaction meets both definitions. For example, a distribution from a marital deduction trust to the settlors grandchildren upon the death of the settlors spouse may be treated as both a direct skip and a taxable termination. The overlap between the two definitions may cause uncertainty regarding the calculation of the GST tax (i.e., on a tax exclusive or tax inclusive basis) and the availability of various exclusions (e.g., the predeceased parent exclusion which is limited to direct skips under present law).5161 Accordingly, the committee wishes to resolve this uncertainty by treating transactions that meet both definitions as a direct skip.

 161 1ASection 14634 of the bill extends the predeceased parent exception to certain taxable terminations.Explanation of Provision

The bill provides that, when a transfer is described as both a direct skip and a taxable termination, the transaction will be treated as a direct skip (i.e., treatment as a direct skip takes precedence over treatment as a taxable termination).Effective Date

The provision is effective for generation skipping transfers occurring after the date of enactment.4. Expansion of exception from generation-skipping transfer tax for transfers to individuals with deceased parents (sec. 14634 of the bill and sec. 2651 of the code)Present Law

Under the "predeceased parent exception", a direct skip transfer to a transferors grandchild is not subject to the generation skipping transfer ("GST") tax if the child of the transferor who was the grandchilds parent is deceased at the time of the transfer (sec. 2612(c)(2)). This "predeceased parent exception" to the GST tax is not applicable to first, transfers to collateral heirs, e.g., grandnieces or grandnephews, or second, taxable terminations or taxable distributions.Reasons for Change

The committee believes that a transfer to a collateral relative whose parent is dead should qualify for the predeceased parent exception in situations where the transferor decedent has no lineal heirs, because no motive or opportunity to avoid transfer tax exists. For similar reasons, the committee believes that transfers to trusts should be permitted to qualify for the predeceased parent exclusion where the parent of the beneficiary is dead at the time that the transfer is first subject to estate or gift tax. The committee also understands that this treatment will remove a present law impediment to the establishment of charitable lead trusts.Explanation of Provision

The bill extends the predeceased parent exception to transfers to collateral heirs, provided that the decedent has no living lineal descendants at the time of the transfer. For example, the exception would apply to a transfer made by an individual (with no living lineal heirs) to a grandniece where the transferors nephew or niece who is the parent of the grandniece is deceased at the time of the transfer.

In addition, the bill extends the predeceased parent exception (as modified by the change in the preceding paragraph) to taxable terminations and taxable distributions, provided that the parent of the relevant beneficiary was dead at the earliest time that the transfer (from which the beneficiarys interest in the property was established) was subject to estate or gift tax. For example, where a trust was established to pay an annuity to a charity for a term for years with a remainder interest granted to a grandson, the termination of the term for years would not be a taxable termination subject to the GST tax if the grandsons parent (who is the son or daughter of the transferor) is deceased at the time the trust was created and the transfer creating the trust was subject to estate or gift tax.Effective Date

The provision is effective for generation skipping transfers occurring after the date of enactment.

Subtitle G. Excise Tax SimplificationA. Provisions Relating to Distilled Spirits, Wines, and Beer (secs. 147010914711 of the bill and secs. 5008(c), 5044, 5053, 5055, 5115, 5175(c), 5207, new sec. 5222(b), and sec. 5418(b) of the code)Present LawCredit or refund for imported bottled distilled spirits returned to bonded premises

Present law provides that when tax-paid distilled spirits which have been withdrawn from bonded premises of a distilled spirits plant are returned for destruction or redistilling, the excise tax is refunded (sec. 5008(c)). This provision does not apply to imported bottled distilled spirits because they are withdrawn from customs custody and not from bonded premises of a distilled spirits plant.Authority to cancel or credit bonds without submission of records

Bond generally must be furnished to the Treasury Department when distilled spirits are removed from bonded premises of a distilled spirits plant for exportation without payment of tax. These bonds are canceled or credited when evidence is submitted to the Treasury that the distilled spirits have been exported (sec. 5175(c)).Required maintenance of records on premises of distilled spirits plant

Distilled spirits plant proprietors are required to maintain records of their production, storage, denaturation, and other processing activities on the premises where the operations covered by the records are carried out (sec. 5207(c)).Transfers from breweries to distilled spirits plants

Under present law, beer may be transferred without payment of tax from a brewery to a distilled spirits plant to be used in the production of distilled spirits, but only if the brewery is contiguous to the distilled spirits plant (sec. 5222(b)).Requirement for wholesale dealers in liquors to post sign

Wholesale liquor dealers (i.e., dealers, other than wholesale dealers in beer alone, who sell distilled spirits, wines, or beer to other persons who re-sell such products) are required to post a sign conspicuously on the outside of their place of business indicating that they are wholesale liquor dealers (sec. 5115).Refund of tax on wine returned to bond

Under present law, when unmerchantable wine is returned to bonded production premises, tax that has been paid is returned or credited to the proprietor of the bonded wine cellar to which the wine is delivered (sec. 5044). In contrast, when beer is returned to a brewery, tax that has been paid is returned or credited, regardless of whether the beer is unmerchantable (sec. 5056(a)).Use of ameliorating material in certain wines

The code contains rules governing the extent to which ameliorating material (e.g., sugar) may be added to wines made from high acid fruits and the product still be labelled as a standard, natural wine. In general, ameliorating material may not exceed 35 percent of the volume of juice and ameliorating material combined (sec. 5383(b)(1)). However, wines made exclusively from loganberries, currants, or gooseberries are permitted a volume of ameliorating material of up to 60 percent (sec. 5384(b)(2)(D)).Domestically produced beer for use by foreign embassies, etc.

Under present law, domestically produced distilled spirits and wine may be removed from bond, without payment of tax, for transfer to any customs bonded warehouse for storage pending removal for the official or family use of representatives of foreign governments or public international organizations (secs. 5066 and 5362(e)). A similar rule also applies to imported distilled spirits, wine, and beer. No such provision exists under present law for domestically produced beer.Withdrawal of beer for destruction

Present law does not specifically permit beer to be removed from a brewery for destruction without payment of tax.Records of exportation of beer

Present law provides that a brewer is allowed a refund of tax paid on exported beer upon submission to Treasury Department of certain records indicating that the beer has been exported (sec. 5055).Transfer to brewery of beer imported in bulk

Imported beer brought into the United States in bulk containers may not be transferred from customs custody to brewery premises without payment of tax. Under certain circumstances, distilled spirits imported into the United States in bulk containers may be transferred from customs custody to bonded premises of a distilled spirits plant where bottling will occur without payment of tax (sec. 5232).Reasons for Change

In addition to imposing taxes, the Internal Revenue Code regulates many other aspects of the alcoholic beverage industry. These regulations date in many cases from the Prohibition Era or earlier. In 1980, the method of collecting excise taxes on alcoholic beverages was changed from a system under which Treasury Department inspectors regularly were present at production facilities to a bonded premises system, which more closely tracks the systems used in connection with other Federal excise taxes. Many of the recordkeeping requirements and other regulatory measures imposed in connection with these taxes have not been modified to conform to these collection system changes. In addition, modification of statutory provisions is warranted in view of advances in technology used in the alcoholic beverage industry and environmental protection concerns. Explanation of ProvisionsCredit or refund for imported bottled distilled spirits returned to bonded premises

The procedures for refunds of tax collected on imported bottled distilled spirits returned to bonded premises are conformed to the rules for domestically produced and imported bulk distilled spirits. Thus, refunds will be available for all distilled spirits on their return to a bonded distilled spirits plant.Authority to cancel or credit bonds without submission of records

For purposes of canceling or crediting bonds furnished when distilled spirits are removed from bonded premises for exportation, the Treasury Department is authorized to permit records of exportation to be maintained by the exporter, rather than requiring submission of proof of exportation to Treasury in all cases.Repeal of required maintenance of records on premises of distilled spirits plant

Distilled spirits plant proprietors are permitted to maintain records of their activities at locations other than the premises where the operations covered by the records are carried out (e.g., corporate headquarters where tax audits currently are conducted), provided that the records are available for inspection by the Treasury Department during business hours.Fermented material from any brewery may be received at a distilled spirits plant

Beer may be transferred without payment of tax from a brewery to a distilled spirits plant to be used in the production of distilled spirits, regardless of whether the brewery is contiguous to the distilled spirits plant. In the case of beer previously removed from a brewery, a transfer to a distilled spirits plant also may occur without the beer being first re-transferred to the brewery.Repeal of requirement for wholesale dealers in liquors to post sign

The requirement that wholesale liquor dealers post a sign outside their place of business indicating that they are wholesale liquor dealers is repealed.Refund of tax on wine returned to bond not limited to unmerchantable wine

The requirement that wine returned to bonded premises be "unmerchantable" in order for tax to be refunded to the proprietor of the bonded wine cellar to which the wine is delivered is repealed.Use of additional ameliorating material in certain wines

The wine labelling restrictions are modified to allow any wine made exclusively from a fruit or berry with a natural fixed acid of 20 parts per thousand or more (before any correction of such fruit or berry) to contain a volume of ameliorating material not in excess of 60 percent.Domestically produced beer may be withdrawn free of tax for use by foreign embassies, etc.

The present-law rule applicable to domestically produced distilled spirits and wine (and imported distilled spirits, wine, and beer) which permits these products to be withdrawn from the place of production without payment of tax for the official or family use of representatives of foreign governments or public international organizations is extended to domestically produced beer.Beer may be withdrawn free of tax for destruction

Beer may be removed from a brewery without payment of tax for destruction, subject to Treasury Department regulations.Authority to allow drawback on exported beer without submission of records

The requirement that proof of exportation be submitted to the Treasury Department in all cases as a condition of receiving a refund of tax is repealed. This proof will continue to be required to be maintained at the exporters place of business.Transfer to brewery of beer imported in bulk without payment of tax

The present law rule applicable to distilled spirits imported into the United States in bulk containers is extended to beer imported into the United States in bulk containers, so that imported beer may, subject to Treasury regulations, be withdrawn from customs custody for transfer to a brewery without payment of tax.Effective Date

These proposals generally are effective beginning 180 days after date of enactment. The provision deleting the requirement that wholesale liquor dealers post a sign outside their place of business is effective on the date of the proposals enactment.B. Consolidation of Tax on Aviation Gasoline (sec. 14721 of the bill and secs. 4041(c), 4081094083, and 9502 of the code)Present Law

Gasoline used in noncommercial (not for hire) aviation is subject to a 19.4-cents-per-gallon excise tax. 18.4 cents per gallon of this tax is collected when the gasoline is removed from a registered and bonded pipeline or barge terminal. The remaining 1 cent per gallon is imposed at the retail level.Reasons for Change

The committee believes greater tax compliance and administrative simplification for taxpayers can be achieved by collecting the entire excise tax on aviation gasoline at only one point in that products chain of distribution.Explanation of Provision

Imposition of the aviation gasoline excise tax is consolidated, with the entire 19.4-cents-per-gallon rate being imposed when the gasoline is removed from a terminal facility.Effective Date

The provision is effective for sales or uses beginning on January 1, 1996.C. Other Excise Tax Provisions1. Authority to grant exemptions from registration requirements (sec. 14731 of the bill and sec. 4222 of the code)Present Law

Under section 4222, certain sales for exempt use of articles subject to Federal excise taxes may not be made without payment of tax unless the manufacturer, the first purchaser, and the second purchaser (if any) are all registered under regulations prescribed by the Secretary.Reasons for Change

Allowing the Internal Revenue Service to exempt certain classes of taxpayers from the registration requirements will simplify the IRSs administration of the registration provisions. Also, the provision will reduce unnecessary paperwork for affected taxpayersExplanation of Provision

The IRS is allowed to provide exemptions from generally applicable excise tax registration requirements for certain classes of taxpayers (rather than only all taxpayers or individually identified taxpayers).Effective Date

The provision applies to sales occurring after the 180 days after the date of enactment.2. Certain combinations not treated as manufacture under retail sales tax on heavy trucks (sec. 14732 of the bill and sec. 4051 of the code) Present Law

A 12-percent excise tax is imposed on the sale of trucks, tractors, and trailers having a gross vehicle weight in excess of specified amounts (sec. 4051). Revenues from the tax are dedicated to the Highway Trust Fund. The tax is imposed on the first retail sale of a taxable vehicle or addition thereto.

Generally, repairs of used vehicles are treated as remanufacture (giving rise to tax on the entire vehicle) if

(1) the transportation function of the truck is changed by additions or modifications to the chassis of the truck;

(2) a new vehicle is fabricated from a wrecked vehicle; or

(3) modifications to a used vehicle are so extensive that they extend the vehicles useful life.

The mere addition of a fifth wheel to a taxable truck is not treated as remanufacture, although the fifth wheel itself would be taxed.Reasons for Change

The committee was informed that different Internal Revenue Service districts are applying these provisions of the retail truck excise tax inconsistently. The committee determined that a statutory clarification was appropriate to ensure uniform application of the law to all taxpayers.Explanation of Provision

Clarification is provided that the following activities do not constitute remanufacture when performed on a used truck or tractor chassis:

(1) removal of a fifth wheel and addition of a power take-off, hoist, and dump body; or

(2) simple addition of a power take-off, hoist, and dump body.

These activities will remain taxable to the extent of the modifications made.Effective Date

The provision is effective on the date of enactment. No inference is intended by the prospective effective date that the activities described constitute remanufacture under present law.3. Exemption from diesel fuel dyeing requirements with respect to certain States (sec. 14733 of the bill and secs. 4082 of the code)Present Law

An excise tax totaling 24.4 cents per gallon is imposed on diesel fuel (code sec. 4081). In the case of fuel used in highway transportation, 17.5 cents per gallon (20 cents after September 20, 1995) is dedicated to the Highway Trust Fund. Revenues equal to 0.1 cent per gallon are dedicated to the Leaking Underground Storage Trust Fund. The remaining portion of this tax is imposed on transportation generally and is retained in the General Fund.

The diesel fuel tax is imposed on removal of the fuel from a terminal facility (i.e., at the "terminal rack"). Present law provides that tax is imposed on all diesel fuel removed from terminal facilities unless the fuel is destined for a nontaxable use and is indelibly dyed pursuant to Treasury Department regulations.

In general, the diesel fuel tax does not apply to nontransportation uses of the fuel. Off-highway business uses are included within this nontransportation use exemption. This exemption includes use on a farm for farming purposes and as fuel powering off-highway equipment (e.g., oil drilling equipment). Use as heating oil also is exempt. (Most fuel commonly referred to as heating oil is diesel fuel.) The tax also does not apply to fuel used by State and local governments, to exported fuels, and to fuel used in commercial shipping. Fuel contained in (or by) intercity buses and trains is partially exempt from the diesel fuel tax.

A similar dyeing regime exists for diesel fuel under the Clean Air Act. That Act prohibits the use on highways of diesel fuel with a sulphur content exceeding prescribed levels. This "high sulphur" diesel fuel is required to be dyed by the EPA. Urban areas in the State of Alaska were exempted from the Clean Air Act, but not the excise tax, dyeing regime for 3 years (until October 1, 1996); the exemption for more remote areas is permanent.Reasons for Change

Most diesel fuel sold in rural areas of Alaska is sold for nontaxable, off-highway uses. This fact, and the Clean Air Act provision exempting those areas from that Acts dyeing requirement led the committee to believe that tax compliance in those areas can be achieved without dyeing diesel fuel destined for nontaxable uses.Explanation of Provision

Diesel fuel sold in the State of Alaska will be exempt from the diesel dyeing requirement during the remainder of the period when that State is exempt from the Clean Air Act dyeing requirements. Thus, dyed diesel fuel may be used in taxable uses without penalties being imposed (subject to a certification procedure to be established by the Treasury Department).Effective Date

The proposal is effective on the first day of the first calendar quarter beginning after the date of enactment.4. Repeal of expired provisions (sec. 14743 and secs. 451(d) and 4495094498 of the code) Present LawTemporary reduction in tax on piggyback trailers

Piggyback trailers and semitrailers sold within the 1-year period beginning on July 18, 1984, were permitted a temporary reduction in the retail excise tax rate on trailers.Expiration of excise tax on deep seabed minerals

The Deep Seabed Mineral Resources Act (Public Law 9609283) imposed an excise tax on certain hard minerals mined on the deep seabed. The tax revenues were intended to fund obligations of the United States under a contemplated Law of the Sea Convention. Because the United States did not sign the treaty, this excise tax never became effective and the tax expired after June 28, 1990.Explanation of Provision

The tax reduction for piggy back trailers and the deep seabed hard minerals excise tax provisions are repealed as "deadwood."Effective Date

The proposals are effective on the date of enactment.

Subtitle H. Administrative ProvisionsA. General Provisions1. Repeal of authority to disclose whether a prospective juror has been audited (sec. 14801 of the bill and sec. 6103 of the code)Present Law

In connection with a civil or criminal tax proceeding to which the United States is a party, the Secretary must disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service (sec. 6103(h)(5)).Reasons for Change

This disclosure requirement, as it has been interpreted by several recent court decisions, has created significant difficulties in the civil and criminal tax litigation process. First, the litigation process can be substantially slowed. It can take the Secretary a considerable period of time to compile the information necessary for a response (some courts have required searches going back as far as 25 years). Second, providing early release of the list of potential jurors to defendants (which several recent court decisions have required, to permit defendants to obtain disclosure of the information from the Secretary) can provide an opportunity for harassment and intimidation of potential jurors in organized crime, drug, and some tax protester cases. Third, significant judicial resources have been expended in interpreting this procedural requirement that might better be spent resolving substantive disputes. Fourth, differing judicial interpretations of this provision have caused confusion. In some instances, defendants convicted of criminal tax offenses have obtained reversals of those convictions because of failures to comply fully with this provision.Explanation of Provision

The bill repeals the requirement that the Secretary disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service.Effective Date

The provision is effective for judicial proceedings pending on, or commenced after, the date of enactment.2. Clarification of statute of limitations (sec. 14802 of the bill and sec. 6501 of the code)Present Law

Passthrough entities (such as S corporations, partnerships, and certain trusts) generally are not subject to income tax on their taxable income. Instead, these entities file information returns and the entities shareholders (or beneficial owners) report their pro rata share of the gross income and are liable for any taxes due.

Some believe that, prior to 1993, it may have been unclear as to whether the statute of limitations for adjustments that arise from distributions from passthrough entities should be applied at the entity or individual level (i.e., whether the 3-year statute of limitations for assessments runs from the time that the entity files its information return or from the time that a shareholder timely files his or her income tax return). In 1993, the Supreme Court held that the limitations period for assessing the income tax liability of an S corporation shareholder runs from the date the shareholders return is filed (Bufferd v. Comm., 113 S. Ct. 927 (1993)).Reasons for Change

Uncertainty regarding the correct statute of limitations hinders the resolution of factual and legal issues and creates needless litigation over collateral matters.Explanation of Provision

The bill clarifies that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit.Effective Date

The provision is effective for taxable years beginning after the date of enactment.3. Certain notices disregarded under provision increasing interest rate on large corporate underpayments (sec. 14803 of the bill and sec. 6621 of the code)Present Law

The interest rate on a large corporate underpayment of tax is the Federal short-term rate plus 5 percentage points. A large corporate underpayment is any underpayment by a subchapter C corporation of any tax imposed for any taxable period, if the amount of such underpayment for such period exceeds $100,000. The large corporate underpayment rate generally applies to periods beginning 30 days after the earlier of the date on which the first letter of proposed deficiency, a statutory notice of deficiency, or a nondeficiency letter or notice of assessment or proposed assessment is sent. For this purpose, a letter or notice is disregarded if the taxpayer makes a payment equal to the amount shown on the letter or notice within that 30-day period. Reasons for Change

 The large corporate underpayment rate generally applies if the underpayment of tax for a taxable period exceeds $100,000, even if the initial letter or notice of deficiency, proposed deficiency, assessment, or proposed assessment is for an amount less than $100,000. Thus, for example, under present law, a nondeficiency notice relating to a relatively minor mathematical error by the taxpayer may result in the application of the large corporate underpayment rate to a subsequently identified income tax deficiency. Explanation of Provision

 For purposes of determining the period to which the large corporate underpayment rate applies, any letter or notice is disregarded if the amount of the deficiency, proposed deficiency, assessment, or proposed assessment set forth in the letter or notice is not greater than $100,000 (determined by not taking into account any interest, penalties, or additions to tax). Effective Date

 The provision is effective for purposes of determining interest for periods after December 31, 1995. 4. Clarification of authority to withhold Puerto Rico income taxes from salaries of Federal employees (sec. 14804 of the bill and sec. 5517 of title 5, United States Code) Present Law

 If State law provides generally for the withholding of State income taxes from the wages of employees in a State, the Secretary of the Treasury shall (upon the request of the State) enter into an agreement with the State providing for the withholding of State income taxes from the wages of Federal employees in the State. For this purpose, a State is a State, territory, or possession of the United States. The Court of Appeals for the Federal Circuit recently held in Romero v. United States (38 F. 3d 1204 (1994)) that Puerto Rico was not encompassed within this definition; consequently, the court invalidated an agreement between the Secretary of the Treasury and Puerto Rico that provided for the withholding of Puerto Rico income taxes from the wages of Federal employees. Reasons for Change

 The committee believes that employees of the United States should be in no better or worse position than other employees vis-a-vis local withholding. Explanation of Provision

 The bill makes any Commonwealth eligible to enter into an agreement with the Secretary of the Treasury that would provide for income tax withholding from the wages of Federal employees. Effective Date

The provision is effective on the date of enactment.B. Tax Court Procedures1. Overpayment determinations of Tax Court (sec. 14811 of the bill and sec. 6512 of the code) Present Law

 The Tax Court may order the refund of an overpayment determined by the Court, plus interest, if the IRS fails to refund such overpayment and interest within 120 days after the Courts decision becomes final. Whether such an order is appealable is uncertain.

 In addition, it is unclear whether the Tax Court has jurisdiction over the validity or merits of certain credits or offsets (e.g., providing for collection of student loans, child support, etc.) made by the IRS that reduce or eliminate the refund to which the taxpayer was otherwise entitled. Reasons for Change

 Clarification of the jurisdiction of the Tax Court and the ability to appeal orders of the Tax Court would provide for greater certainty for taxpayers and the government in conducting cases before the Tax Court. Clarification will also reduce litigation. Explanation of Provision

 The bill clarifies that an order to refund an overpayment is appealable in the same manner as a decision of the Tax Court. The bill also clarifies that the Tax Court does not have jurisdiction over the validity or merits of the credits or offsets that reduce or eliminate the refund to which the taxpayer was otherwise entitled. Effective Date

 The provision is effective on the date of enactment.2. Awarding of administrative costs (sec. 14812 of the bill and sec. 7430 of the code) Present Law

 Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding.

 No time limit is specified for the taxpayer to apply to the IRS for an award of administrative costs. In addition, no time limit is specified for a taxpayer to appeal to the Tax Court an IRS decision denying an award of administrative costs. Finally, the procedural rules for adjudicating a denial of administrative costs are unclear. Reasons for Change

 The proper procedures for applying for a cost award are uncertain in some instances. Clarifying these procedures will decrease litigation over these procedural issues and will provide for expedited settlement of these claims. Explanation of Provision

 The bill provides that a taxpayer who seeks an award of administrative costs must apply for such costs within 90 days of the date on which the taxpayer was determined to be a prevailing party. The bill also provides that a taxpayer who seeks to appeal an IRS denial of an administrative cost award must petition the Tax Court within 90 days after the date that the IRS mails the denial notice.

 The bill clarifies that dispositions by the Tax Court of petitions relating only to administrative costs are to be reviewed in the same manner as other decisions of the Tax Court. Effective Date

 The provision is effective on the date of enactment. 3. Redetermination of interest pursuant to motion (sec. 14813 of the bill and sec. 7481 of the code) Present Law

 A taxpayer may seek a redetermination of interest after certain decisions of the Tax Court have become final by filing a petition with the Tax Court. Reasons for Change

 It would be beneficial to taxpayers if a proceeding for a redetermination of interest supplemented the original deficiency action brought by the taxpayer to redetermine the deficiency determination of the IRS. A motion, rather than a petition, is a more appropriate pleading for relief in these cases. Explanation of Provision

 The bill provides that a taxpayer must file a "motion" (rather than a "petition") to seek a redetermination of interest in the Tax Court. Effective Date

 The provision is effective on the date of enactment. 4. Application of net worth requirement for awards of litigation costs (sec. 14814 of the bill and sec. 7430 of the code) Present Law

 Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding. A person who substantially prevails must meet certain net worth requirements to be eligible for an award of administrative or litigation costs. In general, only an individual whose net worth does not exceed $2,000,000 is eligible for an award, and only a corporation or partnership whose net worth does not exceed $7,000,000 is eligible for an award. (The net worth determination with respect to a partnership or S corporation applies to all actions that are in substance partnership actions or S corporation actions, including unified entity-level proceedings under sections 6226 or 6228, that are nominally brought in the name of a partner or a shareholder.) Reasons for Change

 Although the net worth requirements are explicit for individuals, corporations, and partnerships, it is not clear which net worth requirement is to apply to other potential litigants. It is also unclear how the individual net worth rules are to apply to individuals filing a joint tax return. Clarifying these rules will provide certainty for potential claimants and will decrease needless litigation over procedural issues. Explanation of Provision

The bill provides that the net worth limitations currently applicable to individuals also apply to estates and trusts. The bill also provides that individuals who file a joint tax return shall be treated as one individual for purposes of computing the net worth limitations. Consequently, the net worths of both spouses are aggregated for purposes of this computation. An exception to this rule is provided in the case of a spouse otherwise qualifying for innocent spouse relief.Effective Date

The provision applies to proceedings commenced after the date of enactment.C. Authority for Cooperative Agreements State Tax Authorities (sec. 14821 of the bill and new sec. 7524 of the code)Present Law

The IRS is generally not authorized to provide services to non-Federal agencies even if the cost is reimbursed (62 Comp. Gen. 323, 335 (1983)).Reasons for Change

Most taxpayers reside in States with an income tax and, therefore, must file both Federal and State income tax returns each year. Each return is separately prepared, with the State return often requiring information taken directly from the Federal return. Permitting the IRS to enter into agreements that are designed to promote efficiency through joint tax administration programs with States would reduce the burden on taxpayers because much of the same information could be used by both governments.

For example, the burden on taxpayers could be significantly reduced through joint electronic filing of tax returns, whereby a taxpayer electronically transmits both Federal and State returns to one location. Joint Federal and State electronic filing could simplify and shorten return preparation time for taxpayers. Also, State governments could benefit from reduced processing costs, while the IRS could benefit from the potential increase in taxpayers who would elect to file electronically because they would be able to fulfill both their Federal and State obligations simultaneously.Explanation of Provision

The bill provides that the Secretary is authorized to enter into cooperative agreements with State tax authorities to enhance joint tax administration. These agreements may include first, joint filing of Federal and State income tax returns, second, single processing of these returns, and (3) joint collection of taxes (other than Federal income taxes).

The bill provides that these agreements may require reimbursement for services provided by either party to the agreement. Any funds appropriated for tax administration may be used to carry out the responsibilities of the IRS under these agreements, and any reimbursement received under an agreement would be credited to the amount appropriated.

No agreement may be entered into that does not provide for the protection of confidentiality of taxpayer information that is required by section 6103.Effective Date

The provision is effective on the date of enactment. III. Votes of the Committee

In compliance with clause 2(l)(2)(B) of rule XI of the Rules of the House of Representatives, the following statements are made concerning the votes of the Committee on Ways and Means in its consideration of titles XIII and XIV of the budget reconciliation recommendations.Motion to report titles XIII and XIV

The Committee on Ways and Means approved the reconciliation provisions of titles XIII and XIV by a rollcall vote of 21 yeas and 15 nays (with a quorum being present). The vote was as follows:

 -- (PLEASE REFER TO ORIGINAL SOURCE FOR TABLE) --

 Motion on chairmans amendment

The committee approved Chairman Archers amendment to titles XIII and XIV, as amended, in the nature of a substitute to the original draft of titles XIII and XIV by a rollcall vote of 22 yeas and 15 nays. The vote was as follows:

 -- (PLEASE REFER TO ORIGINAL SOURCE FOR TABLE) --

 Votes on Amendments

Roll call votes were conducted on the following amendments to the Chairmans substitute markup amendment.

An amendment by Mr. Kleczka to delete the title XIII provision relating to transfer of excess pension assets and replace it with a disallowance of any "neutral cost recovery" depreciation deduction system was defeated by a rollcall vote of 16 yeas and 20 nays. The vote was as follows:

 -- (PLEASE REFER TO ORIGINAL SOURCE FOR TABLE) --

An amendment by Mr. Kleczka to title XIII to require that pension plan participants receive reasonable advance notice of withdrawal of excess pension assets was defeated by a rollcall vote of 17 yeas and 20 nays. The vote was as follows:

 -- (PLEASE REFER TO ORIGINAL SOURCE FOR TABLE) --

An amendment by Mr. Cardin to title XIII to require use of interest rate and mortality assumptions for the excess pension plan assets as applicable to plans with unfunded current liabilities was defeated by a rollcall vote of 16 yeas and 21 nays. The vote was as follows:

 -- (PLEASE REFER TO ORIGINAL SOURCE FOR TABLE) --

An amendment by Mr. Rangel and Mrs. Kennelly to title XIII to replace the sunset of the low-income housing tax credit with a disallowance of any "neutral cost recovery" depreciation deduction system was defeated by a rollcall vote of 15 yeas and 22 nays. The vote was as follows:

 -- (PLEASE REFER TO ORIGINAL SOURCE FOR TABLE) --

An amendment by Mr. Ford to title XIII to strike section 13637 (to repeal the tax credit for contributions to community development corporations) was defeated by a rollcall vote of 15 yeas and 21 nays. The vote was as follows:

 -- (PLEASE REFER TO ORIGINAL SOURCE FOR TABLE) --

An amendment by Mr. Kleczka to title XIII to strike section 13631 (to tax certain Indian gaming activities) and to disallow any "neutral cost recovery" depreciation deduction system was defeated by a rollcall vote of 10 yeas and 26 nays. The vote was as follows:

 -- (PLEASE REFER TO ORIGINAL SOURCE FOR TABLE) --

An amendment by Mrs. Kennelly to title XIII to strike sections 13701 and 13702 (to retain the earned income tax credit for individuals without children and to delete the modification to the EITC phaseout and AGI) was defeated by a rollcall vote of 14 yeas and 22 nays. The vote was as follows:

 -- (PLEASE REFER TO ORIGINAL SOURCE FOR TABLE) --

An amendment by Mr. Cardin to title XIII to remove the increase in the EITC phaseout was defeated by a rollcall vote of 14 yeas and 22 nays. The vote was as follows:

 -- (PLEASE REFER TO ORIGINAL SOURCE FOR TABLE) --

An amendment by Mr. Levin to title XIII to strike section 13702 (remove the modifications to AGI for the EITC phaseout) and replace it with a disallowance of any "neutral cost recovery" depreciation deduction system as defeated by a rollcall vote of 15 yeas and 22 nays. The vote was as follows:

 -- (PLEASE REFER TO ORIGINAL SOURCE FOR TABLE) --

An amendment by Mr. Rangel to title XIII to retain the earned income tax credit for individuals without children was defeated by a rollcall vote of 15 yeas and 22 nays. The vote was as follows:

 -- (PLEASE REFER TO ORIGINAL SOURCE FOR TABLE) --

An amendment by Mr. Hancock to title XIII to repeal the reachback provisions of the coal industry retiree health benefit program was approved by a rollcall vote of 20 yeas and 17 nays. The vote was as follows:

 -- (PLEASE REFER TO ORIGINAL SOURCE FOR TABLE) --

 Tax Simplification Revenue Effects estimated at this time.

 -- (PLEASE REFER TO ORIGINAL SOURCE FOR TABLE) --

 IV. Budget Effects of Titles XIII and XIVA. Committee Estimates of Budgetary Effects

In compliance with clause 7 of Rule III of Rules of the House of Representatives, the following statement is made concerning the effects on the budget of the Committee on Ways and Means revenue reconciliation (title XIII) and tax simplification (title XIV) provisions.

Titles XIII and XIV are estimated to have the following effects on budget receipts for fiscal years 1996092002: