101st Congress
1st Session

COMMITTEE PRINT

S. PRT.
101-

REVENUE RECONCILIATION ACT OF 1989

EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON OCTOBER 3, 1989

COMMITTEE ON FINANCE
UNITED STATES SENATE

Lloyd Bentsen, *Chairman*

OCTOBER 12, 1989

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
22-661 WASHINGTON : 1989

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

CONTENTS

(TITLE VI—REVENUE RECONCILIATION PROVISIONS)

EXPLANATION OF TITLE VI (REVENUE RECONCILIATION ACT OF 1989)

SUBTITLE A. EXTENSIONS OF CERTAIN EXPIRING TAX PROVISIONS

1. Exclusion for employer-provided educational assistance (sec. 6101 of the bill and sec. 127 of the Code)

Present Law

Under present law, an employee is required to include in income, for income and employment tax purposes, the value of educational assistance provided by an employer to the employee, unless the cost of such assistance qualifies as a deductible job-related expense of the employee. Amounts expended for education qualify as deductible job-related expenses if the education (1) maintains or improves skills required for the employee's current job, or (2) meets the express requirements of the individual's employer that are imposed as a condition of continuing employment in the same job.

Under prior law, an employee's gross income for income and employment tax purposes also did not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts were paid or incurred pursuant to an educational assistance program that met certain requirements (sec. 127). The exclusion was limited to $5,250 of educational assistance with respect to an individual during a calendar year and did not apply to any payment for, or the provision of any benefits with respect to, any graduate-level courses.

The Deficit Reduction Act of 1984 required that employers file information returns with respect to educational assistance plans under section 127 (sec. 6039D). The purpose of this requirement was to collect data with respect to the use of such plans so as to provide Congress with a means to evaluate the effectiveness of the exclusion.

The educational assistance exclusion expired for taxable years beginning after December 31, 1988.

Reasons for Change

The exclusion for educational assistance was originally enacted for a temporary period in order to provide Congress with an opportunity to evaluate the use and effectiveness of the exclusion. The committee is concerned that there is insufficient data to determine whether or not section 127 has achieved its objectives. The provision is therefore extended in order to allow additional time for this determination.

Explanation of Provision

The exclusion for employer-provided educational assistance is retroactively reinstated and extended so that it expires for taxable years beginning after December 31, 1991. The provision clarifies that, to the extent employer-provided educational assistance is not excludable under section 127 because it exceeds the maximum dollar limitation or because of the limitation on graduate-level courses, it may be excludable from income as a working condition fringe benefit (sec. 132(d)), provided the requirements of that section are otherwise satisfied (e.g., the education is job-related as defined under section 162). Educational assistance may not be excluded under any other provision of section 132.

Effective Date

The provision is effective for taxable years beginning after December 31, 1988.

2. Exclusion for employer-provided group legal services (sec. 6102 of the bill and secs. 120 and 501(c)(20) of the Code)

Present Law

Under present law, amounts contributed by an employer to a group legal services plan on behalf of an employee generally are includible in the employee's gross income.

Under prior law, amounts contributed by an employer to a qualified group legal services plan for an employee (or the employee's spouses or dependents) were excluded from the employee's gross income for income and employment tax purposes (sec. 120). The exclusion also applied to any services received by an employee or any amounts paid to an employee under such a plan as reimbursement for the cost of legal services for the employee (or the employee's spouse or dependents). The maximum amount that could be excluded from gross income was $70 per year. The exclusion for group legal services benefits expired for taxable years ending after December 31, 1988.

In addition, under prior law, an organization, the exclusive function of which was to provide legal services or indemnification against costs of legal services as part of a qualified group legal services plan, was entitled to tax-exempt status (sec. 501(c)(20)). The tax exemption for such an organization expired for years ending after December 31, 1988.

The Deficit Reduction Act of 1984 required that employers file information returns with respect to qualified group legal services plans (sec. 6039D). The purpose of this requirement was to collect data with respect to the use of such plans so as to provide Congress with a means to evaluate the effectiveness of the exclusion.

Reasons for Change

The committee believes it is appropriate to extend, on a temporary basis, the exclusion for employer-provided group legal services and the tax-exemption for group legal services organizations.

Explanation of Provision

The exclusion for employer-provided group legal services and the tax exemption for group legal services organizations is retroactively reinstated and extended so that it expires for taxable years beginning after December 31, 1991.

Effective Date

The provision is effective for group legal services provided in taxable years ending after December 31, 1988, or taxable years of group legal services organizations ending after December 31, 1988.

3. Targeted jobs tax credit (sec. 6103 of the bill and sec. 51 of the Code)

Present Law

Tax credit provisions

The targeted jobs tax credit is available on an elective basis for hiring individuals from nine targeted groups. The targeted groups are: (1) vocational rehabilitation referrals; (2) economically disadvantaged youths aged 18 through 22; (3) economically disadvantaged Vietnam-era veterans; (4) Supplemental Security Income (SSI) recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students aged 16 through 19; (7) economically disadvantaged former convicts; (8) Aid to Families with Dependent Children (AFDC) recipients and Work Incentive (WIN) registrants; and (9) economically disadvantaged summer youth employees aged 16 or 17. Certification of targeted group membership is required as a condition of claiming the credit.

The credit generally is equal to 40 percent of the first $6,000 of qualified first-year wages paid to a member of a targeted group. Thus, the maximum credit generally is $2,400 per individual. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 40 percent of up to $3,000 of wages, for a maximum credit of $1,200. The employer's deduction for wages must be reduced by the amount of the credit claimed.

The credit is not available for wages paid to a targeted group member unless the individual either (1) is employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees), or (2) has completed at least 120 hours of work performed for the employer (20 hours in the case of economically disadvantaged summer youth employees).

The credit is available with respect to targeted-group individuals who begin work for the employer before January 1, 1990.

Authorization of appropriations

Present law also authorizes appropriations for administrative and publicity expenses relating to the targeted jobs tax credit through September 30, 1989. These monies are to be used by the Internal Revenue Service (IRS) and Department of Labor to inform employers of the credit program.

Reasons for Change

The committee understands that the targeted jobs tax credit provides a useful incentive for hiring disadvantaged individuals, but an opportunity for further assessment by the Congress and the Treasury Department is appropriate given changes in the labor market and the use of the targeted jobs credit that may occur over time. In addition, the committee believes that certain minor changes will improve the administration and efficiency of the program.

Explanation of Provisions

Extension of the credit

The targeted jobs tax credit is extended for two additional years, with one modification.

The modification requires that employers specifically identify the categories (but not to exceed two) for which an individual is believed to be eligible when requesting certification of individual eligibility for individuals who have not received a preliminary determination of eligibility from the designated local agency. In addition, the employer must include a statement on the certification request that a good faith effort was made to determine that the individual may be eligible for the credit.

Authorization of appropriations

The authorization for appropriations for administration and publicity expenses is extended for two years. To the extent feasible, the IRS and the Department of Labor should inform employers (e.g., through press releases or announcements) of the extension of the credit.

Effective Date

The provision applies to targeted-group individuals who begin work for the employer after December 31, 1989, and before January 1, 1992. Under the provision, the credit does not apply with respect to individuals who begin work for the employer after December 31, 1991.

The authorization for appropriations is effective for fiscal years 1990 and 1991.

4. Allocation and apportionment of research and experimental expenditures (sec. 6104 of the bill and 864(f) of the Code)

Present Law

Foreign tax credit and source rules

Under the Code, each item of income is assigned either a U.S. source or a foreign source. The foreign tax credit for foreign taxes paid on foreign source income is limited to the amount of U.S. tax otherwise payable on foreign source income. The foreign tax credit is not available against U.S. tax on U.S. source income. (This is known as the foreign tax credit limitation.) A shift in the source of income from foreign to U.S. may increase net U.S. tax for some taxpayers by reducing the foreign tax credit limitation.

In determining foreign source taxable income for purposes of computing the foreign tax credit limitation, and for other tax purposes, taxpayers are required to apportion expenses between foreign source income and U.S. source income (Code secs. 861-864). A shift in the apportionment of expenses from U.S. source to foreign source gross income decreases foreign source taxable income. This decrease may increase U.S. tax by reducing the foreign tax credit limitation.

Research and experimental expense allocation regulation

Treasury Regulation section 1.861-8 (promulgated in 1977) sets forth detailed rules for allocating and apportioning several categories of expenses, including deductible research and experimental expenditures ("research expenses"). The regulation provides that research expenses are ordinarily considered definitely related to all gross income reasonably connected with one or more of 32 product categories based on two-digit classifications of the Standard Industrial Classification ("SIC") system. Research expenses are not traced solely to the income generated by the particular product which benefited from the research activity. Instead, these expenses are associated with all the income within the SIC product group in which the product is classified.

The Treasury regulation contemplates that taxpayers will sometimes undertake research solely to meet legal requirements imposed by a particular governmental entity with respect to improvement or marketing of specific products or processes. In some cases, such research cannot reasonably be expected to generate income (beyond de minimis amounts) outside that governmental entity's jurisdiction. If so, the deductions allowable for such associated research expense are allocated solely to gross income from the geographic source that includes that jurisdiction.

After research expenses incurred to meet legal requirements are allocated under the above rule, any remaining research expenses are generally apportioned to foreign source income based on the ratio of total foreign source sales receipts in the SIC product group with which the expenses are identified to the total such worldwide sales receipts in that product group (the "sales" or "gross receipts" method). In computing this fraction, sales by a party controlled or uncontrolled by the taxpayer may be taken into account if the party can reasonably be expected to benefit from the research expense. However, the regulation provides that a taxpayer using the sales method may first apportion at least 30 percent of research expense remaining after allocation to meet legal requirements exclusively to income from the geographic source where over half of the taxpayer's research and development is performed.

Thus, for example, a taxpayer that performs 50 percent or more of its research and development in the United States may automatically apportion at least 30 percent of its remaining research expense to U.S. source income. A taxpayer can choose to apportion to the geographic source where research and development is performed a percentage of research expense significantly greater than 30 percent if the taxpayer establishes that the higher percentage is warranted because the research and development is reasonably expected to have a very limited or long-delayed application outside that geographic source.

Alternatively, subject to certain limitations, a taxpayer may elect to apportion its research expense remaining after any allocation to meet legal requirements under one of two optional gross income methods. Under these optional methods, a taxpayer generally apportions its research expense on the basis of relative amounts of gross income from U.S. and foreign sources. If a taxpayer makes an automatic place-of-performance apportionment, the taxpayer may not use either optional gross income method.

The basic limitation on the use of the optional gross income methods is that the respective portions of a taxpayer's research expense apportioned to U.S. and foreign source income using these methods can not be less than 50 percent of the respective portions that would be apportioned to each income grouping using a combination of the sales and place-of-performance apportionment methods.

If this 50-percent limitation is satisfied with respect to both income groupings, the taxpayer may apportion the amount of its research expense that remains after allocation under the legal requirements test ratably on the basis of foreign and U.S. gross income. If the 50-percent limitation is not satisfied with respect to one of the income groupings, then the taxpayer must apportion to that income grouping 50 percent of the amount of its research expense which would have been apportioned to that income grouping under the sales and place-of-performance methods. A taxpayer electing an optional gross income method may be able then to reduce the amount of its research expense apportioned to foreign source income to as little as one-half of the amount that would be apportioned to foreign source income under the sales method.

For example, consider a taxpayer with $110 of U.S.-performed research expense and equal U.S. and foreign sales. Assume that $10 of the research expense is to meet U.S. legal requirements and is allocated to U.S. source income. Of the remaining $100, 30 percent ($30) is exclusively apportioned to U.S. source income under the automatic place-of-performance rule and the remaining $70 is divided evenly between U.S. and foreign source income, using the sales method. Thus, under this method $35 would be allocated to foreign source income and $75 would be allocated to U.S. source income. Under the optional gross income methods, the $35 of research expense allocated to foreign sources can be reduced as much as 50 percent, to $17.50. This can occur, for example, if the foreign sales were made by a foreign subsidiary that did not repatriate earnings to the U.S. corporation, and thus a disproportionately high fraction of the U.S. corporation's income is from U.S. sources.

The optional gross income methods apply to all of a taxpayer's gross income, not gross income on a product category basis.

Temporary moratorium and Treasury study

The Economic Recovery Tax Act of 1981 (ERTA) provided that, for a taxpayer's first two taxable years beginning within two years after the date of its enactment (August 13, 1981), all research and experimental expenditures (within the meaning of sec. 174) paid or incurred in those years for research activities conducted in the United States were to be allocated or apportioned to income from sources within the United States (sec. 223 of ERTA).

This two-year moratorium was effectively extended for two additional years by the Tax Reform Act of 1984 (the "1984 Act"). Under section 126 of the 1984 Act, for taxable years beginning generally after August 13, 1983, and on or before August 1, 1985, all of a taxpayer's research and experimental expenditures (within the meaning of sec. 174) attributable to research activities conducted in the United States were to be allocated to sources within the United States for purposes of computing taxable income from U.S. sources and taxable income from sources outside the United States.

One reason Congress cited for enacting the original two-year moratorium was that some foreign countries do not allow deductions under their tax laws for expenses of research activities conducted in the United States. Taxpayers argued that this disallowance caused U.S.-based research to be disadvantaged. First, U.S.-based research expense is deemed to be allocated to a foreign country which may not recognize that such amount is deductible as an expense. The allocation of this U.S.-based research expense to foreign sources had the effect of reducing the foreign tax credit of U.S. taxpayers. Because those taxpayers could take their deductions if the research occurred in the foreign country, taxpayers argued that there was an incentive to shift their research expenditures to those foreign countries whose laws disallow tax deductions for research activities conducted in the United States but allow tax deductions for research expenditures incurred locally.

Accordingly, Congress concluded that the Treasury Department should study the impact of the allocation of research expenses under the 1977 regulation on U.S.-based research activities and on the availability of the foreign tax credit. Pending the outcome of the study, Congress concluded that expenses should be charged to the cost of generating U.S. source income, regardless of whether such research was a direct or indirect cost of producing foreign source income.

On the ground that a reduction in research and development might adversely affect the competitive position of the United States, the 1983 Treasury report recommended the two-year extension of the moratorium that was ultimately enacted by Congress in 1984. The extension was intended to allow Congress to consider further the results of the Treasury study.

The Consolidated Omnibus Budget Reconciliation Act of 1985 (the "1985 Act") extended the moratorium on the application of the research and experimental expense allocation rules of the 1977 regulation generally for one additional taxable year beginning after August 1, 1985, and on or before August 1, 1986.

The Tax Reform Act of 1986 (the "1986 Act") permitted the moratorium on application of the research expense allocation rules in regulation section 1.861-8 to expire. However, for taxable years beginning after August 1, 1986, and on or before August 1, 1987, application of the regulation was liberalized by the 1986 Act in three respects, which were intended by Congress to provide an additional tax incentive to conduct research in the United States while Congress analyzed whether any additional permanent incentive was necessary.

The first liberalization under the 1986 Act was that for the specified one-year period, 50 percent of all remaining amounts allowable as a deduction for qualified research and experimental expenditures (that is, research and experimental expenditures within the meaning of section 174 that are attributable to activities conducted in the United States) after allocation of legally required research expenses could be apportioned to U.S. source income and deducted from such income in determining the amount of taxable U.S. source income. The 1986 Act thus had the effect of increasing the automatic place-of-performance apportionment percentage for U.S.-based research expense from 30 percent to 50 percent.

The 1986 Act further provided that, for the specified one-year period, the portion of those amounts allowable as a deduction for qualified research and experimental expenditures that remained after any legal requirements allocation and the 50 percent automatic place-of-performance apportionment were apportioned either on the basis of sales or gross income. Thus, the 1986 Act's second effective liberalization of the regulation was to allow the automatic place-of-performance apportionment temporarily to taxpayers who elected to apportion expenses using the optional gross income method, rather than only to taxpayers that used the standard sales method of apportionment. Third, the 1986 Act had the effect of temporarily suspending the regulatory rule that prohibits taxpayers from using the optional gross income method to reduce allocation of research expense to foreign source income by more than 50 percent of the amount that would be allocated to foreign source income under the sales method.

The temporary modifications made by the 1986 Act to the research expense allocation rules in regulation section 1.861-8 applied for purposes of computing taxable income from U.S. sources and taxable income from sources outside the United States. The modifications applied only to the allocation of expenditures for research and experimental activities conducted in the United States, and only for the purposes of geographic sourcing of income; the modifications did not apply for other purposes, such as the computation of combined taxable income of a FSC (or DISC) and its related supplier. Also, the modifications did not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of depreciable or depletable property to be used in connection with research or experimentation.

The Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act") further modified, again on a temporary basis, the rules for sourcing research expenditures. These modifications were effective only for the first four months of a taxpayer's first taxable year beginning after August 1, 1987 (treating all applicable expenditures in that taxable year as if they were incurred ratably over the year). Under the 1988 Act, the treatment of research and development expenditures incurred to meet certain legal requirements was unchanged. After applying the legal requirements rule, however, the 1988 Act modifications provided that 64 percent of the U.S.-based research expenses remaining to be allocated and apportioned were allocated to U.S. source income and 64 percent of the remaining foreign-based research expenses were allocated to foreign source income. The remaining research expenditures treated as having been incurred during this four-month period were allocated and apportioned either on the basis of sales or gross income. However, if the gross income method of apportionment was utilized, the amount apportioned to foreign source income could be no less than 30 percent of the amount that would have been apportioned to foreign source income had the sales method been used.

Generally, for the remainder of a taxpayer's first taxable year beginning after August 1, 1987 (and for subsequent taxable years), the rules set forth in regulation section 1.861-8 were (and are) applicable with respect to sourcing research and experimental expenditures.

Reasons for Change

In the 8 years since the first temporary moratorium on the 1977 regulation was enacted, Congress, the Treasury Department, and representatives of affected industries have intensely scrutinized the effects of the research and experimental allocation rules on research activities.[1] That scrutiny has not resulted in an unambiguous recommendation regarding the appropriateness of allocating U.S.-based research expenses to U.S. source income under either the 1977 regulation, the complete moratorium, or the partial moratoria of the 1986 and 1988 Acts. On the one hand, there are those who argue that the moratorium and the partial moratoria had a beneficial effect on U.S. research activity and on U.S. competitiveness in world-wide markets. On the other hand, there are those whose studies prompt them to conclude otherwise. Furthermore, the tax costs of both the total and the partial moratoria have been significant, and the tax benefits they have bestowed are distributed somewhat arbitrarily among taxpayers. At the same time, these taxpayers have faced a prolonged period of uncertainty as to the research and experimental allocation rules that will apply in the coming years, making it more difficult for them to predict the after-tax costs of the research in which they generally must engage, if at all, over extended future periods.

In April 1987 the Treasury Department, noting that "we all have a stake in ending [the controversy] as soon as possible," [2] expressed its view that an appropriate way to balance the concerns of promoting U.S. research and development, on the one hand, and appropriately dividing income tax receipts between the United States and foreign taxing jurisdictions, on the other, would be to make the 1986 Act liberalizations permanent, while further increasing the automatic place-of-performance apportionment percentage from 50 percent to 67 percent. In 1988, a somewhat modified temporary proposal was adopted by the committee, and was subsequently adopted by Congress.

The committee continues to believe that the substantive modifications adopted in the 1988 Act are consistent with tax and com-

---

[1] *See, e.g., Interaction Between U.S. Tax Policy and Domestic Research and Development: Hearing on S. 58 and S. 716 Before the Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance*, 100th Cong., 1st Sess. (1987).

[2] *Id.* at 84.

petitiveness policy, while reducing somewhat the cost of the permanent solution to these issues. The committee is concerned, for example, that the unlimited use of the gross income method of apportionment together with an automatic apportionment percentage of 67 percent would unfairly favor companies that delay or otherwise manipulate the repatriation of earnings of controlled foreign subsidiaries. The committee also wishes to avoid any possible inference, arguably arising under the language of the committee's 1987 bill, that while 64 percent of expenses for U.S. conducted research may be allocated to U.S. source income in order to encourage U.S. research, the regulation might also be used to automatically allocate in some cases 30 percent of the expenses of conducting research abroad to U.S. source income. Thus, the committee believes that if research is conducted abroad, most of those expenses should be allocated and apportioned against foreign source income.

In light of the 1986 Act provisions regarding the sourcing of income from space, the high seas, and Antarctica, the committee believes that it is appropriate to clarify on a permanent basis whether expenses for research conducted in such places is allocated and apportioned according to the rules for allocating expenses of U.S. conducted research or foreign conducted research.

Explanation of Provision

General allocation rule

The bill establishes a new Code provision, section 864(f), which supersedes the Treasury's research and experimentation expense allocation regulation for purposes of determining the source of taxable income, and extends for these purposes the statutory rules for allocation of such expenses contained in the 1988 Act. These rules do not apply, for example, in the allocation and apportionment of deductions for research and experimental expenditures for purposes of computing the taxable income of a foreign taxpayer effectively connected with its conduct of a trade or business in the United States.

The bill allocates research and experimental expenditures as defined by section 174 of the Code ("qualified research and experimental expenditures" as that phrase is used in the bill) entirely to one geographic source if they were incurred to meet legal requirements imposed with respect to improvement or marketing of specific products or processes and cannot reasonably be expected to generate income (beyond de minimis amounts) outside that geographic source (see Treas. Reg. sec. 1.861-8(e)(3)(i)(B)).

With respect to qualified research and experimental expenditures not specifically allocated under the rules described in the preceding paragraph, the bill provides that a taxpayer shall allocate 64 percent of such expenses for research conducted in the United States to U.S. source income, and 64 percent of expenses for foreign-based research and experimentation to foreign source income. Under the bill, a taxpayer may allocate and apportion the remainder of research and experimental expenses on the basis of either sales or gross income. However, if the income based method of apportionment is chosen, the amount apportioned to foreign source income can be no less than 30 percent of the amount that would be apportioned to foreign source income had the sales method been used.

For example, assume that an unaffiliated U.S. taxpayer has $100 of U.S. research expenses and $100 of foreign research expenses, that 50 percent of relevant gross sales produce foreign source income, and that 10 percent of the taxpayer's gross income is from foreign sources. Under the bill, assuming there is no legal requirements allocation, $125.20 of the qualified research and experimental expenditures may be allocated and apportioned to U.S. source income. The bill allocates $64 to U.S. source income using the automatic place-of-performance allocation for U.S. research expenses, and $64 to foreign source income using the automatic place-of-performance allocation for foreign research expenses. Of the remaining $72 of qualified research and experimental expenditures, $61.20 may be apportioned to U.S. source income. A straight gross income apportionment of the $72 remainder would have resulted in apportioning $64.80 to U.S. source income, and $7.20 to foreign source income, while a gross sales apportionment would have resulted in apportioning $36 to U.S. source income and $36 to foreign source income. The gross sales limit provides that a minimum of 30 percent of $36, or $10.80, must be apportioned to foreign source income. Therefore, of the $72 of expenses remaining for apportionment after the automatic place-of-performance allocations, no more than $61.20 may be apportioned to U.S. source income.

The bill expressly does not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of depreciable or depletable property to be used in connection with research or experimentation. Additionally, any qualified research and experimental expenditures treated as deferred under section 174(b) shall be taken into account for purposes of applying these source allocation rules in the taxable year such expenditures are allowed as a deduction.

Affiliated group and possessions corporations

As is already true for research expenses that would, but for the bill, be covered by the general expense allocation rules introduced in the 1986 Act (sec. 864(e)), the bill provides generally that allocation and apportionment of research expenses, like other expenses, is to be determined as if all members of the affiliated group (plus any section 936 companies (possession corporations) that would be eligible to consolidate absent statutory prohibition) were a single corporation. However, in the case of a section 936 company that has elected either the cost sharing or profit split method of computing its intangible property income (sec. 936(h)(5)(C)), its sales and gross income from products produced in whole or in part in a possession, and dividends paid by such company attributable to sales of such products, will not be taken into account under the bill to the extent that the company is allowed a credit under section 936 with respect to gross income on those products that is intangible property income.

Where an affiliated group with qualified research and experimental expenditures has a possession corporation that has elected either the cost sharing or profit split method for computing its intangible property income, its cost sharing amount will be an adjustment to the group's qualified research and experimental expenditures subject to allocation and apportionment under the bill. (This rule applies to the profit split method as well as the cost sharing method with respect to section 936 companies because the amount allocated and apportioned to combined income in the case of such a company electing the profit split method is computed taking into account the cost sharing amount.) Thus, for example, if a group has a possession corporation using cost sharing with respect to its only product and all of the group's research expenses are qualified research and experimental expenditures, then the cost sharing amount under section 936 that is attributable to those qualified research and experimental expenditures will reduce the research expenses allocated between the group's U.S. and foreign source income based on the gross income or gross sales of the group. Similarly, where an affiliated group with qualified research and experimental expenditures has a section 936 company that has elected the profit split method, the qualified research and experimental expenditures taken into account in computing combined taxable income will be an adjustment to the group's qualified research and experimental expenditures subject to allocation and apportionment under the bill.

The bill provides the Treasury with the authority to prescribe such regulations as may be necessary to carry out the purposes of the one taxpayer rule and its exceptions regarding section 936 companies. In addition to providing the safeguards addressed in the regulations under the general one taxpayer rule of section 864(e), these regulations are to provide for the source of gross income and the allocation and apportionment of deductions to take into account the adjustment to group-allocable qualified research and experimental expenditures for research expenses treated as cost sharing amounts under section 936. In addition, these regulations may provide for an adjustment to group-allocable research expenditures to take into account certain bona fide cost sharing payments by foreign affiliates, where necessary and appropriate in light of the purposes of the one taxpayer rule. The committee anticipates that in taking into account cost sharing amounts, the regulations will prevent any disproportionate reduction in the amount of research expenses allocated and apportioned to foreign source income.

Allocation for space, ocean, and Antarctica research expenses

The bill clarifies the rules for research conducted in space, on or beneath the ocean, or in Antarctica. Research expenses incurred by U.S. persons for activities conducted in space, in Antarctica, or on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, U.S. possession, or the United States, are allocated and apportioned in the same manner as if they were attributable to activities conducted in the United States. Similarly, research expenses for such activities incurred by non-U.S. persons are allocated and apportioned as if they were attributable to activities conducted outside the United States.

Effective Date

The provision is effective for taxable years beginning after August 1, 1989, and on or before August 1, 1991.

5. Qualified small-issue bonds (sec. 6105 of the bill and sec. 144(a) of the Code)

Present Law

Interest on certain small issues of private activity bonds is exempt from tax if at least 95 percent of the net proceeds of the bonds is to be used to finance manufacturing facilities or certain land or property for first-time farmers ("qualified small-issue bonds").

Qualified small-issue bonds are issues having an aggregate authorized face amount (including certain outstanding prior issues) of $1 million or less. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of certain related capital expenditures during the 6-year period beginning three years before the date of the issue and ending three years after that date, may not exceed $10 million. In determining whether an issue meets the requirements of the small-issue exception, certain previous small issues (and, in the case of the $10-million limitation, capital expenditures during a 6-year period) are taken into account.

Interest on qualified small-issue bonds is taxable if the aggregate face amount of all outstanding tax-exempt private activity bonds (including exempt-facility bonds, qualified redevelopment bonds, and qualified small-issue bonds) that would be allocated to any beneficiary (other than a section 501(c)(3) organization) of the qualified small-issue bonds exceeds $40 million.

The aggregate amount of qualified small-issue bond financing for first-time farmers for all types of depreciable farm property (including both new and used property) is limited to $250,000 for any person or related persons. The $250,000 is a lifetime limit.

To issue a qualified small-issue bond, the issuer must receive an allocation from the State private activity volume cap. Authority to issue qualified small-issue bonds expires December 31, 1989.

Reasons for Change

The committee believes it is appropriate to permit State and local governments to continue to issue qualified small-issue bonds.

Explanation of Provision

The provision extends authority to issue qualified small-issue bonds for two years (through December 31, 1991).

Effective Date

The provision is effective on the date of enactment.

6. Health insurance deduction for self-employed individuals (sec. 6106 of the bill and sec. 162(l) of the Code)

Present Law

Under present law, self-employed individuals are entitled to deduct 25 percent of the amount paid for health insurance for the individual and the individual's spouse and dependents (sec. 162(l)). This deduction expires for taxable years beginning after December 31, 1989.

Under present law, more than 2-percent shareholders of S corporations are generally treated as partners in a partnership for purposes of the employee fringe benefit provisions of the Code (sec. 1372).

Reasons for Change

The committee believes it is appropriate to extend the 25-percent deduction on a temporary basis and to clarify the application of the provision in the case of certain shareholders in S corporations.

Explanation of Provision

The provision extends the 25-percent deduction so that it expires for taxable years beginning after December 31, 1991. The provision also provides that the 25-percent deduction applies to a more than 2-percent shareholder (as defined under sec. 1372). For purposes of the 25-percent deduction, such an individual's earned income is determined exclusively by reference to the individual's wages (as defined in sec. 3121) from the S corporation. The Secretary is authorized to prescribe additional adjustments relating to the application of the deduction in the case of S corporation shareholders.

Effective Date

The provision is effective for taxable years beginning after December 31, 1989.

7. ESOP exception to additional tax on early withdrawals (sec. 6107 of the bill and sec. 72(t) of the Code)

Present Law

Under present law, an additional 10-percent income tax applies to early withdrawals from a qualified retirement plan (sec. 72(t)). However, certain distributions from an employee stock ownership plan (ESOP) or a tax credit ESOP are exempt from the additional income tax to the extent that the distribution is attributable to assets that have been invested, at all times, in employer securities (as defined in sec. 409(l)) that satisfy the applicable requirements of sections 409 and 401(a)(28) for the 5-year period immediately preceding the plan year in which the distribution occurs (sec. 72(t)(2)(C)). The ESOP exception does not apply to distributions made after December 31, 1989.

Reasons for Change

The committee believes it is appropriate to extend the exception to the 10-percent additional income tax for certain distributions from an ESOP on a temporary basis.

Explanation of Provision

Under the provision, the exception to the early withdrawal tax for certain distributions from an ESOP is extended for 2 years so that it applies to distributions made before January 1, 1992.

Effective Date

The provision is effective for distributions after December 31, 1989.

8. Special rules for undercover operations of the IRS (sec. 6108 of the bill and sec. 7608 of the Code)

Present Law

The Anti-Drug Abuse Act of 1988 provided an exemption for IRS undercover operations from certain Federal laws generally applicable to Federal agencies. Thus, the IRS is permitted to purchase property, acquire businesses, deposit money in banks, and reinvest the proceeds of an undercover operation in that operation, provided that the IRS Commissioner certifies that these activities are necessary for the conduct of an IRS undercover operation. These special rules are similar to the rules applicable to undercover operations of Customs, the FBI, and DEA.

IRS must also submit to the Congress an annual report providing information on undercover operations conducted under these special rules. Because the Anti-Drug Abuse Act was enacted on November 10, 1988, IRS has not yet issued the first required report to the Congress.

These special rules cease to apply after December 31, 1989.

Reasons for Change

The committee believes that it is appropriate to extend this provision for two years to permit the IRS to continue to conduct its undercover operations in a manner similar to other Federal law enforcement agencies. The committee also believes that continued Congressional oversight of these provisions is important; the two-year period before expiration will provide opportunity for the Congress to consider the effectiveness of this provision.

Explanation of Provision

The application of the special rules for undercover operations of the IRS is extended for two years. Thus, these provisions will expire on January 1, 1992.

Effective Date

The provision is effective on the date of enactment, and extends these special rules for two years.

9. Two-year extension of general fund transfers to Railroad Retirement Tier II Trust Fund of amounts from taxation of Tier II benefits (sec. 6109 of the bill)

Present Law

The railroad retirement program consists of a Tier I benefit structure which is generally equivalent in benefits and financing to the social security program, and a separately financed Tier II benefit structure, which is similar to private-sector pension plans. The Tier II benefits are financed primarily by payroll taxes. Tier II benefits are generally includible in income for tax purposes in the same manner as benefits received under any employer-maintained qualified pension plan. The Railroad Retirement Solvency Act of 1983 provides for the transfer from the general fund of the Treasury to the Railroad Retirement Trust Fund of an amount equal to revenues received from the taxation of Tier II benefits. This transfer to the Railroad Retirement Trust Fund applies only to benefits that are received prior to October 1, 1989.

Reasons for Change

The committee believes that the purposes of the Railroad Retirement Solvency Act of 1983 are furthered through the extension of the provision allowing for a transfer of amounts from the general funds of the Treasury to the Railroad Retirement Tier II Trust Fund.

Explanation of Provision

The transfer of proceeds from the taxation of railroad retirement Tier II benefits from the general fund of the Treasury to the Railroad Retirement Trust Fund is extended for two additional years, to October 1, 1991.

Effective Date

The provision is effective for benefits received prior to October 1, 1991.

10. Credit for nonconventional fuels (sec. 6110 of the bill and sec. 29 of the Code)

Present Law

Nonconventional fuels are eligible for a production credit which is equal to $3 per barrel of BTU oil barrel equivalent. Those fuels which are eligible must be produced from a well drilled, or a facility placed in service, before January 1, 1991. Qualified fuels are eligible for the production credit through December 31, 2000.

Gas from a tight sands formation was eligible for the production credit under a special rule (sec. 29(c)(2)(B) as long as natural gas was subject to price controls, under section 107 of the Natural Gas Policy Act of 1978.

Reasons for Change

The most recent information from geologists is that a significant production capacity for production of gas from tight sands formations can be developed. The committee believes that reinstatement of the section 29 incentives for all tight sands gas is desirable in order to accelerate increases in such production since U.S. reliance on imported sources of energy appears to be increasing. The committee also believes that a general two-year extension of the period for placing in service facilities and wells is desirable because of the growing importance of imported energy sources.

Explanation of Provision

(1) Production of gas from a tight sands formation is eligible for the production credit even though the price of natural gas no longer is subject to price control. The production credit for gas produced from a tight sands formation is available for gas from wells drilled after December 31, 1989.

(2) The production credit for nonconventional fuels is extended to apply to wells drilled or facilities placed in service before January 1, 1993, instead of before January 1, 1991.

Effective Date

The reinstatement of gas from tight sands formations is effective on January 1, 1990. Tight sands gas from wells drilled after December 31, 1989, also will be eligible for the production credit. The extension of the placed in service date for all qualified fuels is effective as of January 1, 1990.

11. Low-income rental housing tax credit (secs. 6111 and 6112 of the bill and sec. 42 of the Code)

Present Law

Overview of credit

Section 42 of the Code provides a tax credit that may be claimed by owners of residential rental property used for low-income housing. The credit is claimed annually, generally for a period of 10 years beginning either with the year a building is placed in service or the succeeding taxable year (the credit period).[3]

Determination of credit amount

For buildings placed in service in 1987, the costs of new construction and substantial rehabilitation that are not federally subsidized are eligible for a maximum 9-percent credit, claimed annually for 10 years. For buildings placed in service in 1987, the acquisition cost of existing buildings and the costs of new construction and

---

[3] Section 42 was enacted by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (Oct. 22, 1986) (the 1986 Act), and modified by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (Nov. 10, 1988) (the 1988 Act). Unless expressly stated to the contrary, no inference should be drawn from any differences in the description of present law with respect to section 42 from those set forth in the Conference Reports for the 1986 and 1988 Acts. Reference should be made to those Reports for a more detailed description of present law with respect to section 42.

substantial rehabilitation which are federally subsidized are eligible for a maximum 4-percent credit, also claimed annually for 10 years. For buildings placed in service after 1987, these credit percentages are adjusted to maintain a present value of 70 percent and 30 percent for the two types of credits, and are determined monthly for property placed in service in each month. A taxpayer's credit amount in any taxable year is the product of the appropriate credit percentage and the qualified basis in such year.

Credit percentage

For buildings placed in service after 1987, the credit percentage is determined monthly, to achieve a present value of either 70 percent (most newly constructed and substantially rehabilitated buildings) or 30 percent (existing buildings and all federally-subsidized buildings) of the qualified basis. The present value is calculated as of the last day of the first year of the 10-year credit period. The discount rate used to determine the present value is 72 percent of the average of the annual applicable Federal rates (AFR) for mid-term and long-term obligations applicable for the month the building is placed in service.

The Treasury Department's monthly adjustments of the credit percentages are to be determined on a discounted after-tax basis, based on the average of the annual applicable Federal rates (AFR) for mid-term and long-term obligations for the month the building is placed in service. The after-tax interest rate is to be computed as the product of (1) the average AFR and (2) .72 (one minus the maximum individual Federal income tax rate). The discounting formula assumes each credit is received on the last day of each year and that the present value is computed as of the last day of the first year.

For buildings placed in service after 1987, however, the taxpayer (with the consent of the housing credit agency) may irrevocably elect to determine the credit percentage applicable to the building in advance of the building's placed-in-service date. Such an election will be binding for Federal income tax purposes on the taxpayer, the housing credit agency, and all successors in interest. The election must be made by the fifth day of the month following the close of the month in which a binding agreement is made between the taxpayer and the housing credit agency as to the housing credit dollar amount to be allocated to the building. In the case of a building financed with the proceeds of tax-exempt bonds for which no allocation from a housing credit agency is required, the election must be made by the fifth day of the month following the close of the month the bonds are issued.

The credit percentage for substantial rehabilitation expenditures is determined when the rehabilitation is completed and placed in service, but no later than the end of the 24-month period for which such expenditures are aggregated. These rehabilitation expenditures are treated as a separate new building for purposes of the credit.

Qualified basis

In general.—The qualified basis with respect to which the credit is computed is determined as the percentage of eligible basis in a qualified low-income building attributable to the low-income rental housing units. This percentage is the lesser of (1) the percentage of low-income units to all residential rental units or (2) the percentage of the floor space of the low-income units to the floor space of all residential rental units. In these calculations, low-income units generally are those housing units actually occupied by low-income tenants, whereas residential rental units are all housing units, whether or not occupied.

With respect to the new construction credit, the eligible basis of a building is determined at its placed-in-service date. With respect to the acquisition and substantial rehabilitation credits, the eligible basis of a building is determined at the end of the first taxable year of the credit period. This determination is made before the basis of the building is adjusted to take into account depreciation deductions allowable for such first taxable year.

Additions to qualified basis.—The qualified basis of a building may be increased subsequent to the initial determination only by reason of an increase in the number of low-income units or in the floor space of the low-income units. Credits claimed on such additional qualified basis are determined using a credit percentage equal to two-thirds of the applicable credit percentage allowable for the initial qualified basis. As described below under the description of the State credit ceiling, an allocation of credit authority must be received for credits claimed on additions to qualified basis, in the same manner as for credits claimed on the initial qualified basis, if the building has no unused credit authority that may be applied toward such increase. Unlike credits claimed on the initial qualified basis, credits claimed on additions to qualified basis are allowable annually on a straight-line basis for the portion of the required 15-year compliance period remaining after eligibility for such credits arises, regardless of the year such additional qualified basis is determined.

Eligible basis

In general.—Eligible basis consists of (1) the cost of new construction, (2) the cost of substantial rehabilitation, and (3) the cost of acquisition of existing buildings acquired by purchase (including the additions to qualified basis attributable to rehabilitation expenditures, if any, to such buildings incurred before the close of the first taxable year of the credit period the cost of which does not exceed $2,000 per low-income unit). Qualified basis is determined in the same fractional manner as for new construction or acquisition costs even if all rehabilitation expenditures are made only to low-income units. Only the adjusted basis of depreciable property may be included in eligible basis.

Generally, the eligible basis of a building is determined at the time the building is placed in service. For this purpose, rehabilitation expenditures (resulting in qualified basis in excess of $2,000 of per low-income unit) are treated as placed in service at the close of the period when rehabilitation expenditures are incurred. Such period is not to exceed 24 months. In the case of rehabilitation expenditures incurred in connection with the acquisition of an existing building (and which do not average at least $2,000 of qualified basis per low-income unit), capital expenditures incurred through the end of the first year of the credit period may be included in the original eligible basis. Rehabilitation expenditures need not, however, be incurred by the taxpayer claiming the credit; under certain circumstances, they may have been incurred by the seller of the building. *Cf.* Treas. Reg. sec. 1.167(k)-1(b)(1).

Only the adjusted basis of the building and certain common facilities (*e.g.*, parking areas and recreational facilities) may be included in eligible basis. The adjusted basis is determined by taking into account the adjustments described in section 1016 (other than paragraphs (2) and (3) of sec. 1016(a), relating to depreciation deductions), including, for example, the basis adjustment provided in section 48(q) for any rehabilitation credits allowed under section 38. The cost of land is not included in adjusted basis. The basis of units whose cost per square foot is disproportionate to that of the low-income housing units by more than 15 percent of the average cost per square foot of the low-income units is excluded from eligible basis.

Acquisition of existing buildings.—The cost of acquisition of an existing building may be included in eligible basis and any rehabilitation expenditures to such a building incurred before the close of the first year of the credit period may at the election of the taxpayer also be included in eligible basis, without a minimum rehabilitation requirement. These costs may be included in eligible basis, however, only if the building or a substantial improvement to the building has not been previously placed in service within 10 years and if the building (or rehabilitated property within the building) is not subject to the 15-year housing credit compliance period.

A building that is transferred in a transaction where the basis of the property in the hands of the new owner is determined in whole or part by the adjusted basis of the previous owner (for example, by a gift of property or like-kind exchange) is considered not to have been newly placed in service for purposes of the 10-year placed-in-service requirement. Further, a building which has been acquired by a governmental unit or certain qualified 501(c)(3) or 501(c)(4) organizations is not treated as placed in service by that governmental unit or organization for purposes of the 10-year placed-in-service requirement, if the acquisition occurred more than 10 years from the date the building or a substantial improvement to the building was last placed in service. Further, a building acquired by foreclosure by a taxpayer other than a governmental unit or 501(c)(3) organization is not treated as newly placed in service by that taxpayer for purposes of the 10-year requirement if the foreclosure occurred more than 10 years from the date the building or a substantial improvement to the building was last placed in service and the property was resold within twelve months.

The Treasury Department may waive the 10-year requirement for any building substantially assisted, financed, or operated under the Department of Housing and Urban Development (HUD) section 8, section 221(d)(3), or section 236 programs, or under the Farmers' Home Administration (FmHA) section 515 program (a federally-assisted building) when an assignment of the mortgage secured by property in the project to HUD or FmHA otherwise would occur or when a claim against a Federal mortgage insurance fund would occur.

Federal grants and other subsidies.—Eligible basis does not include the amount of any Federal grant, regardless of whether such grant is includible in gross income. If any portion of the eligible basis attributable to new construction or to substantial rehabilitation expenditures is financed with Federal subsidies (*e.g.*, tax-exempt bonds), the qualified basis is eligible only for the 30-percent present value credit, unless such Federal subsidies are excluded from eligible basis.

A Federal subsidy is defined as any obligation the interest on which is exempt from tax under section 103 or a direct or indirect Federal loan, if the interest rate on such loan is less than the applicable Federal rate. A Federal loan under the FmHA section 515 program is an example of such a Federal subsidy, as is a reduced interest rate loan attributable in part to a Federal grant. Tax-exempt financing or a below-market loan used to provide construction financing for a building will not be treated as a Federal subsidy if such loan is repaid and any underlying obligation (*e.g.*, tax-exempt bond) is redeemed before the building is placed in service.

Minimum set-aside requirement for low-income individuals

Set aside percentage requirements

In general.—Under the general minimum set-aside a residential rental project qualifies for the low-income housing tax credit only if (1) 20 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 50 percent or less of area median income (equivalent to the figure published by HUD under section 8 of the Housing Act of 1937 for very low-income families) or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 60 percent or less of area median income.[4] These income levels are adjusted for family size. All units comprising the minimum set-aside in a project must be suitable for occupancy and used on a nontransient basis, and are subject to the limitation on gross rent charged to residents of set-aside units.

Rent skewing set-aside.—A special set-aside may be elected for projects that satisfy a stricter requirement and that significantly restrict the rents on the low-income units relative to the other residential units in the building (the "rent skewing" set-aside). Projects qualify for this rule only if, as part of the general set-aside requirement, 15 percent or more of all low-income units are occupied by individuals having incomes of 40 percent (rather than 50 percent or 60 percent) or less of area median income, and the average rent charged to tenants in the residential rental units which are not low-income units is at least 300 percent of the average rent charged to low-income tenants for comparable units. Under this special rule, a low-income tenant who initially meets the 40-percent test will continue to qualify in the future as such, as long as the tenant's income does not exceed 170 percent (rather than the general 140-percent limit, described below) of the qualifying income limita-

---

[4] A special set-aside requirement under which a project qualifies if 25 percent or more of the units are occupied by individuals with incomes of 60 percent or less of area median income is provided for New York City.

tion. Additionally, if a project to which this special set-aside requirement applies ceases to comply with the continuous compliance requirement because of increases in existing tenants' incomes, no penalties are imposed if each available low-income unit (rather than each available unit) is rented to tenants having incomes of 40 percent or less of area median income, until the project is again in compliance.

The owner of each project must irrevocably elect the minimum set-aside requirement (including the rent skewing set-aside described above) at the close of the first year of the credit period. In the case of a project consisting of a single building, the set-aside requirement must be met within 12 months of the date the building (or rehabilitated property) is placed in service, and complied with continuously thereafter for a period ending 15 years after the first day of the first taxable year in which the credit is allowable.

In the case of a multiple building project, buildings need not meet the minimum low-income set-aside requirement in the order that the buildings are placed in service. If within 12 months of the placed-in-service date of a prior building the project meets the set-aside requirement with respect to such first building and any subsequent buildings placed in service within the 12-month period, then such first building and included subsequent buildings are part of a qualified low-income project. Subsequent buildings not included in determining whether the project satisfies the set-aside requirement with respect to prior buildings have their own 12-month period within which they are required to be included in the set-aside determination for the project. Since application of this rule may result in buildings which are part of the same project having different credit periods, section 42(g)(5) permits the taxpayer to redefine the mix of buildings considered a part of the project for purposes of determining continued compliance with the set-aside requirement.

Continuous compliance required

The determination of whether a tenant qualifies as low-income for purposes of the minimum set-aside requirement is made on a continuing basis, both with regard to the tenant's income and the qualifying area income, rather than only on the date the tenant initially occupies the unit. An increase in a tenant's income relative to qualifying area income may result, therefore, in a unit ceasing to qualify as occupied by a low-income person. However, a qualified low-income tenant is treated as continuing to be such notwithstanding *de minimis* increases in his income. Under this rule, a tenant qualifying when initially occupying a rental unit will be treated as continuing to have such an income provided his income does not increase to a level more than 40 percent in excess of the maximum qualifying income, adjusted for family size. If the tenant's income increases to a level more than 40 percent above the otherwise applicable ceiling (or if the tenant's family size decreases so that a lower family income applies to the tenant), that tenant is no longer counted in determining whether the project satisfies the set-aside requirement. No penalty or reduction in basis is assessed in such an event, however, provided that each residential rental unit that becomes vacant (of comparable or smaller size to the units occupied by tenants who no longer satisfy the applicable income requirement) is rented to low-income tenants until the project is again in compliance.

Vacant units, formerly occupied by low-income individuals, may continue to be treated as occupied by qualified low-income individuals for purposes of the set-aside requirement (as well as for determining qualified basis) provided reasonable attempts are made to rent the units and no other units of comparable or smaller size in the project are rented to nonqualifying individuals. In no case is a unit considered to be occupied by low-income individuals if all of the occupants of such unit are students, no one of whom is entitled to file a joint income tax return.

Gross rent limitation

The gross rent paid by families in units on which a tax credit is claimed may not exceed 30 percent of the applicable area income qualifying as "low," adjusted for family size. Gross rent includes the cost of any utilities, other than telephone. If any utilities are paid directly by the tenant, the maximum rent that may be paid by the tenant is reduced by a utility allowance prescribed by the Treasury Department.

The gross rent limitation applies only to payments made directly by the tenant. For example, any rental assistance payments made on behalf of the tenant, such as through section 8 of the United States Housing Act of 1937 or any comparable Federal, State or local rental assistance, are not included in gross rent for purposes of the 30-percent limit.

Qualified low-income housing projects and qualified low-income buildings

A qualified low-income building is a building which is subject to the 15-year compliance period and which is part of a qualified low-income project. A qualified low-income project is a project that meets the minimum set-aside requirement and other requirements with respect to the set-aside units at all times that buildings comprising the project are subject to the 15-year compliance period. A project may include multiple buildings having similarly constructed housing units, provided the buildings are located on the same tract of land, are owned by the same person for Federal income tax purposes, and are financed pursuant to a common plan of financing. Owner-occupied buildings with four or fewer units are ineligible for the credit.

Compliance period and penalty for noncompliance

Qualified residential rental projects must remain as rental property and must satisfy the minimum set-aside requirement, described above, throughout a 15-year compliance period. Units on which credits are claimed, in addition to those meeting the minimum set-aside requirement on which a credit is allowable, must continuously comply with this requirement. The taxpayer may defer the beginning of the credit period to the taxable year following the taxable year the building is placed in service. This enables the deferral of the beginning of the 15-year compliance period. Within 90 days of the end of the first taxable year of the credit period, the taxpayer must make certain certifications to the Secretary of the Treasury regarding set-aside compliance and other matters.

Owners and operators of low-income housing projects on which a credit has been claimed may correct any noncompliance with the set-aside requirement within a reasonable period after the noncompliance is discovered or reasonably should have been discovered. If the taxpayer can correct the noncompliance in the manner required, there is no recapture.

If the qualified basis of a building for which a low-income housing credit was claimed is reduced (other than in the event of certain casualty circumstances) or if the property is disposed of without the posting of a bond satisfactory to the Secretary of the Treasury, the accelerated portion of the credit for all prior years may be recaptured. There is no recapture of the credit for certain *de minimis* changes in qualified basis by reason of changes in the floor space of low-income housing units. For partnerships comprised of at least 35 partners, unless the partnership elects otherwise, no change in ownership will be deemed to occur provided that within any 12-month period, at least 50 percent (in value) of the original ownership is unchanged.

State low-income housing credit authority limitation

In general

Generally, all buildings eligible for the low-income housing credit must receive an allocation of credit authority from the State or local credit agency in whose jurisdiction the qualifying low-income housing project is located. In all cases, credit allocations are counted against a State's annual credit authority limitation for the calendar year in which the credits are allocated. Generally, credits subject to the State credit authority limitation include any credits attributable to expenditures not financed with tax-exempt bonds subject to the bond volume limitation.

The aggregate amount of such credits allocated within the State is limited by the State annual low-income credit authority limitation. The annual credit authority limitation for each State is equal to $1.25 for every individual who is a resident of the State. For purposes of the credit authority limitation, the District of Columbia and U.S. possessions (*e.g.*, Puerto Rico, the Virgin Islands, Guam, and American Samoa) are treated as States. No credit authority is provided for years after 1989.

In general, credits may be allocated only during the calendar year in which the building or rehabilitated property is placed in service. Three exceptions are provided to this general rule. First, credits may be allocated for additions to qualified basis which occur after the building is placed in service. Second, credits may be allocated in a later year pursuant to an earlier binding agreement made no later than the year in which the building is placed in service. Third, a building may be placed in service in the year in which the credit allocation is received or in either of the two succeeding years provided that the taxpayer's basis (land and depreciable property) in the project by the close of the calendar year in which the credit allocation is made by the housing credit agency is at least 10 percent of its reasonably expected basis in the project at the time the project is placed in service. This provision applies only to credit allocations for new construction, substantial rehabilitation expenditures eligible for the 70-percent present value credit, and existing buildings as to which a credit is allowable for substantial rehabilitation expenditures.

Transferability

A new owner of a building during its 15-year compliance period is eligible to continue to receive the credit as if the new owner were the original owner, using the same qualified basis and credit percentages as used by the original owner. In the case of transfers of an interest in credit property the credit is apportioned pro rata between the two parties. Rehabilitation expenditures on such property may qualify for a credit in the same manner as rehabilitation expenditures on other qualifying property. The accelerated portion of credits claimed in previous years will be recaptured upon a transfer, subject to the election of the original owner to post a bond. All dispositions of ownership interests in buildings are treated as transfers for purposes of recapture, except for a special rule for certain partnerships. There is no election for the new owner to assume the recapture liability for prior year credits.

Passive loss rules

In general

Deductions from passive trade or business activities or rental activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income. Similarly, credits from passive activities generally are limited to the tax attributable to the passive activities. Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next year. Suspended losses from an activity are allowed in full when the taxpayer disposes of his entire interest in the activity.

These limitations apply to individuals, estates, trusts, and personal service corporations. A special rule limits the use of passive losses and credits with respect to portfolio income in the case of closely-held corporations.

Special rules

$25,000 allowance in the case of rental real estate activities.—A special rule is provided for passive losses and credits attributable to rental real estate activities. In the case of rental real estate activities, a taxpayer who is an individual is allowed to deduct up to $25,000 of passive losses (to the extent that they exceed income from passive activities) if the taxpayer actively participates in the rental real estate activity (and has at least a 10-percent interest in it). The $25,000 amount is phased out ratably as the taxpayer's adjusted gross income, with certain modifications, increases from $100,000 to $150,000.

$25,000 allowance for low-income housing and rehabilitation credits.—Under a special rule, the $25,000 allowance also applies to low-income housing and rehabilitation credits (on a deduction-

equivalent basis), regardless of whether the taxpayer claiming the credit actively participates in the rental real estate activity generating the credit. In addition, the adjusted gross income phaseout range for the $25,000 amount for these credits is from $200,000 to $250,000 (rather than the generally applicable phaseout range of $100,000 to $150,000).

Restrictions on use of credit to offset tax

The low-income housing credit is subject to the rules of the general business credit (sec. 38), including the maximum amount of income tax liability that may be reduced by a general business credit in any one year. This limitation generally is equal to the excess (if any) of the taxpayer's net income tax over the greater of (1) the taxpayer's tentative minimum tax for the year, or (2) 25 percent of so much of the taxpayer's net regular tax liability as exceeds $25,000.

The rules for credit carryovers provide that unused credits for any taxable year may be carried back to each of the three preceding taxable years and then carried forward to each of the 15 following years. No portion of the low-income housing credit for any taxable year may be carried back to a taxable year ending before 1987 (sec. 39(d)(4)).

Effective date

The credit generally is effective for buildings placed in service after December 31, 1986, other than property grandfathered from the depreciation rule changes made by the Tax Reform Act of 1986. Buildings placed in service after December 31, 1989, may qualify for the credit only if they meet the credit carryover allocation rules. The authority of housing credit agencies to allocate low-income housing credits expires December 31, 1989.

Reasons for Change

In general

The committee is concerned about the lack of affordable housing for people of low-income and considers it appropriate that the Federal Government play a significant role in the development of additional housing. The committee believes the low-income housing credit is a useful incentive for the increase in the housing stock available to low-income tenants. The permanent extension of the credit will provide certainty as to the availability of the credit. Low-income housing like other real estate projects require long lead times in its planning and development.

Given the limited amount of aggregate credit available, however, the committee considers it necessary to take steps to improve its efficiency to ensure that as much housing as possible is created with the credit and that credit projects effectively serve State and local housing needs. Many of the provisions adopted by the committee are designed to further that goal.

The committee believes that the credit is the proper vehicle to encourage extended low-income use beyond the initial 15 year compliance period. Owners wishing to dispose of their property may convey the property for any amount of consideration subject to continued low-income use restrictions. If the owners are unable to effect such a transfer, there should be a mechanism to allow the allocating agency a reasonable period of time to find another qualified purchaser.

The committee recognizes that it may be necessary to reexamine the use of Federal tax subsidies for the provision of low-income housing such as the low-income housing credit as other laws affecting the provision of low-income housing, and as the nation's housing needs change.

Increase in affordable housing

The committee considers it desirable for the credit to be used to increase the housing stock available to low-income tenants. It is concerned that the credit not be used simply to churn the existing housing stock. Limiting the credit to new construction and to existing buildings which are substantially rehabilitated serves as an incentive to the creation of new housing. Further, the committee is concerned that the definition of "substantial rehabilitation" under present law is inadequate to further the purpose of taking otherwise uninhabitable units and returning them to the available housing stock. At the same time, the committee realizes that a very serious problem exists with respect to low-income housing the owners of which will soon be eligible to prepay certain low-cost Federal loans and convert their housing to market rent use.

The committee recognizes that many factors influence the cost of providing a unit of rent-restricted housing for low-income individuals and that the costs attributable to these factors may vary by area. For example, some areas have high costs for land, while other areas have high utility costs or high construction costs. When an area experiences high costs for such factors and at the same time has a relatively low area median income, rental income generated (subject to the rent restriction requirements) may be insufficient to make provision of low-income units economically feasible without further subsidy. The committee believes it is important to facilitate utilization of the credit in such difficult to develop areas.

Increased efficiency of the credit

The committee is desirous that the low-income housing credit be allocated in a manner that ensures that housing will be available to those most in need. The committee is also concerned that certain States have been allocating credits simply on a first-come first-served basis. It considers the establishment of allocation criteria and priorities essential to target the credit to those projects which will most effectively serve State and local housing needs.

Improvement of marketability and administration

The committee recognizes the importance of certainty in making investment decisions. The committee believes it is appropriate to make changes to the calculation of the gross rent limitation to provide more certainty to investors. The committee also concludes that adjustments to the deep-rent skewing provisions are necessary.

The committee believes that encouraging the provision of low-income housing is an important goal of national housing policy. The Federal Government can foster this goal through several means, and, at this time, the committee believes that providing tax incentives to private investors to invest in low-income housing projects is the most appropriate way to achieve this aim. In this connection, the committee is concerned that present law excludes some individuals from the pool of likely investors in low-income housing property.

Improved administrability of the credit and other issues

The committee is concerned that various features of present law, intended to be primarily administrative in nature, unnecessarily interfere with the most effective utilization of the credit. For example, the requirement of present law that a credit allocation be received on a building-by-building basis, rather than for the project of which such buildings are a part, has also resulted in difficulty in projecting exact credit availability and project cash flows. The committee believes that it is inappropriate to have one rule governing the date on which eligible basis is determined for new construction and a different rule governing the date on which eligible basis is determined for acquisition property. Present law unnecessarily requires the filing of certain credit forms just two weeks before the Federal income tax returns of individual taxpayer investors are also due.

Explanation of Provisions

Extension of the credit

The bill makes the low-income housing credit (generally scheduled to expire December 31, 1989) permanent.[5]

Extended low-income use commitment

The bill provides that a taxpayer will only be eligible for a credit allocation if he or she enters into an extended low-income housing commitment with the housing credit agency.[6] The commitment must be binding on the taxpayer and all successors of the taxpayer with respect to the property for which the credit is allocated. The commitment must require that portion of the building occupied by low-income tenants (the applicable fraction) for each taxable year in the extended use period is not less than an amount specified in the commitment. The commitment must be recorded under State law as a restrictive covenant and must permit eligible low-income individuals the right to enforce the commitment in the courts of the State in which the property is located. The commitment must provide for an extended period of low-income use. The extended use period must extend at least 15 years beyond the close of the compliance period.

The bill provides two exceptions to the extended use requirement. First, if a building for which the credit has been allocated is acquired by foreclosure, the extended use period terminates on the

[5] The committee directs the Internal Revenue Service to monitor and promote compliance with the section 42 requirements.

[6] Such commitment must also exist between a taxpayer and the housing credit agency for any building which is to be financed with tax-exempt bonds on which the taxpayer intends to claim the credit even though the taxpayer may not be required to receive an allocation under the State annual credit ceiling.

date of such acquisition. Second, if after the fourteenth year of the compliance period the taxpayer submits a written request to the housing credit agency to find a person to acquire the taxpayer's interest in the low-income portion of the building, and if by the end of the fifteenth year of the compliance period the housing credit agency has been unable to present a buyer with a qualified contract who will continue to operate the low-income portion of the building as a qualified low-income building, the extended use period will terminate with the termination of the compliance period.[7]

For the purpose of the second exception, the bill defines a qualified contract as a *bona fide* contract to acquire not less than the applicable fraction, as specified in the commitment, multiplied by a minimum purchase price. The bill defines the first component of the minimum purchase price as adjusted investor equity. Adjusted investor equity is the aggregate amount of cash taxpayers invested with respect to the project increased by a cost of living adjustment for each calendar year since the project was placed in service.[8] The inflation adjustment is determined by changes in the consumer price index (CPI), but is never to exceed five percent. To adjusted investor equity is added the outstanding indebtedness (at the time of sale) secured by, or with respect to, the building and any other capital contributions not reflected in either adjusted investor equity or the outstanding indebtedness. An example of this latter amount would arise if it were necessary to replace a building's furnace and any loan taken to finance the furnace were not secured by the furnace or the building. Any cash distributions [9] from the project are subtracted from the above three components to arrive at the minimum purchase price.

The bill modifies the at risk rules applicable to certain nonrecourse financing provided by qualified nonprofit organizations to conform to the extended low-income use requirement by requiring that full repayment of such loans occur within 90 days after the earlier of the date the building ceases to be a qualified low-income building or the date which is 15 years after the end of the compliance period.

Determination of credit amount

Under the bill, no credit is allowable for the acquisition of an existing building unless a substantial rehabilitation standard is met. Generally, under this standard, rehabilitation expenditures must result in qualified basis equal to or greater than $3,000 per low-income unit. If the new substantial rehabilitation standard is satisfied, the substantial rehabilitation expenditures are eligible for the 70-percent present value credit (if not federally-subsidized) and the

[7] The bill allows that this second exception does not apply to the extent that either the commitment or State law contains more stringent requirements.

[8] The amount invested with respect to a project is measured by those amounts which are reflected in the adjusted basis of the project. For example, required annual fees for legal and accounting work are not amounts invested in the project.

[9] The committee intends that this amount not be limited to amounts actually paid to the taxpayer, but also includes any amounts available for distribution to the taxpayer. For example, a working capital reserve account would constitute funds available to be distributed to the taxpayer.

existing portion of the building is eligible for the 30-percent present value credit.

The rehabilitation expenditures must be on the low-income units or common areas substantially benefiting the low-income tenants (*e.g.*, replacement of a boiler, improvements to plumbing and electrical systems). Rehabilitation expenditures are those which improve the habitability of the low-income units. Expenditures of a cosmetic nature qualify as rehabilitation only when ancillary to, and an integral part of, expenditures which improve the habitability of the low-income unit.

The bill provides that the determination of eligible basis for new buildings and substantial rehabilitation expenditures conform to that for acquisition property by allowing the determination to be made at the end of the first taxable year of the credit period. The determination of eligible basis is made before any adjustments to basis are made for depreciation allowable during the first taxable year.[10]

The bill provides that, in areas which are designated by the Secretary of HUD as difficult to develop, the eligible basis of a new building or the eligible basis of rehabilitation expenditures in the case of an existing building undergoing substantial rehabilitation be deemed to be 130 percent of eligible basis claimed for depreciation. This calculation of eligible basis would not be available with respect to federally-subsidized buildings.

The bill provides that no more than 20 percent of metropolitan areas be designated as difficult to develop and that no more than 20 percent of nonmetropolitan areas be designated as difficult to develop. The percentage limitation is based on the population of the designated metropolitan area relative to the population of all metropolitan areas, and similarly for nonmetropolitan areas.

In determining which areas are difficult to develop, the bill provides that the Secretary of HUD consider several factors. It may be costly to produce low-income housing in one area relative to the rest of the country because that area has higher land costs than the rest of the country. Alternatively, the costs of producing low-income housing in that area may be higher than elsewhere because that area has higher construction costs or higher utility costs than the rest of the country. A combination of the above factors may make it more costly to provide low-income housing in some areas than in others. In determining whether an area's costs are high relative to the rest of the nation, the Secretary of HUD may find it appropriate to use indices of land costs, construction costs, and utility costs. Alternatively, the Secretary may find it appropriate to use private market rents (not subject to rent control or other restrictions) as indicative of the cost of providing rental housing units in a given area.

However, the committee recognizes that it is not costs alone that make an area difficult to develop, but rather the costs of providing a low-income housing unit compared to the rental income that low-income housing unit will generate. The Secretary of HUD should,

---

[10] Section 7872(c)(1)(D) does not apply to a transaction involving a below market loan if none of the principal purposes of the interest arrangements of the below market loan is to increase the amount of the credit allowable under section 42.

therefore, compare an area's costs to an area's median income in reaching the determination that an area is difficult to develop. Consequently, it is possible that one area's costs of providing housing are low relative to similar costs nationwide, but the area's income is sufficiently low that the Secretary would designate the area as difficult to develop.

Eligible basis

The bill modifies the 10-year rule by adding three categories of property eligible for waiver of the rule by the Secretary of the Treasury. First, the 10-year rule may be waived for a federally-assisted building if the mortgage on the building is eligible within one year of the application for waiver for prepayment under the Emergency Low Income Housing Preservation Act of 1987 or under the Housing Act of 1949 and either HUD or FmHA certifies that the building will be converted to market use absent the waiver. If this waiver is granted, the mortgagor must agree in writing not to prepay the mortgage. Such property is eligible for credit allocation subject to the rehabilitation expenditures requirement, described above.

Second, the 10-year rule may be waived for a building acquired from a failed financial institution or from a receiver or conservator of such an institution if the Secretary of the Treasury determines (after consultation with the appropriate Federal agency or regulatory authority) that such acquisition is necessary to avert an expenditure of Federal funds by such Federal agency or regulatory authority. This waiver is to apply to properties owned by commercial banks, savings and loan institutions, and credit unions that are regulated or whose deposits are insured by a Federal agency, regulatory authority, or insurance program. For this purpose, a financial institution is failed if a conservator, receiver, or other legal custodian has been appointed for the financial institution (or, in the case of a foreign bank, a U.S. branch), pursuant to an adjudication or other official determination by a court of competent jurisdiction, the appropriate Federal banking agency, or other public authority. The expenditure to be averted is the amount: (1) which the Federal agency or regulatory authority (including any Federal insurance program) would be required to pay in connection with the failure of such financial institution, and (2) which would be reduced by the sale of a property where the price received for the property will be increased as a result of the property being eligible for low-income housing credits even though the 10-year holding period was not satisfied except by receipt of the waiver.

Third, the ten-year rule may be waived to facilitate the sale of a building if the mortgage on the building is held by HUD, or the building itself is owned by HUD (following foreclosure of a mortgage) or the Farmers Home Administration.

The bill also expands the definition of "federally-assisted building" to include any building that has more than four residential rental units originated, insured, or guaranteed by the Federal Government. In addition, the bill provides that the credit is not available to properties receiving assistance under the HUD section 8 moderate rehabilitation program.

Gross rent limitation

The bill provides certain changes in the rules regarding the calculation of the gross rent limitation. The deep-rent skewing rule is modified to provide that the rents charged for non-rent-restricted units need be only at least 200 percent of those charged for comparable rent-restricted units.

The bill also provides that, for purposes of both section 42 and the deep-rent-skewing rules of section 142(d) (relating to tax-exempt bonds for residential rental property), in the determination of the gross rent limitation applicable to rent-restricted units the incomes used are no longer to be adjusted for actual family size. Instead, each unit is presumed to house a certain number of people based upon the number of bedrooms in the unit. A studio apartment is presumed to house one person and each bedroom of a unit is presumed to house 1.5 persons.[11] However, for the purposes of determining whether a family qualifies as a "low-income" family eligible for a rent-restricted unit, the bill retains present law. That is, families renting rent-restricted units must have actual family incomes adjusted for family size which, at the irrevocable election of the taxpayer, are either not in excess of 60 percent of area median income or not in excess of 50 percent of area median income.

The determination of the gross rent limitation applicable to a three-bedroom unit is made as follows. A three-bedroom unit is assumed to house 4.5 persons (three bedrooms multiplied by 1.5 persons per bedroom). The section 8 very low-income figure for a family of 4 is added to the section 8 very low-income figure for a family of 5 and the result is divided by two to determine the very low-income figure for the presumed family size of 4.5. The applicable gross rent limitation is 30 percent of the resulting very low-income figure for the presumed family of 4.5. For example, if the very low-income figure for a family of four is $19,000, and the very low-income figure for a family of five is $21,000, the gross rent limitation for a rent-restricted three-bedroom unit is $6,000 per year (30 percent of $20,000). To qualify to rent this three-bedroom unit, a family of five must have an income less than or equal to $21,000, while a family of four must have an income less than or equal to $19,000.

The provision of supportive services does not disqualify a rental property (so long as none of the residents are exempted from the provision governing below market loans by reason of continuing care contracts with the facility). Supportive services are those designed to enable residents to remain independent and avoid placement in a hospital, nursing home or intermediate care facility for the mentally or physically handicapped. Any fees provided for supportive services which are paid by a governmental agency directly to the owner of building is included in gross rent. However, in this circumstance the gross rent limitation applicable to a qualifying low-income limit is increased by 20 percent.[12] The committee reit-

[11] The committee intends that the Secretary of the Treasury, in consultation with the Secretary of HUD, issue regulations detailing the minimum living area which must constitute a bedroom and prohibiting general living or dining areas from being claimed as bedrooms for those units which are not studios.

[12] This provision does apply when the fees paid by a governmental agency explicitly include a capital cost or housing component.

erates, however, its intent that no hospital, nursing home, sanitarium, dormitory, or trailer park, be treated as a qualified low-income project.

Qualified low-income housing projects and qualified low-income buildings

The bill provides that 80 percent of the qualified basis of an owner-occupied building with four or fewer units will be eligible for the credit if the acquisition or rehabilitation of the building occurs as part of a development plan sponsored by a State or local government or qualified nonprofit organization.

The bill provides that buildings located on disparate or scattered geographic sites may be deemed to be a single project both for purposes of credit allocation and compliance if 100 percent of the units are rent-restricted units occupied by tenants with qualifying income. As under present law, all of the buildings must be financed pursuant to a common plan of financing and owned by the same person for Federal income tax purposes.

Purchase options

The bill provides that any determination as to whether Federal income tax benefits are allowable to a taxpayer with respect to a qualified low-income building is made without regard to a certain purchase options exercisable at the end of the compliance period. These options must be held by a qualified nonprofit organization, limited equity cooperative or resident management group recognized by HUD that do not provide financing with respect to the building. The option price cannot be less than the sum of (1) the principal amount of all indebtedness secured by the building, with the exception of indebtedness incurred within the five years immediately prior to sale, and (2) all Federal, State, and local taxes attributable to such sale. In determining the Federal income (but not other) taxes attributable to the sale, the tax liability resulting from the agreement to pay taxes attributable to the sale will be taken into account.

State low-income housing credit authority limitation

In recognition of the fact that a State may not allocate or use all available credits in a given year, and that sometimes credits allocated may be returned (e.g., a building to which credits were allocated is never placed in service), the committee bill provides that all such unused and returned credits may be carried over for one year. Unused credits are defined as the difference between $1.25 multiplied by the State's population, and the State's aggregate credit allocations for that year. Returned credits are credits previously allocated to projects which do not become qualified projects within the year or any credits for which an allocation is cancelled by the mutual consent of the housing credit agency and the allocation recipient.

The committee anticipates that occasionally one or more States may fail to allocate their housing credits carried over from the preceding year. When this eventuality occurs, the bill provides that the Secretary may allocate the aggregate unused housing credit carryover among those States which fully allocated their State housing credit ceiling for the preceding year. The Secretary's allocation is to be a pro rata distribution, based on population, among those States which did not have any unused credit carryover in the preceding year and which request an additional credit allocation by May 1. A State is determined to have unused housing credit carryover if the amount of unused credits (as defined above) exceeds the difference of aggregate housing credit allocations for a given year and $1.25 multiplied by the population of the State for that year.

As a consequence of these carryover provisions, a State's annual housing credit ceiling is determined as the sum of the following: (1) $1.25 multiplied by the population of the State, (2) any unused credits from the immediately preceding year, (3) any returned credits, and (4) any unused housing credit carryover received from the Secretary after proper application.

The bill provides that the credit be allocated on a project basis, rather than on a building-by-building basis as under present law. The credit allocation is to be divided among the buildings in the project as they are placed in service. For purposes of the credit allocation, a taxpayer wishing to treat a building as part of a project must designate all the buildings which are to be part of the project by the end of the first year of the project period (*i.e.*, by the end of the first calendar year in which an allocation could be made for the first building placed in service as part of such project). In the absence of such a designation by the taxpayer, the Secretary shall treat the project as consisting solely of one building. To receive a credit allocation for the entire project, rather than only those buildings placed in service during the year of the allocation, the taxpayer must still satisfy the present law rules for a carryover allocation, except that such carryover allocation need not be divided among the buildings at the time of the allocation.

The bill requires that the housing credit agency adopt an allocation plan containing selection criteria for ranking the various projects applying for credit allocations. The selection criteria must include project location (*e.g.*, broad geographic distribution, designated targeted areas such as inner cities, Community Development Block Grant neighborhoods, distressed communities, pockets of poverty, and rural areas), housing needs characteristics (*e.g.*, low vacancy rate, income mix of tenants within the project, and meeting State, regional, or local housing needs and priorities), project characteristics (*e.g.*, whether the project increases the stock of low-income housing, whether substantial rehabilitation expenditures are needed by the project, energy conservation, quality of units, and type of financing), sponsor characteristics (*e.g.*, nonprofit sponsorship and minority participation in development and management), participation of local tax-exempt organizations, encouragement of mixed-use housing, project financial feasibility and viability, and tenant populations with special housing needs (*e.g.*, elderly, minority, handicapped, disabled, homeless, large families, and displaced). The committee intends that an allocation plan would not fail this requirement if it provides a set-aside of credit authority for particular types of projects or geographic areas.

Additionally, the agency may not allocate more credit to a project than it determines is necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period. In making this determination, the agency shall consider the sources and uses of the funds, the available Federal, State, and local subsidies committed to the project, and the total financing planned for the project as well as the proceeds or receipts expected to be generated by reason of tax benefits.

The bill requires that housing credit agencies provide notice and opportunity to comment to the chief executive officer of the locality in which the project is located. In addition, the Committee anticipates that the housing credit agency will require developers to list financial information in their credit applications. Such information would include a breakdown of sources and uses of funds sufficiently detailed to enable the agency to ascertain where and what costs will be incurred and what will comprise the total financing package, including the various subsidies and the anticipated syndication or placement proceeds that will be raised. Whether or not includible in eligible basis, the following cost information should be required before allocation of the credit: site acquisition costs, site preparation costs, construction costs, construction contingency, general contractor's overhead and profit, architect and engineer's fees, permit and survey fees, insurance premiums, real estate taxes during construction, title and recording fees, construction period interest, financing fees, organizational costs, rent-up and marketing costs, accounting and auditing costs, working capital and operating deficit reserves, and syndication and legal fees and other costs. Actual data must be made available upon request of the allocating agency after the project has been placed in service. Costs, including developer fees, should be examined by the agency for reasonableness. The Committee also contemplates that agencies require the submission of *pro forma* financial statements setting forth the anticipated project cash flows.

The bill requires that the housing credit agency approval process take a form similar to that required by section 147(f)(2) with respect to the approval of the issuance of tax-exempt private activity bonds. Such approval may not occur until after a public hearing with reasonable public notice and an opportunity for those interested to present their views. The referendum provisions of section 147(f)(2) are not applicable.

Passive loss rules

The bill modifies the application of the passive loss restrictions on the low-income housing credit by removing the adjusted gross income limitations on the $25,000 deduction-equivalent allowance of credits with respect to rental real estate activities. Thus, up to a $25,000 deduction-equivalent amount of credits is available to an individual under the provision, regardless of his adjusted gross income.[13]

[13] The bill also removes the adjusted gross income limits on the deduction-equivalent amount of rehabilitation credits with respect to rental real estate activities. Thus, under the two provisions of the bill, the $25,000 deduction-equivalent allowance of present law is retained, but no adjusted gross income limits apply under the $25,000 rule for either low-income housing credits or rehabilitation credits.

Effective Dates

The bill is generally effective for determinations made under section 42 with respect to housing credit dollar amounts allocated from State housing credit ceilings for calendar years after 1989.[14] For projects not subject to the credit allocation limits, the provisions generally apply to buildings placed in service after December 31, 1989.

The provision which removes the adjusted gross income limitation for low-income housing credits under the passive loss rule is effective in taxable years ending after December 31, 1989, for property placed in service after December 31, 1989. In addition, if the property is held through a partnership or other passthrough entity, the taxpayer's interest in the partnership or other passthrough entity must have been acquired after December 31, 1989.

The new 10-year rule waiver provisions are effective on the date of enactment.

12. Modification of rehabilitation tax credit under passive loss rule (sec. 6112 of the bill and sec. 469(i) of the Code)

Present Law

Rehabilitation tax credit in general

An income tax credit is provided for certain expenditures incurred in rehabilitation of certified historic structures and certain nonresidential buildings placed in service before 1936. The amount of the credit is determined by multiplying the applicable rehabilitation percentage by the basis of the property that is attributable to qualified rehabilitation expenditures. The applicable rehabilitation percentage is 20 percent for certified historic structures and 10 percent for qualified rehabilitated buildings (other than certified historic structures) that are nonresidential and that were originally placed in service before 1936.

A building is eligible for the 20-percent credit only if it is substantially rehabilitated and is listed in the National Register or is certified by the Secretary of the Interior as being of historical significance to the registered historic district in which it is located. A building is eligible for the 10-percent credit only if it is substantially rehabilitated and meets a structural requirement relating to the percentage of its external and internal walls that are retained in place upon completion of the rehabilitation.

The basis of any property eligible for the rehabilitation credit is reduced by the full amount of the allowable credit. Thus, no cost

---

[14] The committee intends that should it subsequently decide to subject the credit to a "sunset" date, it believes it is appropriate to conform the treatment of newly constructed property which is substantially financed with tax-exempt bonds to other newly constructed or substantially rehabilitated property in regard to when the credit may be claimed. While generally the credit may be claimed only for property placed in service in the year the credit allocation is received, an exception exists for newly constructed or substantially rehabilitated property which is not substantially financed with tax-exempt bonds. This exception permits credits to be claimed for property placed in service within two years after a credit allocation was received, if 10 percent of estimated project costs were incurred in the year in which the allocation was made. To conform, newly constructed property which is substantially financed with tax-exempt bonds should be permitted to claim the credit for buildings placed in service within two years after the bonds were issued, if at least 10 percent of estimated project costs were incurred by the close of the calendar year in which the bonds were issued.

recovery allowance or depreciation deduction is allowed for rehabilitation expenditures that are considered funded by the rehabilitation credit.

In addition, the rehabilitation credit is subject to recapture if the rehabilitated building is disposed of or otherwise ceases to be qualified investment property at any time during the five year period beginning after the year the property is placed in service.

Restrictions on use of credit to offset tax

The rehabilitation credit is subject to the rules of the general business credit, including the maximum amount of income tax liability that may be reduced by a general business credit in any one year. This limitation generally is equal to the excess (if any) of the taxpayer's net income tax over the greater of (1) the taxpayer's tentative minimum tax for the year, or (2) 25 percent of so much of the taxpayer's net regular tax liability as exceeds $25,000. Thus, the credits may not offset the taxpayer's alternative minimum tax.

Unused credits generally may be carried back 3 taxable years and then forward 15 years (to the extent permitted by other applicable limitations, if any).

Passive loss restrictions on credit use

In general

Under the passive loss rule, deductions from passive trade or business activities or rental activities generally may not be deducted against other income, to the extent such deductions exceed income from all such passive activities (exclusive of portfolio income). Similarly, credits from passive activities generally are limited to the tax attributable to the passive activities. Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next year. Suspended losses from an activity are allowed in full when the taxpayer disposes of his entire interest in the activity. The rule applies to individuals, estates, trusts, and personal service corporations. A special rule limits the use of passive activity losses and credits with respect to portfolio income in the case of closely held corporations.

Special rules

$25,000 allowance in the case of rental real estate activities.—A special rule is provided for passive activity losses and credits attributable to rental real estate activities. In the case of rental real estate activities, an individual may deduct up to $25,000 of passive activity losses (to the extent they exceed income from passive activities) if the individual actively participates in the rental real estate activity (and has at least a 10 percent interest in it). The $25,000 amount is phased out ratably as the taxpayer's adjusted gross income, with certain modifications, increases from $100,000 to $150,000.

$25,000 allowance for low-income housing and rehabilitation credits.—Under a special rule, the $25,000 allowance also applies to low-income housing and rehabilitation credits (on a deduction equivalent basis), regardless of whether the individual claiming the credit actively participates in the rental real estate activity gener-

ating the credit. In addition, the adjusted gross income phaseout range for the $25,000 amount for these credits is $200,000 to $250,000 (rather than the generally applicable phaseout range of $100,000 to $150,000).

Reasons for Change

The committee believes that preservation and rehabilitation of existing historic buildings and nonresidential buildings first placed in service before 1936 should be encouraged. The Federal Government can foster this goal through several means, and at this time, the committee believes that providing tax incentives to private investors to engage in rehabilitation activities is an appropriate way to achieve this aim.

In this regard, the committee is concerned that present law excludes some individuals from the pool of likely investors in rehabilitation property. The committee bill modifies the otherwise applicable restrictions on availability of the rehabilitation credit to upper-income individuals, with the aim of expanding the investment in these types of projects, while retaining all other applicable limitations.

Explanation of Provision

The bill modifies the application of the passive loss restrictions to the rehabilitation tax credit by removing the adjusted gross income limitations on the $25,000 deduction equivalent allowance of the credits with respect to rental real estate activities. Thus, up to a $25,000 deduction equivalent amount of rehabilitation credit is available to an individual under the provision regardless of his adjusted gross income.[15]

The bill otherwise retains present law with respect to the rehabilitation credit.

Effective Date

The provision is effective in taxable years ending after December 31, 1989, for property placed in service after December 31, 1989. In addition, if the property is held through a partnership or other passthrough entity, the taxpayer's interest in the partnership or other passthrough entity must have been acquired after December 31, 1989.

13. Research and experimentation tax credit (sec. 6113 of the bill and sec. 41 of the Code)

Present Law

Incremental credit

General rule.— A 20-percent tax credit is allowed for qualified research expenditures incurred by a taxpayer in carrying on a trade

[15] The bill also includes certain low-income housing credit provisions, including a provision removing the adjusted gross income limits on the deduction equivalent amount of low-income housing credits with respect to rental real estate activities. Thus, under the bill, the $25,000 (deduction equivalent) allowance of present law is retained but no adjusted gross income limits apply under the $25,000 rule for either low-income housing credits or rehabilitation credits.

or business. Except for certain university basic research payments, the credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the "base period," meaning the preceding three taxable years.

The credit is scheduled to expire after December 31, 1989.

Base limitation.—The amount of base-period research expenditures is treated as equal to at least 50 percent of the taxpayer's qualified research expenditures for the current year.

Trade or business limitation.—Research expenditures of a taxpayer are eligible for the credit only if paid or incurred in a particular trade or business already being carried on by the taxpayer.

Eligible expenditures.—Research expenditures eligible for the 20-percent incremental credit consist of (1) "in-house" expenditures by the taxpayer for research wages and supplies used in research; (2) certain time-sharing costs for computer use in research; and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf.

Expenditures attributable to research which is conducted outside the United States do not enter into the credit computation. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).[16]

Aggregation rules and changes in business ownership.—To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons, research expenditures of the taxpayer are aggregated with research expenditures of certain related persons for purposes of computing any allowable credit.

Special rules apply for computing the credit when a business changes hands, under which qualified research expenditures for periods prior to the change of ownership generally are treated as transferred with the trade or business which gave rise to those expenditures.

University basic research credit

In addition to the 20-percent incremental credit, there is a 20-percent tax credit for certain corporate expenditures for university basic research. This credit applies to the *excess* of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research *over* (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation.[17]

[16] The 1986 Act provided statutory rules defining qualified research for purposes of the incremental credit as research undertaken to discover information that is technological in nature and that pertains to functional aspects of products. Also, the 1986 Act expressly excluded certain types of expenditures from eligibility for the credit, including post-production research activities, duplication or adaptation costs, and surveys, studies, and certain other costs.

[17] The amount of credit-eligible basic research expenditures to which the university basic research credit applies does not enter into the computation of the incremental credit. The remain-

Continued

This credit also is scheduled to expire after December 31, 1989.

Relation of credit to section 174 deduction

For taxable years beginning after 1988, the amount of any deduction allowable to a taxpayer under section 174 or any other provision for qualified research expenditures is reduced by an amount equal to 50 percent of the taxpayer's research credit determined for that year.

Reasons for Change

The committee concluded that it is appropriate to increase the research credit's incentive effect by providing taxpayers with a permanent credit for undertaking research, thereby eliminating the uncertainty resulting from temporary extensions of the credit.

In extending the research credit, the committee wished to respond to the criticism that the incentive effect of the present-law research credit was diminished as a result of the method of computing the taxpayer's base amount. Critics have noted that although an increase in research expenditures resulted in a taxpayer receiving a larger credit for that year, it also resulted in higher base period amounts (and therefore smaller credits) in the following three years. As a consequence, the present-law credit's marginal incentive effect provided in the first year was largely offset in the following three years. The committee, therefore, modified the method of calculating a taxpayer's base amount in order to enhance the credit's incentive effect. The committee did wish, however, to retain an incremental credit structure in order to maximize the credit's efficiency by not allowing (to the extent possible) credits for research that would have been undertaken in any event.

Although the committee believes it is important to readjust the base amount annually in a way which does not undercut the incentive effect of the credit (which occurs when a firm's base is adjusted solely by reference to its own prior levels of research spending), the committee also determined it was appropriate that the base adjustments reflect firm-specific factors. By adjusting each taxpayer's base to its own experience, the committee wanted to make the credit widely available at the lowest possible revenue cost.

Because businesses often determine their research budgets as a fixed percentage of gross receipts, it is appropriate to index each taxpayer's base amount to average growth in its gross receipts. By so adjusting each taxpayer's base amount, the committee believes the credit will be better able to achieve its intended purpose of rewarding taxpayers for research expenses in excess of amounts which would have been expended in any case. Using gross receipts as an index, firms in fast-growing sectors will not be unduly rewarded if their research intensity, as measured by their ratio of qualified research to gross receipts, does not correspondingly increase. Likewise, firms in sectors with slower growth will still be able to earn credits as long as they maintain research expenditures commensurate with their own sales growth.

---

ing amount of credit-eligible basic research expenditures—i.e., the amount to which the university basic research credit does not apply—enters into the incremental credit computation.

Adjusting a taxpayer's base by reference to its gross receipts also has the advantage of effectively indexing the credit for inflation and preventing taxpayers from being rewarded for increases in research spending that are attributable solely to inflation.

In redesigning the credit, the committee also determined that the credit's base limitation should be increased to reduce disparities among taxpayers in the amount of credit (as a percentage of total qualified research) they receive. By phasing in an increase in the base limitation, no taxpayer will earn credits for taxable years beginning after 1994 which exceed five percent of its total qualified research spending for that year.

The committee further decided that it is appropriate to extend the availability of the credit to start-up firms which, although not presently conducting a particular trade or business, plan to use the results of their research in the active conduct of a future trade or business.

In view of the significant modifications to the research credit, the committee concluded that it would be useful to periodically reevaluate the credit. To assist in evaluation, the committee directed the Treasury Department to conduct a study every five years in order to report whether revenue losses attributable to the research credit are consistent with those projected at the time of enactment (or, in the case of later studies, those projected at the time of the previous study), to evaluate whether the rules for computing the base for start-up firms are appropriate in view of actual trends in qualified research expenditures and gross receipts of those firms, and to review available evidence on the effectiveness of the credit in stimulating additional research expenditures.

The committee recognizes that the research credit is the equivalent of a Federal payment to the taxpayer. Thus, because the taxpayer does not pay for research to the extent of the credit, the taxpayer's deduction under section 174 for research expenses should be reduced by the amount of the research credit claimed, as in the case of other tax credits provided for by the Code.

Explanation of Provisions

Incremental credit: sales ratio R&E tax credit

General rule

A 20-percent tax credit is allowed to the extent that a taxpayer's qualified research expenditures for the current year exceed its base amount for that year. The credit is made permanent.

The base amount for the current year is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years.

Fixed-base percentage

Existing firms.—If a taxpayer both incurred qualified R&E expenses and had gross receipts [18] during each of at least three years

[18] The Treasury Department is authorized to prescribe regulations providing that de minimis amounts of qualified R&E expenses and gross receipts may be disregarded (including under the start-up company rules described *infra*).

from 1984 to 1988, then its "fixed-base percentage" is the ratio that its total qualified R&E expenses for the 1984-88 period bears to its total gross receipts for this period (subject to a maximum ratio of .16, as described below).

Start-up companies.—If a taxpayer did not both incur qualified R&E expenses and have gross receipts during each of at least three years between 1984-1988, then for each of its first five taxable years after 1989 in which it incurs qualified R&E expenses, the taxpayer is assigned a fixed-base percentage of .03.

After its first five taxable years after 1989 in which it incurs qualified R&E expenses, a start-up firm's fixed-base percentage is computed as follows: (1) for the firm's sixth year, its fixed-base percentage is equal to one-sixth of its research-to-gross receipts ratio for its fourth and fifth years; (2) for the firm's seventh year, its fixed-base percentage is one-third of its ratio for its fifth and sixth years; (3) for the firm's eighth year, its fixed-base percentage is one-half of its ratio for its fifth through seventh years; (4) for the firm's ninth year, its fixed-base percentage is two-thirds of its ratio for its fifth through eighth years; (5) for the firm's tenth year, its fixed-base percentage is five-sixths of its ratio for its fifth through ninth years; and (6) after a firm's tenth year, its fixed-base percentage is its actual research-to-gross receipts ratio for five years selected by the firm from its fifth through tenth years.

Maximum fixed-base percentage.—In no event will a taxpayer's fixed-base percentage exceed .16.

Base limitation

As under current law, a taxpayer's base may not be less than a certain percentage of current-year qualified R&E expenditures. The base limitation percentage for all firms is 50 percent for taxable years beginning in 1990; 55 percent for taxable years beginning in 1991; 60 percent for taxable years beginning in 1992; 65 percent for taxable years beginning in 1993; 70 percent for taxable years beginning in 1994; and 75 percent for taxable years beginning in 1995 or later.

Trade or business limitation

A taxpayer is treated as meeting the trade or business requirement with respect to in-house research expenses if, at the time such in-house research expenses are incurred, the principal purpose of the taxpayer in making such expenditures is to use the results of the research in the active conduct of a future trade or business of the taxpayer or certain related taxpayers.

Consistent treatment of R&E expenses

Qualified research expenses taken into account in computing a taxpayer's fixed-base percentage are to be determined on a basis which is consistent with the determination of qualified research expenses for the current year.[19] Thus, if a taxpayer includes (or ex-

---

[19] The Treasury Department is granted authority to prescribe regulations to prevent distortions in calculating a taxpayer's qualified research expenses or gross receipts due to a change in accounting methods used by the taxpayer between the current year and a year taken into account in computing the taxpayer's fixed-base percentage.

cludes) certain expenditures in determining its qualified research expenses for the current year, it must provide the same treatment for all such expenditures incurred during any year taken into account in computing the taxpayer's fixed-base percentage, regardless of whether the period for filing a claim for credit or refund has expired for any year taken into account in computing the fixed-base percentage.[20]

Treasury Department study

The Treasury Department is required to conduct a study during each 5-year period beginning on January 1, 1990, to determine whether revenue losses from the credit are consistent with the projections, to evaluate whether the rules for computing the base for start-up firms are appropriate in view of actual trends in qualified research expenditures and gross receipts of those firms, and to analyze the effectiveness of the credit in promoting research.

Eligible expenditures

The expenditures eligible for the credit are the same as under present law.

Aggregation rules and changes in business ownership

The rules relating to aggregation of related persons and changes in business ownership are the same as under present law, with the modification that when a business changes hands, qualified research expenses and gross receipts for periods prior to the change of ownership are treated as transferred with the trade or business which gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage.

In addition, the bill provides that a foreign affiliate's gross receipts which are not effectively connected with the conduct of a trade or business in the United States do not enter into the computation of the credit.

University basic research credit

The university basic research credit is permanently extended.

Relation of credit to section 174 deduction

The amount of any deduction allowable to a taxpayer under section 174 or any other provision for qualified research expenditures is reduced by an amount equal to 100 percent of the taxpayer's research credit determined for that year.

The bill clarifies that research expenses are deductible under section 174 only to the extent that they are reasonable under the circumstances.[21]

---

[20] No inference is intended whether current law requires a taxpayer, in calculating its credit amount for a particular year, to determine its base amount by adjusting qualified research expenses for an earlier base-period year for which an assessment of a deficiency or refund of an overpayment is barred by the statute of limitations.

[21] Thus, the bill provides for a rule contrary to the holding in *Driggs v. United States*, 706 F. Supp. 20 (N.D. Tex. 1989). The committee intends that the reasonableness requirement under section 174 be parallel to the reasonable allowance requirement for salaries and other compensation under section 162(a)(1), in that amounts purportedly paid for research may be recharacterized as disguised dividends, gifts, loans, or other similar payments. The committee does not intend that the reasonableness requirement under section 174 be used to question whether or not research activities themselves are of a reasonable type or nature.

Effective Date

The provisions are effective after December 31, 1989.

14. Business energy tax credits for solar, geothermal, and ocean thermal property made permanent (sec. 6114 of the bill and sec. 46(b)(2) of the Code)

Present Law

Three nonrefundable business energy tax credits are allowed for certain types of energy property; these tax credits are scheduled to expire after December 31, 1989. The credits (the rates and the property to which they pertain) are:

(1) Business solar—10% credit;
(2) Geothermal—10%; and
(3) Ocean thermal—15%.

Under section 38, these (and other) tax credits may not be used to offset more than 25 percent of regular tax liability above $25,000 or the tentative minimum tax for the taxable year.

The expiration date for these credits was extended for one additional year, i.e., from December 31, 1988, to December 31, 1989, in the Technical and Miscellaneous Revenue Act of 1988. Earlier, these tax credit rates were extended through 1988 in the Tax Reform Act of 1986.

Reasons for Change

The committee believes that it is essential to continue to provide incentives for the development of alternative energy sources which do not rely upon fossil fuel formations.

Explanation of Provision

The energy tax credits for solar energy, geothermal, and ocean thermal property are extended permanently, at the current rate.

Effective Date

The provision is effective on January 1, 1990.

15. Mortgage revenue bonds and mortgage credit certificates

a. Extension of qualified mortgage bonds and mortgage credit certificates (sec. 6115 of the bill and sec. 143 of the Code)

Present Law

Qualified mortgage bonds

In general

Mortgage revenue bonds qualifying for tax-exemption under section 103 of the Code ("qualified mortgage bonds") are bonds the net proceeds of which are used to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied homes located within the jurisdiction of the issuer of the bonds.

Eligible purchasers

In general, eligible purchasers must have not owned a residence within the three prior years and must have incomes below 115 percent of the median income for the area or State where the residence is located. For families consisting of less than three persons, the income limitation is 100 percent of the area or State median income.

Purchase price limitations

The acquisition cost of a residence financed with qualified mortgage bonds may not exceed 90 percent (110 percent in targeted areas) of the average area purchase price applicable to the residence.

Recapture

All or part of the subsidy provided by qualified mortgage revenue bond financing or mortgage credit certificates (described below) is recaptured on dispositions of assisted housing which occur within 10 years of purchase by mortgagors whose incomes increased substantially since purchase of their homes. The maximum amount recaptured is 1.25 percent of the original balance of the loan for each year the loan is outstanding, or 50 percent of the gain realized on the disposition, whichever is less. For sales in years six through 10, the 1.25 percent per year is phased out. This recapture provision only applies to loans originated, and mortgage credit certificates issued, after December 31, 1990.

Limitations on volume, arbitrage and unspent proceeds

Mortgage revenue bonds are subject to the general per capita volume limitation on private purpose obligations. Issuers of mortgage subsidy bonds generally must issue mortgages at rates that cannot exceed the rate of interest on the bonds by more than 1.125 percentage points. In general, bond proceeds not used to make mortgages and mortgage principal payments must be used to redeem outstanding bonds.

Sunset

The authority of State and local governments to issue tax-exempt mortgage subsidy bonds is scheduled to terminate on December 31, 1989.

Mortgage credit certificates

In general

Qualified governmental units may elect to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs) (sec. 25). MCCs entitle homebuyers to nonrefundable income tax credits (not to exceed $2,000 per year) for a specified percentage of interest paid on mortgage loans on their principal residences. Once issued, an MCC remains in effect as long as the residence being financed continues to be the certificate-recipient's principal residence. MCCs are generally subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Sunset

Mortgage credit certificates are scheduled to sunset with respect to nonissued mortgage subsidy bonds elected after December 31, 1989.

Reasons for Change

The committee believes that the qualified mortgage bond and mortgage credit certificate program should be permanently extended without modification. Substantive revisions were made to the program in the Technical Corrections and Miscellaneous Revenue Act of 1988 (TAMRA). Permanent extension will ensure that the program can meet its goals without interruption.

Explanation of Provision

Qualified mortgage bonds and the mortgage credit certificates program is permanently extended (bonds issued and MCCs issued pursuant to elections to trade-in State bond volume limitations, after December 31, 1989).

Effective Date

The provision is effective on the date of enactment.

b. Mortgage credit certificates time limit suspension (sec. 6115 of the bill and sec. 25 of the Code)

Present Law

Generally, a qualified issuer may either issue Mortgage Revenue Bonds (MRBs) or exchange MRB authority for authority to issue Mortgage Credit Certificates (MCCs). After it has exchanged the authority the issuer can proceed with the actual issuance of the MCCs. The Tax Reform Act of 1986 imposed new restrictions, including tighter targeting, on MRBs and MCCs. The statutory language made these restrictions effective for MCCs issued after August 15, 1986. The Conference Committee Report, on the other hand, provided that these restrictions were effective with respect to bond authority exchanged for authority to issue MCCs after August 15, 1986. The General Explanation of the Tax Reform Act of 1986 noted that a technical correction would be necessary to correct the statutory language to conform to the legislative intent. This technical correction to apply the 1986 Act restrictions to exchanges of bond authority and not issuances of MCCs after August 15, 1986 was enacted in the Technical and Miscellaneous Revenue Act of 1988.

Code section 25(e)(3)(B) renders a MCC invalid unless the mortgagor incurs debt by the close of the second calendar year after the exchange of authority. The time limit under this section was not suspended by the 1986 Act.

Reasons for Change

Because of the drafting error, an issuer that had exchanged authority but had not issued MCCs prior to August 15, 1986 was technically subject to the 1986 Act restrictions. The issuer was forced to wait for enactment of the technical correction before it could issue

MCCs that did not meet the 1986 Act restrictions. The delay in the enactment of the technical correction until 1988 allowed the operation of Code section 25(e)(3)(B) to preclude use of authority exchanged before 1986 and to severely limit availability of authority exchanged during 1986 on or before August 15, 1986.

Code sec. 25(e)(3)(B) renders a MCC invalid unless the mortgagor incurs debt by the close of the second calendar year after the exchange of authority. Under this provision, all exchanges of authority in 1985 were invalidated on December 31, 1987 and were unavailable to issuers when the technical was passed several months later. Similarly, 1986 exchanges of authority on or before August 15, 1986 were only valid if debt was incurred by December 31, 1988. Because the technical correction allowing issuance of MCCs was not enacted until October 1988, utilization of these MCCs was severely hampered: i.e., the two-year time period of Code section 25(e)(3)(B) began to run on the exchange but absence of the technical correction delayed or precluded the issuance of MCCs which in turn delayed or precluded the mortgagor from incurring debt.

Explanation of Provision

The provision provides that the two-year time period allowed in Code section 25(e)(3)(B) commences running on the date of enactment of this technical correction for bond authority exchanged before August 15, 1986, but not issued as of that date.

Effective Date

The provision is effective on the date of enactment.

Subtitle B. Corporate Provisions

1. Limit dividends received deduction with respect to certain non-taxed income of consolidated subsidiaries (sec. 6201 of the bill and sec. 246 of the Code)

Present Law

A distribution to a shareholder is generally treated as a dividend to the extent of the distributing corporation's current or accumulated earnings and profits. Corporate recipients of dividends generally are entitled to a dividends received deduction equal to at least 70 percent of the dividend. (An 80-percent or 100-percent deduction is permitted if the recipient has sufficient ownership of the stock of the distributing corporation.) The dividends received deduction serves to reduce substantially or eliminate multiple taxation with respect to income earned and corporate-level tax paid by distributing corporations on distributions to corporate shareholders.

If a group of corporations files a consolidated return, taxable income is determined by reference to the income and deductions of all members of the group and is, in substance, computed as if the group operated as a single corporation. No income is separately attributed to minority owners of a subsidiary that joins in filing a consolidated return. Thus, for example, income of a subsidiary bears no corporate-level tax if its parent corporation or other members of the group have losses sufficient to offset that income, even though the subsidiary may have taxable income economically attributable to minority ownership. If the minority owner and the parent or other group members had been joint venturers with respect to the subsidiary's business, then the income attributable to minority ownership could not be sheltered by losses of other members of the group but would be fully taxed to the minority owners.

In order to be eligible to file a consolidated return, a subsidiary generally must be related to the rest of the group through the group's ownership of at least 80 percent of the vote and value of all classes of subsidiary stock. However, stock described in section 1504(a)(4) (generally, nonvoting preferred stock that does not participate in corporate growth to any significant extent) is not counted for this purpose. Thus, minority shareholders holding nonvoting preferred stock may be entitled to virtually all the subsidiary's earnings without preventing consolidation. In this situation, the earnings to which the preferred shareholders are entitled can be sheltered by the losses of other members of the group without limitation. The subsidiary can pay these non-taxed earnings to the minority corporate shareholders as dividends eligible for the 70-percent dividends received deduction. Such earnings thus bear no corporate-level tax to the distributing corporation and bear a maximum tax to the recipient corporation of only 10.2 percent (34 percent of the 30 percent that is taxable after the dividends received deduction).

Reasons for Change

The committee believes that the dividends received deduction serves to mitigate multiple level corporate taxation where it applies. Under present law, groups filing consolidated returns can use that privilege effectively to shelter earnings attributable to minority investors in a subsidiary with losses or credits attributable to other corporate entities in which those minority shareholders do not have an economic interest. The committee is concerned that the dividends received deduction is available with respect to distributions made to such minority shareholders where those distributions have not borne a corporate level tax.

When the minority ownership is in the form of stock that is not taken into account for purposes of determining eligibility for consolidation, so that there is no limitation on the percentage of value of the subsidiary that may be owned by such minority shareholders, the opportunity to take advantage of the consolidated return rules and the dividends received deduction in this manner is particularly great. The consolidated group may in effect sell the benefit of its consolidated net operating losses or credits through the availability of the dividends received deduction for distributions to minority shareholders. For example, such a sale occurs when minority shareholders accept a lower pre-tax return in the form of a dividend from the subsidiary than they otherwise would accept if they had directly invested in the assets of the subsidiary, due to the after-tax benefit of the dividends received deduction.

The current statutory prohibitions against loss trafficking (e.g., section 382) have not generally been applied to cover the transfer of the benefits of net operating losses through the use of the dividends received deduction.

Accordingly, the committee believes that it is appropriate to limit the availability of the dividends received deduction in certain situations.

Explanation of Provision

The bill disallows the dividends received deduction for a portion of dividends paid out of current earnings and profits with respect to stock described in section 1504(a)(4) (generally, nonvoting preferred stock that does not participate in corporate growth to any significant extent) in certain circumstances.

The provision applies only to dividends paid from a subsidiary of an affiliated group of corporations filing a consolidated return.

The amount of dividends with respect to which the dividends received deduction is disallowed is determined by applying a fraction, the numerator of which is the consolidated loss offset and the denominator of which is the distributing corporation's separately computed taxable income. The fraction is applied to the lesser of a) the amount of dividends on stock described in section 1504(a)(4) paid out of current earnings and profits or b) the consolidated loss offset.

The consolidated loss offset with respect to a distributing subsidiary corporation includes specific items of any other member of the same affiliated group as the distributing corporation, which items are treated as used to offset the separately computed taxable income of such corporation. The items included are: any net operating loss or net operating loss carryover under section 172; any loss that is treated as a loss from the sale or exchange of a capital asset, or capital loss carryover under section 1212; and the deduction equivalent of any excess credit or credit carryover other than the foreign tax credit.

Separately computed taxable income is the taxable income of the distributing corporation computed as if it were not a member of an affiliated group.

The Treasury Department is authorized to exempt taxpayers from the limitation to the extent taxpayers can establish that the distributions in question were made out of earnings that were taxed to the distributing corporation or the consolidated group of which it is a member.

The Treasury Department is also authorized to provide antiabuse rules. It is expected that regulations would prevent avoidance of the rules through the contribution of built-in loss assets or other direction of losses to the subsidiary by other members of the group. It is also expected that regulations would prevent avoidance of the rules through delaying distributions until later years or through the use of tiered subsidiaries or similar devices.

Except as the Treasury Department may otherwise provide, it is expected that regulations will provide that the separate taxable income of any distributing corporation for purposes of this provision shall include the separate taxable income of any other member of the group to the extent any current earnings and profits of the distributing corporation is directly or indirectly attributable to such income. Such regulations will be effective as of the effective date of this provision. Current earnings and profits of the distributing corporation would be directly or indirectly attributable to such income, for example, where such earnings and profits arise because of a dividend or other distribution out of taxable income of another corporation, or where such earnings and profits arise because undistributed earnings of another corporation are reflected in the current earnings and profits of the distributing corporation by reason of the applicable investment adjustment rules of the consolidated return regulations.

The bill provides the Treasury Department authority to require the issuer to report to holders and the Internal Revenue Service when the dividends received deduction is not allowable under this provision with respect to part or all of the dividends paid on stock.

Effective Date

The provision is generally effective for distributions after October 2, 1989. However, it does not apply to distributions with respect to subsidiary stock issued on or before that date, or issued after that date pursuant to a binding written contract in effect on that date and at all times thereafter before such stock is issued, so long as certain transactions described below do not occur.

Otherwise grandfathered stock ceases to be grandfathered if the issuing corporation ceases to be a member of the affiliated group of which it was a member at the time the stock was issued (or at the time the contract to issue such stock became binding), or becomes a member of any group, unless such event occurs in a transaction that would not result in the recognition of any deferred intercompany gain under the consolidated return regulations by reason of the acquisition of the entire group.[22] Grandfathered stock also ceases to be grandfathered if such stock is retired or purchased by the issuer or by any member of the affiliated group of which the issuer is a member, unless the retirement is pursuant to an obligation to reissue under a binding written contract (which may be evidenced by the terms of the stock that has been issued by the corporation) in effect on October 2, 1989 and at all times thereafter until such stock is reissued.

Auction rate preferred stock is treated for this purpose as issued when the contract requiring the auction became binding and is not considered issued at the time of each auction conducted pursuant to such commitment. The contract requiring the auction for this purpose is the contract (which may be evidenced by the terms of the stock that has been issued by the corporation) committing the corporation to provide for the conduct of auctions with respect to the stock. Thus, auction rate preferred stock that was issued on or before October 2, 1989, or after that date in accordance with the terms of a binding written contract to issue such stock in effect on that date and at all times thereafter until such stock is issued, does not cease to be grandfathered merely because auctions pursuant to the terms of such original issuance or pursuant to the terms of such binding contract are conducted after October 2, 1989.

For purposes of these transition rules, stock that has been issued but has never been held by a person not a member of the group is not considered to have been issued.

2. Defer interest deduction on certain high-yield original issue discount (OID) obligations until interest is paid (sec. 6202 of the bill and sec. 163 of the Code)

Present Law

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

Reasons for Change

The committee is concerned about the frequent use of high-yield, long-term OID instruments and instruments that make payments in instruments of the issuer (*e.g.*, so-called payment-in-kind (PIK) bonds) and the effect these instruments may have on the amount of

[22] See Treas. Reg. sec. 1.1502-14(f)

debt in the corporate sector of economy. The committee believes that the interest deduction permitted for these instruments, even though no cash is paid, encourages their use in highly-leveraged financial structures. The committee believes that the tax benefit from the deduction prior to payment is particularly strong when the issuer is subject to the corporate income tax.

The committee believes that the amount of long-term high-yield OID and PIK instruments issued by corporations will be reduced if the interest deduction on such instruments is postponed until the interest is paid.

Explanation of Provision

In general

Under the bill, a C corporation may not deduct (or otherwise take into account) [23] any portion of OID on an applicable high yield discount obligation until such portion is actually paid. Payments in the form of stock or obligations of the issuer would not be considered paid for this purpose. The bill does not change the present law rule allowing interest to be deducted no earlier than the date on which it accrues. *See* sec. 461(g). Nor does it change the requirement that the holder include such interest in income as it accrues.

Definition of applicable high yield discount obligation

An applicable high yield discount obligation is a debt instrument that meets three requirements. First, the maturity date of the instrument must be more than five years from the date of issue.

Second, the yield to maturity on the instrument must equal or exceed the sum of the applicable Federal rate (AFR) for the calendar month in which the obligation is issued [24] plus five percentage points. The Secretary of the Treasury may by regulation apply a higher rate if the taxpayer establishes to the satisfaction of the Secretary of the Treasury that such rate is based on the same principles as the AFR and is appropriate for the term of the instrument. This authority may be exercised so as to allow a rate that more exactly establishes the average market yield on outstanding marketable obligations of the United States at the same time the obligation was issued and for the same maturity as the obligation. *Cf.* Prop. Reg. sec. 1.1274-6(a)(3).

Third, the instrument must have significant OID. An instrument has significant OID if the aggregate amount that would be includible in gross income with respect to the instrument before the close of any accrual period ending more than five years after the date of issue exceeds the sum of (1) the aggregate amount of interest to be paid under the instrument before the close of such accrual period and (2) the product of the issue price of such instrument and its yield to maturity. For these purposes, amounts required to be paid

---

[23] For example, for purposes of section 263(f), interest would not be taken into account until paid.

[24] For these purposes, the AFR is determined without reference to the lowest 3-month rate provided by section 1274(d)(2).

on the last day of the accrual period are treated as required to be paid before the close of the accrual period.

Example 1.—An instrument with a twenty year maturity and an issue price of $100, pays $33.61 annually beginning in year six and $210.03 (plus $33.61 of interest) at maturity, producing a yield to maturity of 16 percent. The instrument has significant OID because the aggregate amount that would be includible in gross income with respect to the instrument before the close of at least one accrual period ending more than five years after the date of issue exceeds the sum of (1) the aggregate interest to be paid under the instrument before the close of the period and (2) the product of the issue price of the instrument and its yield to maturity. For example, the aggregate amount that would be includible in income with respect to the instrument as of the accrual period ending six years after issuance, $143.64 ($110.03 plus $33.61), exceeds the sum of the aggregate interest to be paid with respect to the instrument, $33.61, plus the product of the issue price and the yield to maturity, $16.

Example 2.—The facts are the same Example 1, except that the instrument pays $110.03 in year five, $16 per year thereafter, and $100 (plus $16 of interest) at maturity. The instrument does not have significant OID because the aggregate amount that would be includible in gross income with respect to the instrument before the close of each accrual period ending more than five years after the issue date does not exceed the sum of (1) the aggregate interest to be paid under the instrument before the close of the period and (2) the product of the issue price and the yield to maturity. For instance, the aggregate amount that would be includible in income with respect to the instrument as of the accrual period ending six years after issuance, $126.03 ($110.03 plus $16), is less than the sum of the aggregate interest to be paid with respect to the instrument, $126.03, plus the product of the issue price and the yield to maturity, $16.

Special rules

For purposes of determining whether a debt instrument is an applicable high yield discount obligation, any payment made under the instrument shall be assumed to be made on the last day permitted under the instrument. In addition, any payment to be made in the form of another obligation or stock of the issuer or a related person (within the meaning of Code sec. 453(f)(1)) shall be assumed to be made when such obligation or stock is required to be paid or redeemed in cash or property other than such an obligation or stock.

Information requirements

The Secretary of the Treasury is granted regulatory authority to require that information be set forth on the applicable high yield obligation. For example, the Secretary of the Treasury may require that the instrument disclose the fact that the instrument is an applicable high yield obligation and other information, such as the tax treatment of the obligation. However, the Treasury Secretary shall not require that information be set forth on instruments not publicly offered prior to disposition by the first buyer. In addition, the issuer of publicly offered applicable high yield obligations is required to furnish such information as the Secretary of the Treasury shall prescribe.

Failure of an issuer to set forth information required to be set forth on a debt instrument or to furnish information required to be furnished is subject to the same penalties as such failures with regard to OID instruments. *See* Code sec. 6706.

Regulatory authority

Under the provision, the Secretary of the Treasury is required to prescribe such regulations as may be appropriate to carry out the purpose of the provision. These regulations may include modifications in the provision in the case of varying rates of interest, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments, conversion rights, or other circumstances. Such regulations may, for example, provide rules for the Federal income tax treatment of debt instruments payable in foreign currency or stock of the issuing corporation.

In the case of debt instruments providing for a variable rate of interest (within the meaning of Prop. Reg. sec. 1.1275-5) issued before the issuance of regulations, the committee expects that regulations to be issued by the Treasury Department will provide that the determination of whether an obligation is an applicable high yield discount obligation will be made by treating the debt instrument as if it provided for a fixed interest rate corresponding to the rate established by the variable rate on the issue date. The committee also expects that similar rules would apply where the instrument provides for different variable rates for different accrual periods.

In the case of debt instruments providing for contingent interest, the committee expects that the regulations to be issued by the Secretary of the Treasury may take into account the expected amount of any such contingent payments in determining whether an obligation is an applicable high yield obligation. *Cf.* Code sec. 1272(a)(6).

The committee expects that the regulations to be issued by the Secretary of the Treasury would prevent avoidance of the purpose of the provision through the use of issuers other than C corporations, agreements to borrow amounts due under the debt instrument, or other arrangements. Such regulations may, for example, address the taxation of obligations collateralized by corporate debt that would constitute applicable high yield discount obligations if issued directly by a C corporation.[25] The committee expects that such regulations also would address situations in which a C corporation, in effect, issues applicable high yield discount obligations by issuing an obligation bearing stated interest while entering into an agreement to borrow amounts to pay such interest. The committee understands that such regulations would be retroactive in appropriate circumstances.

[25] The regulations might, for instance, treat the collateralized debt as an applicable high yield discount obligation, at least when the C corporation participates in the collateralization. Such participation might be deemed to have occurred if the first buyer engages in collateralization shortly after purchasing the debt instrument.

Effective Date

In general

The provision would be effective for instruments issued after July 10, 1989. An assumption by a taxpayer of an instrument issued by another person is treated as a new issuance by the taxpayer for purposes of this rule.

Instruments issued as interest

The provision would not apply to any instrument that is issued pursuant to the terms of a debt instrument issued before July 11, 1989, or which is otherwise excepted from the provision under the transition relief described below. Thus, if the terms of a debt instrument provide for the payment of interest in the form of additional instruments, the provision does not apply to the additional instruments (*e.g.*, the issuance of a payment-in-kind obligation after July 10, 1989, as interest on a payment-in-kind obligation issued before July 11, 1989).

Instruments issued in connection with certain acquisitions

In general

In addition, the provision does not apply to an instrument issued after July 10, 1989, that meets three requirements. The three requirements are: (1) the completion of, or commitment to consummate, an acquisition, (2) the determination to issue an obligation to which the provision would otherwise apply, and (3) the establishment of a sufficient connection between the acquisition and the use of such obligation as financing for the acquisition.

Acquisition requirement

In order to meet the first requirement, the issuer (or a related party) must have: (1) made an acquisition before July 11, 1989, (2) made an acquisition after July 10, 1989, pursuant to a written binding contract in effect on July 10, 1989, and at all times thereafter, or (3) made an acquisition after July 10, 1989, pursuant to a tender offer that was filed with the Securities and Exchange Commission on or before July 10, 1989. An acquisition includes an acquisition of stock (including the stock of the acquirer) or assets.

Determination requirement

In order to meet the second requirement, the issuer must have made a determination to issue an obligation to which the provision would otherwise apply. A determination to issue such an obligation will be considered made if certain terms of the obligations are evidenced in written documents that (1) were transmitted before July 11, 1989, between the issuer and any governmental bodies or prospective parties to the issuance or acquisition, and (2) are customarily used for the type of financing or acquisition involved.

Required terms.—For this purpose, the terms of the instrument that must be evidenced in the transmitted documents are: (1) the fact that the instrument will be issued with significant OID, (2) the maximum maturity term of the instrument, and (3) issue price of the instrument or the maximum amount of proceeds to be raised by the issuance of such instrument. The required terms of the instrument will not be considered to be sufficiently evidenced if the issuer has an option to amend or extend the required terms of the instrument or has an option to convert an instrument to which this provision does not apply to an instrument to which this provision does apply.[26]

The requirement that the fact that the instrument will be issued with significant OID will not be considered to be met if, before July 11, 1989, the issuer evidences a determination to issue instruments that provide for the annual payment of at least a portion of the yield and the instruments, as ultimately issued, do not provide for such payments.

If the maturity term of the instrument is not determined before July 11, 1989, such term will be considered to be determined so long as the actual maturity term of instrument, when issued, does not exceed ten years.

Appropriate evidentiary documents.—Documents which can be used to evidence the determination to issue otherwise disqualified obligations include: (1) the closing documents, the binding written contract, or the tender offer relating to the acquisition requirement described above; (2) a registration statement filed with the Securities and Exchange Commission by the prospective issuer that describes a public offering of OID or PIK instruments; (3) a loan commitment provided by a lending institution to the prospective issuer of the OID or PIK instrument; or (4) a private placement memorandum circulated to prospective investors on behalf of the prospective issuer. Evidence of the required terms of the otherwise disqualified obligation may be determined from a document even if such obligation is not the principal subject of such document.

For this purpose, prospective parties to the acquisition include those parties with a significant financial interest in the transaction (other than as agents of the acquirer). Thus, potential sellers of the stock or assets being acquired and potential lenders that provide temporary or permanent financing with respect to the acquisition would be considered to be prospective parties to the acquisition. However, such written documents as internally generated computer outputs which contemplate the issuance of OID or PIK instruments in connection with an acquisition or memoranda or letters that are exchanged between a prospective acquirer or issuer and the acquirer's agent generally would not be considered to be transmitted with a prospective party to the acquisition.

Connection requirement

In order to meet the third requirement, an obligation must be issued in connection with the required acquisition. This required connection is properly established if the documents that evidence the determination to issue the obligation contain a reference to the use of such obligation as financing for the acquisition.

---

[26] For example, assume that before July 11, 1989, a taxpayer had issued preferred stock that could be converted by the taxpayer, at any time, into an obligation to which this provision would otherwise apply. Should the taxpayer exercise the conversion option, the newly issued obligations would not be protected from the application of this provision even though the preferred stock from which it was converted was issued before July 11, 1989.

The connection requirement is not met if the instrument actually issued does not have reasonably the same required terms (as described above) that were evidenced on or before July 10, 1989. Thus, if the amount of proceeds actually raised by the issuance of the obligations exceeds the amount determined on or before July 10, 1989, in the identifying written document or documents by more than a de minimis amount, the entire issuance will be treated as obligations to which this provision applies (assuming all other requirements are met). In addition, the maturity term of the instrument as issued or the amount of the proceeds raised by the issuance of the instruments may be less than the length of the maturity term or the amount of proceeds that were identified before July 11, 1989, without disqualifying the instrument for transitional relief.

Instruments issued in refinancings

Furthermore, this provision would not apply to an instrument issued to refinance an obligation to which this provision does not apply if the following four conditions are met: first, the maturity date of the refinancing instrument may not be later than the maturity date of the refinanced instrument; second, the issue price of the refinancing instrument may not exceed the adjusted issue price of the refinanced instrument (as determined at the time of the refinancing); third, the stated redemption price at maturity of the refinancing instrument may not be greater than the stated redemption price at maturity of the refinanced instrument; and fourth, the interest payments required under the refinancing instrument before maturity may not be less than (and may not be paid later than) the interest payments required under the refinanced instrument.

Instruments issued pursuant to certain bankruptcy proceedings

Finally, this provision would not apply to an instrument that is issued after July 10, 1989, pursuant to a reorganization plan in a Title 11 or similar case (as defined in sec. 368(a)(3) of the Code) so long as the required terms (as described above) of the instrument, as issued, do not exceed the required terms of the instrument as specified in the last reorganization plan filed before July 11, 1989, in such case.

3. Repeal nonrecognition treatment when securities are received in section 351 transactions (sec. 6203 of the bill and sec. 351 of the Code)

Present Law

No gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control of the corporation (sec. 351). Accordingly, a transferor may transfer appreciated property to a corporation in exchange for stock and a debt obligation of the corporation that is a security, without recognition of gain.

Different rules apply for debt obligations that are not considered to be "securities" under section 351. Such other debt obligations are treated as "boot." A transferor who receives boot is taxed on the lesser of the amount of the boot or the gain realized on the exchange generally as if the transferred property had been sold. (However, no loss is recognized.)

Under the corporate reorganization provisions, if a taxpayer transfers property in a reorganization and receives securities with a principal amount in excess of any securities surrendered, such excess is treated as boot. Such a taxpayer must recognize gain, if any, to the extent of the boot received in the exchange.

The receipt of any debt obligation constituting boot generally qualifies for installment sale treatment. Under the installment sale rules, taxpayers generally take into account gain on the installment method but must pay interest on the deferred tax liability in certain circumstances.[27] However, the installment method is not available in certain circumstances (for example, if the property transferred is stock or securities traded on an established market, or in the case of certain transfers between related parties). In addition, in certain circumstances, a taxpayer will accelerate gain if the installment note is pledged as security for an indebtedness (sec. 453A).

Reasons for Change

The committee believes that a transferor who receives securities in a section 351 transaction does not continue an investment in the transferred assets to the extent of the securities received. In such instances, it is more appropriate to characterize the transaction as a taxable sale (to the extent of the securities received) rather than a tax-free exchange. The committee therefore believes that securities received in a section 351 transaction should be treated as boot. Such treatment would generally conform the tax consequences of the receipt of securities in a section 351 transaction to the tax consequences accorded securities received in a transaction qualifying as a tax-free reorganization.

Explanation of Provision

Securities received in a section 351 transaction are treated as boot. The provision does not apply, however, to: (1) any exchange that is pursuant to a plan of reorganization in which the securities are subject to section 354 (or so much of section 356 as relates to section 354); or (2) any exchange where the stock or securities received in the exchange are distributed in a transaction to which section 355 (or so much of section 356 as relates to section 355) applies.

Effective Date

The provision applies to transfers after October 2, 1989, unless the transfer was pursuant to a written binding contract in effect on that date and at all times thereafter before such transfer.

---

[27] The basis consequences to the transferee in a section 351 transaction are determined under section 362 of the Code. That section provides that the basis of property received by the corporation is the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

In addition, the provision applies to transfers made by C corporations after July 11, 1989, other than (1) transfers where (i) the transferor, immediately after the transfer, owns stock in the transferee that meets the 80-percent vote and value test of section 1504(a)(2) (excluding stock described in sec. 1504(a)(4)) and (ii) the transfer was not part of a plan to reduce the transferor's interest in the transferee (or a successor corporation) below the 80-percent vote or value level, and (2) transfers pursuant to a written binding contract in effect on July 11, 1989 and at all times thereafter before such transfer.

4. Provisions relating to regulated investment companies

a. Require mutual funds to distribute 98 percent of ordinary income (sec. 6204(a) of the bill and sec. 4982 of the Code)

Present Law

In order to avoid a penalty excise tax, a regulated investment company (RIC), commonly called a "mutual fund," generally must distribute before January 1 of any year at least 97 percent of its ordinary income earned during the prior calendar year and 98 percent of its capital gain net income for the 12-month period ending on October 31 of that year (Code sec. 4982). The penalty excise tax is equal to 4 percent of the excess (if any) of the required distribution for the calendar year over the actual distributed amount for such year.

Reasons for Change

The penalty excise tax is intended to limit the use of RICs to achieve deferral of taxable income to shareholders, with certain *de minimis* rules to allow for the difficulty in determining the exact amounts of capital gain and ordinary income. The committee determined that mutual funds could reasonably be expected to estimate 98 percent of their ordinary income. By reducing the *de minimis* amounts to levels warranted by actual experience, the provision eliminates unnecessary deferral.

Explanation of Proposal

Under the bill, the distribution required to avoid the penalty excise tax is increased to 98 percent of ordinary income.

Effective Date

The provision is effective for calendar years ending after July 10, 1989.

b. Denial of deduction for transferable mutual fund load charges if shareholder does not hold shares for more than six months (sec. 6204(b) of the bill and sec. 852 of the Code)

Present Law

A shareholder's basis in shares purchased in a regulated investment company (RIC), commonly called a "mutual fund," is the cost of acquiring the shares. This cost includes an expense such as a sales fee or "load charge" incurred in connection with the purchase. Thus, upon sale or exchange of the shares, the shareholder's gain is reduced, or loss is increased, by the amount of such expense (Code secs. 1011 and 1001).

If a RIC shareholder receives an exempt-interest dividend and sells his shares without holding them for more than six months, his loss on the sale is denied to the extent of the dividend. Likewise, if a RIC shareholder receives a capital gain dividend and sells his shares without holding them for more than six months, his loss on the sale is denied to the extent of the dividend (sec. 851(b)(4)).

Reasons for Change

For some RICs that belong to a family or series of funds, a load charge is imposed when shares of a fund are purchased, but an additional load charge is waived if the shares are received in exchange for those of another fund within the family or series. In that situation, a shareholder can purchase shares of a fund, exchange them for shares of a fund for which the load charge is waived, and claim that loss is increased, or gain reduced, by an amount equal to the load charge. Thus, present law encourages a shareholder who plans to purchase shares in one particular fund within a family of funds to first purchase shares in a different fund in the same family and immediately exchange the purchased shares for the desired shares in order to claim a capital loss equal to the load charge.

The committee believes that a load charge should not enter into the calculation of gain or loss until the shareholder has borne significant economic risk with respect to the underlying shares. A six-month holding period ensures that the shareholder bears such risk and reduces the possibility that a shareholder will engage in unnecessary purchases of mutual fund shares in order to recognize a capital loss.

In addition, the committee believes that a six-month holding period shows recognition for the fact that a shareholder benefits from a load charge so long as he holds shares in the family of funds.

Explanation of Provision

If a taxpayer (1) incurs a load charge in acquiring mutual fund shares and thereby obtains a reinvestment right, (2) disposes of those shares within six months, and (3) acquires shares in a mutual fund for which the otherwise applicable load charge is reduced by reason of the reinvestment right, then the original load charge increases the taxpayer's basis in the original shares only to the extent that the otherwise applicable load charge for the second acquisition is not reduced. Such charge is treated as incurred with respect to the shares purchased pursuant to the reinvestment right and increases basis in the reinvested shares if the shares are held for more than six months.

A person receiving mutual fund shares in a nonrecognition transaction succeeds to the treatment under the provision of the person who previously owned the shares. For example, assume H incurs a load charge in acquiring mutual fund shares and thereby obtains a reinvestment right, and holds the shares for two months before giving them to W. If W exchanges the shares for those of another fund and the otherwise applicable load charge is reduced, W's basis in the original shares is increased by the load charge incurred by H only if W holds the exchanged shares for more than four months.

A load charge is any sale or similar charge incurred by a person in acquiring shares of a regulated investment company, but does not include a charge incurred by reason of the reinvestment of a dividend. A reinvestment right is any right to acquire shares of one or more mutual funds with the payment of a reduced load charge. The term reinvestment right includes a privilege that may be modified without the consent of the shareholder.

Effective Date

The provision applies to load charges incurred after October 3, 1989, in taxable years ending after such date.

c. Require mutual funds to include dividend income on the ex-dividend date (sec. 6204(c) the bill and sec. 852 of the Code)

Present Law

Dividends from stock owned by a regulated investment company (RIC), commonly called a "mutual fund," are includible in the company's income when received. (*See* Rev. Rul. 78-117, 1978-1 C.B. 214)

Reasons for Change

As a general matter, inclusion of dividends in income on the ex-dividend date results in more accurate measurement of income than inclusion when received. In addition, such inclusion works no additional recordkeeping burdens on a RIC, which includes dividends in income on the ex-dividend date for accounting purposes. Accordingly, the committee believes it appropriate that RICs include dividends in income on the ex-dividend date.

Explanation of Provision

The bill requires that a mutual fund include a dividend received by it in income when the stock becomes ex-dividend with respect to the dividend. If a RIC acquires stock after such date and acquires the right to receive the dividend, the RIC must include the dividend in income on the date of acquisition.

Effective Date

The provision is effective for dividends on stock becoming ex-dividend after date of enactment.

5. Reduce built-in gain and loss threshold for sections 382 and 384 (sec. 6205 of the bill and secs. 382(h)(3)(B) and 56(g)(4)(H) of the Code)

Present Law

Sections 382 and 384 of the Code restrict the use of built-in losses and built-in gains of a corporation when there are certain changes in the control of a corporation. These rules apply only if the net unrealized built-in loss or built-in gain exceeds 25 percent of the fair market value of the assets of the corporation.

Under the minimum tax adjusted current earnings regime, built-in losses are limited, without a threshold, if there is a change of ownership under section 382 (Code sec. 56(g)(4)(H)).

Reasons for Change

The committee believes that the 25-percent threshold requirement of sections 382 and 384, which is a rule of administrative convenience, is too generous. The committee concluded that the threshold requirement should be reduced and that no threshold is justified if the amount of the built-in gain or built-in loss is substantial.

The committee believes that once an effective threshold is adopted for regular tax purposes that does not permit significant amounts of built-in losses to avoid the limitation, it is appropriate to extend the same threshold to the minimum tax as a rule of administrative convenience.

Explanation of Provision

The restrictions in sections 382 and 384 on the use of built-in gains and built-in losses of a corporation will apply if the built-in loss or built-in gain exceeds the lesser of (1) 15 percent of the fair market value of the assets of the company or (2) $25 million.

A corresponding threshold is provided for built-in losses under the minimum tax adjusted current earnings regime.

Effective Date

The provision generally is effective for ownership changes and acquisitions after October 2, 1989, in taxable years ending after such date. The provision, however, does not apply to any ownership change or acquisition pursuant to a written binding contract in effect on or before October 2, 1989, and at all times thereafter before such ownership change or acquisition.[28] However, in the case of a reorganization described in subparagraph (G) of section 368(a)(1) of the Internal Revenue Code of 1986, as amended, or an exchange of debt for stock in a title 11 or similar case, as defined in

[28] The committee understands that, under present law, a written binding contract to acquire stock may be treated as exercised and thus result in an ownership change.

section 368(a)(3) of such Code, the provision would not apply to any ownership change or acquisition resulting from such a reorganization or proceeding if a petition in such case was filed with the court before October 3, 1989.

6. Require basis reduction for nontaxed portion of dividends on self-liquidating stock (sec. 6206 of the bill and sec. 1059 of the Code)

Present Law

In general, corporations are entitled to a deduction equal to 70 percent of the dividends received from a domestic corporation. An 80-percent dividends received deduction is allowable if the corporate shareholder owns 20 percent or more of the stock of the domestic corporation and a 100-percent dividends received deduction is allowable if the corporate shareholder owns at least 80 percent of the stock of the domestic corporation.

A corporate shareholder's basis in stock is reduced by the portion of a dividend eligible for the dividends received deduction if the dividend is "extraordinary." In general, a dividend is extraordinary if the amount of the dividend equals or exceeds 10 percent (5 percent in the case of preferred stock) of the shareholder's adjusted basis in the stock and the shareholder has not held the stock, subject to a risk of loss, for at least 2 years prior to the date the amount or payment of the dividend is declared, announced, or agreed to, whichever is the earliest (sec. 1059).

Reasons for Change

Corporate stockholders may receive dividends eligible for the dividends received deduction in circumstances where the dividends more appropriately should be characterized as a return of capital. In many of these cases, the dividends are not subject to the "extraordinary dividend" rules of present law, so the holder's basis in the stock is not reduced as it should be economically. Thus, the holder can sell the stock and create an artificial capital loss in an amount approximately equal to the return-of-capital dividends. The committee believes that basis reduction in such cases is appropriate to accurately reflect the true economic effect of these types of transactions.

Explanation of Provision

The provision treats dividends with respect to certain preferred stock as extraordinary dividends under section 1059 (regardless of holding period), thus requiring reduction in stock basis. The provision applies to dividends with respect to preferred stock if (1) when issued, such stock has a dividend rate which declines (or reasonably can be expected to decline) in the future, (2) the issue price of such stock exceeds its liquidation rights or its stated redemption price, or (3) such stock is otherwise structured to enable corporate shareholders to reduce tax through a combination of dividend received deductions and loss on the disposition of the stock.

Stock and dividends subject to the provision include instruments treated as stock under any provision of law. Dividends subject to the provision include dividends deemed received under section 305 or any other provision.

In determining whether a dividend rate declines, or whether the stock would otherwise be subject to the provision, the effect of section 305 or other provisions of law on the timing and amount of the dividend shall be taken into account. The provision is not intended to apply to (i) dividends on preferred stock whose dividend rate declines due to an unforeseen economic downturn in the issuer's business, or (ii) dividends on floating rate or auction rate preferred stock whose dividend rate declines solely in response to changes in prevailing market conditions.

The Secretary of the Treasury is authorized to prescribe regulations that would apply this rule to dividends with respect to stock other than preferred stock in appropriate cases.

Effective Date

The provision applies to stock issued after July 10, 1989, unless issued pursuant to a written binding contract in effect on July 10, 1989, and at all times thereafter before the stock is issued.

7. Modify excess loss account recapture rules to prevent shifting of basis to debt (sec. 6207 of the bill and sec. 1503(e) of the Code)

Present Law

Under the consolidated return regulations, in general, a parent corporation must reduce its basis in the stock of a subsidiary with which it files a consolidated return by the amount of distributions the parent receives from the subsidiary and the amount of any deficit in earnings and profits of the subsidiary. Similarly, a parent corporation increases its basis in the stock of a subsidiary by the amount of contributions to the subsidiary and earnings and profits of the subsidiary. In general, when distributions and losses from the subsidiary exceed the contributions to and earnings of the subsidiary, an "excess loss account" is created. This amount is generally included in the income of the parent on certain dispositions of the stock of the subsidiary.

Under the present consolidated return regulations, a parent corporation that has an excess loss account in the stock of a subsidiary can, on disposition of the subsidiary's stock, elect to apply the excess loss account to reduce the basis of other stock or debt held by the parent in the subsidiary after the disposition.

Reasons for Change

The committee believes that when deductions creating an excess loss account have been taken with respect to an equity investment that is disposed of, it is not appropriate to permit deferral of gain recognition by shifting the recapture liability to a debt investment. The committee is also aware that some taxpayers have attempted to manipulate the rules of present law to accomplish sales of a subsidiary for a debt obligation in transactions which defer the recognition of gain.

Explanation of Provision

The provision modifies the excess loss account recapture rules to prevent the reallocation of the excess loss account to reduce the basis of debt in the subsidiary held by the parent corporation after a disposition. Thus, on disposition of the stock of a subsidiary corporation, gain attributable to an excess loss account must be recognized rather than deferred through a reduction in the basis of debt held by the parent corporation in the subsidiary.

The provision is not intended to affect the ability of taxpayers to diminish the amount of an excess loss account by contributions to capital (including contributions of indebtedness) or to prevent taxpayers from taking a loss for indebtedness of a subsidiary (to the extent otherwise permitted) if such debt becomes worthless.

The Treasury Department is directed to reexamine in certain cases the consolidated return rules permitting reallocation of the excess loss account to reduce the basis of other stock held by the parent corporation in the subsidiary corporation.

Effective Date

The provision generally is effective for dispositions after July 10, 1989, in taxable years ending after such date. The provision, however, does not apply to any disposition pursuant to a written binding contract in effect on July 10, 1989, and at all times thereafter before such disposition.

8. Clarify Treasury regulation authority relating to debt/equity (sec. 6208(a) of the bill and sec. 385 of the Code)

Present Law

The characterization of an investment in a corporation as debt or equity for Federal income tax purposes generally is determined by reference to numerous factors that are deemed to reflect aspects of the economic substance of the investor's interest in the corporation. There presently is no definition in the Internal Revenue Code or the income tax regulations which can be used to determine whether an interest in a corporation constitutes debt or equity for Federal income tax purposes. Such a determination is made under principles developed in case law. Courts have approached the issue of distinguishing debt and equity by analyzing and weighing the relevant facts and circumstances of each case. Generally, there has been a tendency to characterize an instrument entirely as debt or entirely as equity. Some cases, however, have treated certain instruments as part debt and part equity. *See, e.g., Farley Realty Corporation* v. *Commissioner,* 279 F.2d 701 (2d Cir. 1960).

In 1969, Congress granted the Secretary of the Treasury the authority to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or as indebtedness for Federal income tax purposes (sec. 385). The regulations were to prescribe factors to be taken into account in determining, with respect to particular factual situations, whether a debtor-creditor relationship or a corporation-shareholder relationship existed. Proposed regulations under section 385 were issued in 1980 and 1981, although they were withdrawn in 1983. To date, no additional regulations have been issued.

Reasons for Change

Instruments often possess some debt-like and some equity-like characteristics and thus cannot readily be classified under present-law principles either wholly as debt or wholly as equity. The committee believes that the Treasury Department should be accorded the opportunity to separately characterize different portions of such instruments as debt or equity. In addition, the committee believes that it is important that the Treasury Department provide guidance to taxpayers on debt-equity issues in an expeditious manner.

Explanation of Provision

Section 385 is amended to allow the Treasury Department to characterize an instrument having significant debt and equity characteristics as part debt and part equity. For example, such treatment may be appropriate in circumstances where a debt instrument provides for payments that are dependent to a significant extent (whether in whole or in part) on corporate performance, whether through equity kickers, contingent interest, significant deferral of payment, subordination, or an interest rate sufficiently high to suggest a significant risk of default.

The Treasury Department will continue to be authorized, although not required, to issue comprehensive debt-equity regulations under section 385. However, the Treasury Department is directed to increase the issuance of IRS published rulings on debt-equity issues.

No inference is intended that the Internal Revenue Service can not characterize an instrument as part debt and part equity under present law.

Effective Date

The Treasury Department's regulatory authority under this provision to characterize an instrument as part debt and part equity applies only on a prospective basis. Such authority can be exercised only with respect to instruments issued after public guidance is published, whether by regulation, ruling, or otherwise, stating the position of the Treasury Department with respect to the characterization of such instruments.

9. Require reporting to the IRS of certain acquisition and recapitalization transactions (sec. 6208(b) of the bill and secs. 6043 and 6652 of the Code)

Present Law

There is no requirement under present law that the parties to an acquisition or recapitalization transaction report information to the Treasury Department or the Internal Revenue Service with respect to such transaction, except as incident to the filing of Federal income tax returns.

Reasons for Change

The committee is concerned that it is difficult for the Internal Revenue Service to audit acquisition and recapitalization transactions effectively because the information relevant to such transactions is disaggregated among the returns of different taxpayers. In addition, taxpayers may not identify particular items on their returns as relating to an acquisition or recapitalization transaction or may not identify the specific transaction involved.

The committee believes that requiring the reporting of certain information with respect to acquisition and recapitalization transactions will improve compliance with the tax laws and will enable the IRS to audit taxpayers more effectively with respect to such transactions.

Explanation of Provision

In general

The Treasury Department is directed to require information reporting, in general, when: (1) one or more persons acquire control of a corporation in a transaction (or series of related transactions) or (2) there is a recapitalization of a corporation or other substantial change in the capital structure of a corporation. Control for this purpose means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. Control is determined in accordance with the provisions of section 304(c)(1), including the attribution provisions applicable to that section.

The committee intends that a substantial change in the capital structure of a corporation include transactions whereby a substantial portion of the equity of a corporation is replaced with debt. Such transactions could include, for example, leveraged distributions made by a corporation with respect to its stock, leveraged stock redemptions, or a corporation's issuance of debt to its shareholders. The Treasury Department is expected to issue guidance concerning what transactions will be considered as resulting in a substantial change in the capital structure of a corporation. The committee intends a recapitalization to include reorganizations under section 368(a)(1)(E). Other transactions that have the effect of a significant change in capital structure (for example, by replacing a significant amount of equity with debt) are also intended to be within the scope of the Treasury authority, without regard to whether they are in the form of a taxable or tax-free transaction.

If reporting is required with respect to a transaction (or series of related transactions), the corporation that is acquired or recapitalized or otherwise undergoes a change in its capital structure will be required to make a return at the time and in the manner prescribed by the Secretary of the Treasury. The information to be reported includes the identity of the parties to the transaction, the fees involved, any changes in the capital structure of the corporation, and such other additional information as the Treasury Department may require to be reported with respect to such transaction.

The committee expects the Treasury Department to issue guidance in this area promptly to enable taxpayers to file information returns with respect to transactions covered by this provision.

Penalties

Non-compliance with the reporting requirement is subject to penalties of $500 per day for each day that the information return is overdue, up to a maximum penalty of $100,000. In addition, the criminal penalty provisions of present law apply (see Code secs. 7203, 7206 and 7207).

De minimis rules and other rules of convenience

The committee intends that the Treasury Department will exempt small transactions from any reporting requirement hereunder. For these purposes, the committee considers an acquisition in which the total consideration involved is less than $10 million to be a small transaction. The committee considers a recapitalization or other substantial change in the capital structure of a corporation involving less than a $10 million distribution or involving less than $10 million in value of the stock or debt of the corporation to be a small transaction. The Treasury Department is specifically authorized, however, to exempt certain larger transactions from the reporting requirement if the Treasury Department determines such an exemption to be appropriate.

The Treasury Department is specifically authorized to develop other rules that would exempt particular categories of transactions from the reporting requirement if compliance would be unduly burdensome and exemption from the reporting requirements would not be inconsistent with the purposes of this provision.

Effective Date

The provision is effective for transactions after March 31, 1990.

10. Treasury study of "debt vs. equity" and integration issues (sec. 6208(c) of the bill)

Present Law

Interest on debt is generally deductible by the issuer and is includible in the income of the holder. In the case of tax-exempt or foreign holders, however, the interest is not taxable with the result that neither the issuer nor the holders pay any tax on income with respect to amounts distributed as interest.

The U.S. income tax system is not integrated, i.e., corporations and their shareholders are generally treated as separate taxable entities. Thus, income earned by a corporation and distributed to shareholders may be taxed twice: once at the corporate level when earned and again at the shareholder level when such income is distributed to shareholders.

Reasons for Change

The committee is concerned with the differing Federal income tax treatment of debt and equity and with economic distortions resulting from the failure to integrate the individual and corporate tax systems. The committee concluded that a Treasury Department study of "debt vs. equity" and integration issues would be helpful to the Congress in its continuing evaluation of the Federal income tax system.

Explanation of Provision

The Treasury Department is required to study whether the present law distinctions between debt and equity are meaningful and whether there are cases in which it would be appropriate to recharacterize currently deductible interest expense, in whole or in part, as nondeductible dividends or vice versa.

The Treasury Department also is required to study the policy and revenue implications of proposals that would integrate the corporate and individual income tax systems, including a deduction for dividends paid by a corporation and a shareholder credit or exclusion for such dividends.

In addition, the Treasury Department is directed to consider the policy and revenue implications of the current tax treatment of corporate distributions with respect to debt and equity owned by tax-exempt entities and foreign persons.

The Treasury Department is required to report its findings and recommendations to the House Committee on Ways and Means and the Senate Committee on Finance no later than one year following the date of enactment. In the course of making the study, the committee encourages the Treasury Department to consult with the Federal Reserve Board and other Federal agencies, as appropriate.

Effective Date

The provision is effective on the date of enactment.

11. Require corporate estimated tax payments on tax liabilities for certain S corporation income (sec. 6209 of the bill and sec. 6655 of the Code)

Present Law

In general, an S corporation is not subject to tax on its taxable income. Rather, taxable income of an S corporation flows through to its shareholders in a manner similar to a partnership. However, there are limited instances when an S corporation is subject to tax. These instances include: (1) the recognition of a built-in gain within 10 years of the date that a former C corporation elected S corporation status (sec. 1374(a)); (2) the receipt of passive investment income in excess of 25 percent of total annual gross receipts if the corporation has earnings and profits from a year in which it was not an S corporation (sec. 1375(a)); and (3) the recapture of investment tax credits claimed during a taxable year in which the corporation was not an S corporation (sec. 1371(d)).

Although situations exist for which an S corporation is liable for income tax, present law does not require the corporation to make estimated tax payments. Instead, the tax must be paid no later than the unextended due date of the S corporation tax return.

Reasons for Change

The items for which S corporations are subject to income tax are generally items for which C corporations are subject to income tax. Thus, S corporations should be generally subject to the estimated tax payments for those items in the same manner as C corporations.

Explanation of Provision

The bill provides that an S corporation is required to make estimated tax payments if it has tax attributable to: (1) the recognition of built-in gains under section 1374(a);[29] (2) the receipt of excess passive investment income under section 1375(a); or (3) the recapture of investment tax credits pursuant to section 1371(d).[30] The rules contained in section 6655 for estimated tax payments by corporations will generally apply.

For purposes of the portion of required estimated tax payments attributable to built-in gains and investment tax credit recapture, an S corporation will not be able to utilize the exceptions which allow estimated tax payments to be based on the corporation's prior year tax (secs. 6655(d)(1)(B)(ii) and 6655(d)(2)(B)). The prior year's tax exception will be available to all S corporations (including "large" S corporations) with respect to the portion of required estimated tax payments attributable to excess passive income (even if there was no tax attributable to excess passive income in the prior year). In all situations, an S corporation will be able to use the annualization exception (sec. 6655(e)).

Effective Date

The provision is effective for estimated tax payments due for taxable years beginning after December 31, 1989.

12. Limitation on carrybacks of certain net operating losses of C corporations (sec. 6210 of the bill and sec. 172 of the Code)

Present Law

A corporation that incurs net operating losses (NOLs) generally can carry the NOLs back 3 taxable years and forward 15 taxable years (sec. 172). Carrying the NOLs back against prior taxable income allows a corporation to recognize currently the benefit of those losses by obtaining a refund of Federal income taxes paid in prior years.

Reasons for Change

The committee believes that the ability of corporations to carry back NOLs that are created by certain debt-financed transactions is contrary to the purpose of the NOL carryback rule. Specifically, the purpose of the rule is to allow corporations to smooth out the

---

[29] The provision also applies to tax that is attributable to certain capital gains of S corporations pursuant to sec. 1374 as effective before the changes made by the Tax Reform Act of 1986.

[30] No inference is intended as to the proper estimated tax treatment for any item for any prior year or for any item for any taxpayer other than an S corporation.

swings in taxable income that result from business cycle fluctuations and unexpected financial reverses. The committee believes that when a corporation is involved in certain debt-financed transactions, the underlying nature of the corporation is substantially altered. In addition, the committee believes that the interest expense associated with such transactions does not have a sufficient nexus with prior period operations to justify a carryback of NOLs attributable to such expense. Therefore, the committee believes that it is inappropriate to permit a corporation to carry back an NOL generated by such a transaction to a year prior to the year in which such transaction occurred.

Explanation of Provision

In general

The ability of C corporations to obtain refunds of taxes paid in prior years by carrying back NOLs is limited in cases where the losses are created by interest deductions allocable to certain corporate equity-reducing transactions.

Corporate equity reduction transaction

A corporate equity reduction transaction ("CERT") means either a major stock acquisition or an excess distribution. A major stock acquisition is an acquisition by a corporation (or any group of persons acting in concert with such corporation) of at least 50 percent of the vote or value of the stock of another corporation. All acquisitions made during any 24-month period are aggregated for these purposes. A major stock acquisition does not include an acquisition where the acquiring corporation has made a section 338 election, or, except to the extent provided in regulations, an acquisition of stock of another corporation which, immediately before the acquisition, was a member of an affiliated group (within the meaning of section 1504(a)), other than the common parent of such group.

An excess distribution is the excess of the aggregate distributions and redemptions made by a corporation during the taxable year with respect to its stock (other than stock described in section 1504(a)(4)), over 150 percent of the average of such distributions and redemptions for the preceding 3 taxable years. The amount of distributions and redemptions made by a corporation during a taxable year are reduced by consideration (other than stock) received in exchange for stock (other than stock described in section 1504(a)(4)) issued by the corporation during such year. Notwithstanding the above, a distribution or redemption (or series thereof) is not treated as an excess distribution if it does not exceed 10 percent of the value of the corporation's outstanding stock (other than stock described in section 1504(a)(4)) measured at the beginning of the corporation's taxable year.

Limitation of net operating loss carryback

If a C corporation has an NOL in the taxable year in which it is involved in a CERT or in the following 2 taxable years, the corporation may be limited in its ability to carry back some portion of the loss. A C corporation is treated as being involved in a CERT if it is either the acquired or acquiring corporation, or successor thereto (in the case of a major stock acquisition) or the distributing or redeeming corporation, or successor thereto (in the case of an excess distribution). Any portion of an NOL that cannot be carried back due to the operation of this provision may be carried forward to the corporation's future taxable years, as otherwise provided under present law.

The portion of the corporation's NOL carryback that is limited is the lesser of (1) the corporation's interest expense that is allocable to the CERT, or (2) the excess of the corporation's interest expense in the loss limitation year over the average of the corporation's interest expense for the 3 taxable years prior to the taxable year in which the CERT occurred. If the lesser of these two amounts is less than $1 million, the provision does not apply.

The Secretary of the Treasury is authorized to specify the method of allocating a corporation's interest expense to a CERT. Until regulations are promulgated, however, a corporation's indebtedness is allocable to a CERT to the extent that the corporation's indebtedness could have been reduced if the CERT had not occurred, in the manner prescribed under section 263A(f)(2)(A)(ii) (without regard to clause (i) thereof). The interest expense associated with such allocable indebtedness is equal to a pro rata portion of the corporation's total interest expense.

For purposes of determining whether a corporation's interest expense exceeds the prior 3-year average, it is expected that regulations would provide that increases attributable solely to fluctuations in interest rates would not be taken into account.

If a corporation has an NOL in any of the 2 taxable years succeeding the taxable year in which the CERT occurred, a portion of the corporation's NOL carryback may still be limited under the provision. Specifically, the limitation for each of the 2 years is the lesser of (1) the corporation's interest expense for the current year that is allocable to the CERT that occurred in the prior year, or (2) the excess of the corporation's interest expense for the current year over the average of the corporation's interest expense for the 3 taxable years prior to the taxable year in which the CERT occurred. The provision does not apply, however, if the amount determined above is less than $1 million.

A special rule provides that if an unforeseeable, extraordinary and adverse event occurs during a loss limitation year but after the CERT, the corporation's indebtedness first is allocated to unreimbursed costs paid or incurred in connection with the event, in the same manner as indebtedness is allocated to a CERT under the bill. Any remaining indebtedness is then allocable to the CERT. In addition, interest expense on indebtedness allocated to such an event is not taken into account for purposes of determining whether the corporation's interest expense in the loss limitation year exceeds the average for the 3-year period prior to the CERT.

The Secretary of the Treasury is authorized to prescribe regulations that would exempt transactions from application of the provision where corporate equity has not been replaced by debt. In addition, the Secretary is authorized to prescribe regulations for applying the provision where more than 1 corporation is involved in a CERT.

Examples

The operation of the provision may be illustrated by the following examples.

(1) Profitable corporation P, a calendar year C corporation, is capitalized with $150 million of debt and $50 million of equity. P's annual interest expense has been $15 million for the past 3 years. P has paid a 1% annual dividend to its shareholders, or an average of $.5 million, for each of the past 3 years. On January 1, 1990, P borrows $50 million and distributes the proceeds to its shareholders. Due to increased interest deductions of $5 million, P incurs an NOL in 1990 of $4 million.

P was involved in a CERT in 1990 because P made an excess distribution to its shareholders (i.e., the $50 million distribution exceeds 150% of the average $.5 million dividend). The portion of P's $4 million NOL that is limited under the provision is the lesser of (1) P's interest expense that is allocable to the CERT ($5 million), or (2) the excess of P's interest expense in 1990 ($20 million) over P's average interest expense for the past 3 years ($15 million), or $5 million. Thus, P would not be able to carry back the $4 million NOL to any taxable year prior to 1990. In addition, if P has NOLs in 1991 and 1992 due to interest deductions allocable to the 1990 CERT, a similar computation would be made in each of those years and P may be limited in its ability to carry back the losses to pre-1990 taxable years. If P has income in subsequent years, however, P would be able to use the NOLs to offset that income.

(2) Same facts as in Example (1), except that P does not incur any additional borrowing in 1990. Rather, P distributes $50 million from its own reserves to its shareholders. P's annual interest expense remains at $15 million following the distribution. Since the distributed funds no longer generate corporate earnings, however, P incurs an NOL in 1990 of $3 million.

P was still involved in a CERT in 1990 because P made an excess distribution to its shareholders. The portion of P's $3 million NOL that is limited under the provision is the lesser of (1) P's interest expense that is allocable to the CERT ($5 million), or (2) the excess of P's interest expense in 1990 ($15 million) over P's average interest expense for the past 3 years ($15 million), or zero. Thus, P's NOL carryback is not limited under the provision, and P would be able to carry back the $3 million loss to its pre-1990 taxable years, subject to any other restrictions of present law.

In addition, if P's interest expense in the loss limitation year had exceeded the prior 3-year average solely due to an increase in interest rates, it is expected that regulations would exempt P from the provision.

Effective Date

The provision applies to CERTs occurring after August 2, 1989, in taxable years ending after that date.

In determining whether a CERT has occurred after August 2, 1989, the following is not taken into account: (1) acquisitions or redemptions of stock, or distributions with respect to stock, occurring on or before August 2, 1989; (2) acquisitions or redemptions of stock after August 2, 1989, pursuant to a written binding contract (or tender offer filed with the SEC) in effect on August 2, 1989, and at all times thereafter before such acquisition or redemption; or (3) any distribution with respect to stock after August 2, 1989, which was declared on or before August 2, 1989.

If any of the 3 taxable years that comprise the average against which interest expense in a loss limitation year is compared, ends on or before August 2, 1989, a corporation may use the interest paid or accrued (determined on an annualized basis) during the taxable year that includes August 3, 1989, on indebtedness outstanding on August 2, 1989, rather than the 3-year average.

13. Small business exemption from recognition of gain or loss on liquidating sales or distributions (exemption from repeal of the *General Utilities* doctrine) (sec. 6211 of the bill and sec. 336 of the Code)

Present Law

Gain or loss is generally recognized by a corporation on a liquidating sale or distribution (including a deemed sale occurring when stock of a corporation is acquired and an election is made to treat the transaction as an asset sale). This rule was added to the Code by the Tax Reform Act of 1986. Prior to the 1986 Act, gain was generally recognized for nonliquidating sales or distributions but not for liquidating sales (including sales involving the acquisition of the corporation). In addition, certain nonliquidating distributions to long-term individual shareholders were not taxed prior to the 1986 Act. The 1986 Act generally conformed the tax treatment for liquidating sales and distributions to the treatment accorded in nonliquidating sales or distributions by requiring the corporation to recognize gain in all cases.

The 1986 Act provided transition relief for certain small corporations. Corporations eligible for this relief were granted two additional years, until December 31, 1988, in which they could distribute assets, liquidate, or convert to subchapter S status without recognizing a corporate level gain except for gain on ordinary income assets or capital assets held less than six months, or gain from certain conduit transactions with ineligible corporations.

Eligible corporations were those in existence on August 1, 1986, and whose value on the later of that date or the date of adoption of a plan of liquidation did not exceed $10 million, provided that on August 1, 1986 and at all times thereafter, more than 50 percent (by value) of the stock of such corporation was owned by a qualified group. A qualified group consisted of 10 or fewer individuals who at all times during the five year period ending on the date of adoption of the plan of liquidation (or during the life of the corporation, if shorter) owned more than 50 percent of the value of the corporate stock. Corporations whose value exceeded $5 million were eligible only for partial relief and the relief was phased out entirely for corporations whose value exceeded $10 million.

Reasons for Change

The committee believes that the relief from corporate level taxation for small corporations that expired at the end of 1988 should be reinstated.

Explanation of Provision

The bill generally makes permanent the 1986 Act relief from recognition of corporate level gain by small corporations. Relief under the bill applies to any small corporation (whether or not in existence on August 1, 1986) and applies if at least 50 percent (by value) of the stock of the corporation is held by 10 or fewer qualified shareholders each of whom has held his or her stock for at least 5 years (or is treated as having held such stock for such period under attribution rules). As under the 1986 Act transition rule, ordinary income property and short term capital gain property are not eligible for relief. Conforming changes are made to the definition of short term capital gain property to reflect changes in the definition that have occurred since 1986.

As under the 1986 Act transition rules, relief is provided to small corporations for certain nonliquidating distributions and conversions to subchapter S status. Similarly, relief is provided where a section 338 election is made by the acquiror of a small corporation.

As under the 1986 Act transition rules, the bill also provides relief from shareholder level tax pursuant to section 333 of the Code.

The bill provides relief only for corporations whose value does not exceed $10 million; however, only partial relief is provided for corporations whose value exceeds $5 million. In determining the value of the corporation, the bill requires that the amount of any redemptions, distributions, or corporate contractions occurring in the prior five years, other than reasonable regular dividends or other expenses paid in the ordinary course of business, be included in such value.

Effective Date

The provision is effective for transactions occurring after December 31, 1988.

14. Treatment of safe harbor leases of membership organizations (sec. 6212 of the bill and sec. 277 of the Code)

Present Law

Deductions of membership organizations

In the case of a membership organization which is operated primarily to furnish services or goods to its members, deductions arising from providing such services or goods to its members are allowed only to the extent of income derived from providing such services or goods to its members (sec. 277). In essence, the rule prohibits losses incurred from transactions with members to offset income derived from transactions with nonmembers.

Safe harbor leases

The Economic Recovery Tax Act of 1981 (P.L. 97-34) provided a set of rules that were intended to be a means of transferring tax benefits that are structured in the form of a lease. Under these rules (known as the "safe harbor lease rules"), certain transactions involving tangible personal property were treated as lease for Federal income tax purposes regardless of their nontax economic substance. If the transaction met the safe harbor requirements, the lessor in the agreement was treated as the property owner for Federal income tax purposes and was entitled to cost recovery deductions and investment credits. Under these rules, by entering into a nominal sale and safe-harbor leaseback, a person who acquired and used the property could have, in effect, sold some of the tax benefits associated with the property to a corporation, while retaining all other economic benefits and burdens of ownership. The safe harbor lease rules were repealed by the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248).

Reasons for Change

It has come to the attention of the committee that a number of electricity generating cooperatives which are subject to section 277 have entered into safe harbor lease transactions under which these cooperatives, in effect, sold tax benefits. In such transactions, the cooperative, in form, first sells the property to a corporation in exchange for an interest bearing note and cash equal to all or a portion of the value of the tax benefits from the property and then leases the property back from that corporation for a rental that equals to payments on the note.

Under the form of the transaction, the cooperative has interest income and rental expense from the transaction. The Internal Revenue Service has taken the position that the interest income is income not derived from transactions with members while the rental expense must be allocated between income derived from members and nonmembers. As a result, a cooperative that does most of its business with members is treated as receiving amounts of interest income which can be offset only by the relatively small amount of rental expense allocable to nonmember business, resulting in significant additional tax liability to the cooperative.

The committee believes that the substance of a safe harbor lease transaction, and not its form, should govern the tax treatment. Consequently, the committee believes that safe harbor lease transactions should not result in higher levels of taxation than would occur if the benefit of the safe harbor lease was made in the form of a grant from the Federal Government. The committee believes, however, that the safe harbor lease should not result in avoidance of taxation by the cooperative of its income from nonmembers. Accordingly, the committee believes that the interest income and the rental expense arising from safe-harbor leases should be allocated between members and nonmember income.

Explanation of Provision

The bill provides that the interest income and rental expense from the sale and leaseback of the property under a safe harbor lease are to be first netted and the difference allocated between members and nonmembers in proportion to the business done with each group.

Effective Date

The provision is effective for all open taxable years.

Subtitle C. Employee Benefit Provisions

1. Repeal of section 89 nondiscrimination rules (secs. 6301 and 6302 of the bill and sec. 89 of the Code)

Present Law

Under present law, nondiscrimination rules apply to employer-provided health benefits and group-term life insurance plans (sec. 89). In addition, section 89 requires that certain types of employee benefit plans meet minimum qualification requirements (e.g., that the plan be in writing and that plan participants be notified of plan provisions). Prior to the enactment of section 89 in the Tax Reform Act of 1986, prior law applied other nondiscrimination rules to group-term life insurance plans, cafeteria plans, and self-insured health plans.

Under present law, if the employer has separate lines of business or maintains separate operating units, each separate line of business or operating unit may be tested separately under the nondiscrimination rules relating to qualified plans by taking into account only those employees in that line of business or operating unit.

Reasons for Change

While most employee compensation is taxable income to the employee, employer-provided health coverage generally is excludable from the gross income of the employee receiving the coverage. The annual cost to the Federal Government of this tax-favored treatment is estimated to be $32.6 billion for fiscal year 1990. This cost is projected to increase to $50.8 billion for fiscal year 1994.[31]

In enacting the Tax Reform Act of 1986, the Congress determined that the substantial revenue cost related to employer-provided health insurance coverage is justified only if the tax benefits fulfill important public policy objectives. Increasing health coverage among rank-and-file employees who otherwise would not purchase or could not afford such coverage was identified as a primary policy objective underlying the exclusion for employer-provided health care coverage. Conversely, the Congress believed that the cost to the Federal Government of tax-favored employer-provided accident and health coverage is not justified if such coverage disproportionately benefits highly compensated employees. In order to achieve this objective, nondiscrimination rules were enacted to permit the full exclusion from income of employer-provided health benefits only if the benefits are provided to required numbers of nonhighly compensated employees and the level of benefits provided to highly compensated employees on average does not dispropor-

[31] See, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1990-1994*, JCS-4-89 (February 28, 1989).

tionately exceed the average benefits provided to rank-and-file employees.

The committee believes that nondiscrimination in the provision of employer-provided health coverage remains an important policy objective, and that the significant tax expenditures for employer-provided health coverage is justified only if such coverage does not discriminate in favor of highly compensated employees. However, the committee believes that the present-law nondiscrimination rules, or similar rules, are not at this time an appropriate way of achieving this objective. The present-law rules are overly complex and unduly burdensome on employers and therefore the committee believes it is appropriate to repeal the present-law section 89 rules.

Explanation of Provision

In general

The provision repeals present-law section 89, and generally reinstates the rules applicable before its enactment. Generally, prior law contained nondiscrimination rules relating to employer-provided self-insured medical reimbursement plans (sec. 105(h)), cafeteria plans (sec. 125), and group-term life insurance plans (sec. 79(d)). These prior law rules are reinstated under the provision. The committee recognizes that the nature of these benefits may differ from the nature of retirement benefits. Therefore, it is expected that the Secretary will, where appropriate, interpret the rules relating to these benefits in a different manner than those rules that apply in the area of qualified retirement plans, even where the statutory requirements with respect to such benefits are similar.

Separate lines of business or operating units

The Tax Reform Act of 1986 directed the Secretary to issue guidance on certain pension requirements, including the requirements relating to separate lines of business (sec. 414(r)). Under present law, until the Secretary issues guidance on which taxpayers may rely with respect to such rules, an employer's compliance with its reasonable interpretation of the requirement, based on the statute and its legislative history, if made in good faith, constitutes compliance with the requirement.

Under the provision, in the case of any plan year of a qualified retirement plan that begins on or before the date the Secretary or his delegate issues guidelines and begins issuing determinations under section 414(r)(2)(C), an employer shall be treated as operating separate lines of business if the employer reasonably determines that it meets the requirements of section 414(r) (other than paragraph (2)(C) thereof). The committee intends that the Secretary will, upon the issuance of guidance relating to separate lines of business, grant a reasonable period of time for employer to comply with the guidance.

As under present law, it is generally intended that a line of business or operating unit include all employees necessary for the preparation of property for sale to customers. Whether lines of business or operating units are separate is a facts and circumstances determination requiring examination of each particular situation. Differences and similarities between the services provided and products produced by claimed lines of business or operating units are among the factors to be considered.

It is intended that separate lines of business may be established under the reasonable good faith standard under certain circumstances, for example, in the case of operations that are vertically integrated and that traditionally are operated by unrelated entities. For example, a vertically integrated oil company may be able to treat its retail marketing operations as a line of business separate from its production and refining operations because the marketing of petroleum products is traditionally conducted by independent individual operators rather than by integrated companies. Similarly, horizontally integrated businesses may be treated as maintaining separate lines of business where the employer produces or markets different products (e.g., different types of agricultural crops) through separate business units. Of course, in all cases, all requirements of the separate line of business rules must be satisfied (e.g., sec. 414(r)(2)).

Effective Date

The provision is effective as if included in the Tax Reform Act of 1986.

2. Modification of rules relating to employee leasing and dependent care assistance programs (sec. 6303 of the bill and secs. 414 and 219 of the Code)

Present Law

For purposes of specified pension requirements, a leased employee is treated as the employee of the person for whom the leased employee performs services (the "recipient"). A leased employee is generally defined as any person who is not an employee of the recipient if (1) such services are provided to the recipient under an agreement between the recipient and the organization providing the person's services (the "leasing organization"), (2) the person performs such services for the recipient (or for the recipient and related persons) on a substantially full-time basis for at least 1 year, and (3) such services are of a type historically performed, in the business field of the recipient, by employees.

In addition, under present law, an employee may exclude certain benefits received under an employer-provided dependent care assistance program if certain requirements are satisfied (sec. 129).

Reasons for Change

The committee is concerned that the statute and proposed Treasury regulations relating to leased employees are overly broad. The committee believes that under present law, these rules treat as leased employees certain individuals who were not intended to be so treated.

The committee is also concerned with the rules relating to dependent care assistance programs. The committee believes that the present-law rules with respect to such programs are overly harsh in that all employees are subject to taxation if an employer discriminates in favor of the highly paid. It is the intention of the committee that only those high paid who receive discriminatory benefits should be required to include dependent care assistance in taxable income.

Explanation of Provision [32]

Under the provision, the present-law historically performed test is repealed and replaced with a new rule defining who must be considered a leased employee. This change is made because the proposed regulations under the leased employee rules (sec. 414(n)) are overly broad in defining who may be a leased employee. Under the provision, the proposed regulations are no longer valid.

Under the provision, an individual is not considered a leased employee unless the individual is under the control of the recipient organization. The determination of whether an individual is controlled by the employer is based on all the facts and circumstances. Among the factors that are relevant in this determination are whether the recipient organization: (1) prescribes the individual's work methods; (2) supervises the individual; (3) sets the individual's working hours; and (4) sets the individual's level of compensation. Other factors that may be considered include those that are relevant for determining whether the employer is responsible for employment taxes on the compensation paid to the individual. The Secretary may designate other relevant factors. It is not necessary that all these factors indicate that the individual is under the control of the employer in order to find that such individual is a leased employee. Nor is it necessary that the recipient organization be responsible for employment taxes in order to find that the individual is a leased employee because, if the recipient organization is liable for employment taxes, the individual is an employee of the organization who generally must be taken into account. The provision does not alter the definition of a common-law employee, nor the rules that such employees are to be taken into account unless specifically excluded.

The provision clarifies present law in that support staff of professional service organizations continue to be treated as leased employees (to the extent they are not already considered employees because they are common-law employees). A professional service organization is an organization providing professional services in the field of health, law, engineering, architecture, accounting, actuarial services, financial services, consulting, or in such other fields as the Secretary may prescribe. This clarification with respect to the support staff of professional service organizations is not intended to create an inference with respect to the support staff of organizations other than professional service organizations.

Under the provision, persons who perform services incidental to the sale of goods or equipment or incidental to the construction of a facility are generally not leased employees. This rule does not extend to the operation (including supervision over such operation) of the goods, equipment, or completed facility.

[32] The provision is substantially similar to provisions contained in S. 5, as passed by the Senate on June 23, 1989.

In those specific situations where the Internal Revenue Service has ruled that service relationships do not involve "leased employees" under the test of present law requiring the services to be of a type historically performed, in the business field of the recipient, by employees, the recipients of those rulings may continue to rely on them as not involving support staff of professionals or the performance of services under the control of the recipient.

In addition, under the provision, the nondiscrimination rules under section 129(d) as that section was amended by the Tax Reform Act of 1986 continue to apply to dependent care assistance programs but are modified in the following respects. First, if a plan fails to meet the requirements of section 129(d), only highly compensated employees must include benefits under the program in gross income. Second, if a dependent care assistance program fails the 55-percent benefits test, then highly compensated employees must include in gross income only that amount of benefit in excess of that level of benefit that would meet the benefits test. Finally, under the provision, the 55-percent benefits test can be applied on a separate line of business basis (sec. 414(r)).

Effective Date

Under the provision, the revised definition of leased employee is effective for years beginning after December 31, 1983.

With respect to dependent care assistance programs, the provision is effective for years beginning after December 31, 1988.

3. Provisions relating to employee stock ownership plans (ESOPs) (sec. 6311 of the bill and sec. 133 and new sec. 4978B of the Code)

Present Law

ESOPs in general

An employee stock ownership plan (ESOP) is a qualified stock bonus plan or a combination of a stock bonus plan and money purchase pension plan that meets certain requirements and under which employer securities are held for the benefit of employees. Present law generally prohibits loans between a qualified plan and a disqualified person (sec. 4975). An exception to this rule is provided in the case of an ESOP.

If employer securities are acquired by an ESOP with loan proceeds, the ESOP is referred to as a leveraged ESOP. The ESOP may borrow directly from a financial institution (typically with a guarantee from the employer), or the employer may borrow from a financial institution and in turn lend the funds to the ESOP which then uses them to acquire employer securities. The employer securities are typically pledged as security for the loan. The employer makes contributions to the ESOP which are then used to repay the acquisition loan. Shares that are acquired with an acquisition loan are allocated to the accounts of ESOP participants as the loan is repaid.

In general, the type of employer securities that may be held by an ESOP are (1) common stock of the employer that is readily tradable on an established securities market, or (2) if there is no such common stock, common stock issued by the employer having a combination of voting power and dividend rights at least equal to that class of common having the greatest voting power and that class of common having the greatest dividend power. Noncallable preferred stock is treated as employer securities if such stock is convertible into stock that meets the requirements of (1) or (2), whichever is applicable.

ESOPs are required to pass through to plan participants certain voting rights with respect to employer securities. If the employer has a registration-type class of securities, the ESOP is required to permit each participant to direct the plan as to the manner in which employer securities allocated to the account of the participant are entitled to vote. If the employer does not have a registration-type class of securities, the plan is required to permit each particpant to direct the plan as to the manner in which voting rights are to be exercised only with respect to certain enumerated corporate issues, such as the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, and similar transactions as prescribed by the Secretary.

Partial interest exclusion for ESOP loans

A bank, an insurance company, a corporation actively engaged in the business of lending money, or a regulated investment company may exclude from gross income 50 percent of the interest received with respect to a "securities acquisition loan "used to acquire employer securities for an ESOP (sec. 133). A "securities acquisition loan" is generally defined as (1) a loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities for the ESOP, or (2) a loan to a corporation to the extent that the corporation transfers an equivalent amount of employer securities to the ESOP and such securities are allocable to accounts of ESOP participants within 1 year of the date of the loan (an "immediate allocation loan").

Reasons for Change

The present-law tax incentives for ESOPs were designed to encourage employers to establish ESOPs and to encourage individuals to sell employer securities to ESOPs. The committee is concerned that, in some cases, the significant tax benefits accorded ESOP transactions are not being passed through to plan participants. The committee is also concerned that the use of the tax benefits has extended beyond the intended purpose of the benefits, and that the revenue loss associated with the tax benefits has increased beyond the originally anticipated loss, without a corresponding benefit to employees. For example, the committee is aware that some companies have simply restructured existing employee benefit programs to take advantage of the ESOP tax benefits, with little or no change in benefits to employees despite the significant tax savings realized by the employer.

At this time, the committee has been particularly concerned about the use of the partial interest exclusion. The committee believes that this tax benefit should be limited to cases in which the ESOP owns a significant portion of the employer. A requirement that the ESOP own a significant portion of the employer will help to ensure that the revenue loss associated with the provision is accompanied by a significant benefit to employees.

The committee also believes that ESOP participants should be accorded treatment similar to that of other stock owners. In particular, the committee believes that where special tax benefits are involved, ESOP participants should have full voting rights.

Explanation of Provision

The provision limits the circumstances in which the partial interest exclusion applies. In general under the provision the partial interest exclusion does not apply to a securities acquisition loan unless (1) immediately after the acquisition of the securities acquired with the loan the ESOP owns at least 30 percent of each class of outstanding stock of the corporation issuing the employer securities or 30 percent of the total value of all outstanding stock of the corporation, (2) the term of the loan does not exceed 15 years, and (3) each participant is entitled to direct the plan as to the manner in which shares allocated to the participant's account that were acquired with a section 133 loan are to be voted. These requirements apply to transfers of stock with respect to an immediate allocation loan as well as other types of securities acquisition loans. The requirement that the term of the loan does not override other requirements relating to ESOPs, such as the rules under section 4975.

The 30-percent requirement is designed to ensure that the ESOP holds a substantial percentage of the company's stock. After the sale of the stock to the ESOP, the ESOP must generally hold the employer securities for at least 3 years. An excise tax is imposed on the employer sponsoring the ESOP if, within 3 years after the acquisition of the employer securities with a loan to which section 133 applies, the ESOP disposes of employer securities and the total number of employer securities held by the ESOP is less than the total number held after the acquisition or the value of the employer securities held by the plan after the disposition is less than 30 percent of the value of the outstanding securities. The excise tax does not apply to certain distributions, such as distributions to plan participants and distributions with respect to certain corporate reorganizations.

An excise tax is also imposed if the ESOP disposes of the employer securities before the securities are allocated to accounts of participants and the proceeds from such disposition are not so allocated.

The amount of each excise tax is 10 percent of the amount realized on the disposition. The excise tax rules are similar to those that apply in situations where there has been a sale of stock to an ESOP that entitles the seller to defer recognition of gain on the sale (sec. 1042) or an estate tax deduction (sec. 2057).

The voting requirements of the provision apply to all shares acquired with the loan to which the partial interest exclusion applies. This requirement applies to all issues and applies regardless of whether the employer has a registration-type class of securities. In addition, if the shares are convertible preferred stock, the participants must be entitled to direct the voting of such stock as if the preferred stock had the voting rights of the common stock of the employer having the greatest voting power.

Effective Date

The provision would generally be effective with respect to loans made after June 6, 1989, including (except as provided below) loans made after June 6, 1989, to refinance loans made on or before June 6, 1989. The provision would not apply to any loan (1) pursuant to a binding written commitment to make a securities acquisition loan in effect on June 6, 1989, and at all times thereafter before the loan is made, (2) the proceeds of which are use to acquire employer securities pursuant to a written binding contract (or tender offer registered with the Securities and Exchange Commission) in effect on June 6, 1989, and at all times thereafter before such securities are acquired, (3) to the extent made to finance the acquisition of employer securities by an ESOP pursuant to one or more collective bargaining agreements between employee representatives and one or more employers which was agreed to on or before June 6, 1989, and ratified before such date or within a reasonable period thereafter and which agreement sets forth the material terms of the acquisition (which requirement may be met if the agreement sets forth the material terms of the ESOP), or (4) with respect to which a filing was made with an agency of the United States on or before June 6, 1989, which specified the aggregate principal amount of the loan or debt obligations, and (a) such filing specifies that the loan is intended to be a securities acquisition loan (as defined in sec. 133) and is for registration required to permit the offering of such loan, or (b) such filing is for approval required in order for the ESOP to acquire more than a certain percentage of the stock of the employer. The grandfather in item (4) relates only to governmental filings required in order for the ESOP debt to be issued or the employer securities to be acquired by the ESOP and, thus, for example, does not apply to requests for a determination letter from the Internal Revenue Service that the ESOP is a qualified plan.

In addition, the provision would not apply to loans made after June 6, 1989, to refinance loans made on or before such date (or to refinance loans described in the preceding paragraph), if (1) such refinanced loan meets the requirements of section 133 (as in effect before the amendments made by the provision, (2) the outstanding principal amount of the loan is not increased, and (3) the term of such loan does not extend beyond the later of (a) the last day of the term of the original securities acquisition loan, or (b) the last day of the 7-year period beginning on the date the original securities acquisition loan was made.

The refinancing rules described above also apply in the case of a securities acquisition loan that consists of a loan to the employer with a corresponding loan to the ESOP (a "back-to-back" or "mirror" loan) (see sec. 133(b)(3)), if the loan is restructured so that the loan is directly from the financial institution to the ESOP with a guarantee from the employer rather than a loan from the employer.

The committee understands that ESOP loan transactions are not identical, and that the course of events leading up to the conclusion of a transaction differs from case to case. Thus, with respect to the grandfather rule for loans made pursuant to a written binding commitment, the committee recognizes that whether there is a written binding loan commitment depends on all the facts and circumstances and that the existence of such a commitment can be demonstrated in a variety of ways.

It is not necessary that the final loan documents be executed by the parties in order to demonstrate the existence of a written binding loan commitment. The existence of such a commitment can be demonstrated, for example, by any combination of documents which include some or all of documentation of the lender, written communications by the borrower or the borrower's agent (e.g., an investment banker or a broker), and documentation of the borrower showing that the loan was approved by the lender and that the offer to make the loan was received by the borrower. No one particular document is necessary to qualify for the grandfather.

The documentation would have to include the principal terms of the loan, such as the principal amount, interest rate or spread or formula pursuant to which the interest rate will be set, and maturity of the loan. It is intended that the grandfather will not fail to be met if the loan commitment is for a specified amount and the borrower borrows less than the full amount. In addition, the grandfather will not fail to be met merely because the interest rate is to be set in accordance with rates prevailing at the time the loan is made, or because the only modification in the loan terms is a reduction in the interest rate that occurs before the loan is made. The grandfather will also not fail to be met merely because a loan commitment that met the conditions of the grandfather had an expiration date and the commitment was extended before the expiration date without change in the material terms of the commitment.

The written binding commitment grandfather applies to all types of securities acquisition loans. Thus, for example, immediate allocation loans, as well as other types of securities acquisition loans, would be grandfathered under the provision if a binding written commitment to make a securities acquisition loan existed on June 6, 1989, and at all times thereafter before the loan is made.

4. Transfer of excess pension plan assets to pay current retiree health benefits (secs. 6321-6330 of the bill and new sec. 420 of the Code)

Present Law

Under present law, pension plan assets may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. Any assets that revert to the employer upon such termination are included in the gross income of the employer and are subject to a 15-percent excise tax (sec. 4980).[33]

Subject to certain limitations, an employer may under present law make deductible contributions to a defined benefit pension

[33] Section 6343 of the bill increases the excise tax to 20 percent.

plan up to the full funding limitation. The full funding limitation is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan or (b) 150 percent of the plan's current liability, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets. Special deduction rules apply in the case of contributions to plans established before January 1, 1954, as a result of an agreement between employee representatives and the Government of the United States during a period of Government operation of a major part of the productive facilities of the industry in which such employer is engaged (sec. 404(c)).

Under present law, a pension plan may provide medical benefits to retirees through a section 401(h) account. These medical benefits, when added to any life insurance protection provided under the plan, are required to be incidental or subordinate to the retirement benefits provided under the plan. Under Treasury regulations, the medical benefits are considered incidental or subordinate to the retirement benefits if, at all times, the aggregate of employer contributions (made after the date on which the plan first includes such medical benefits) to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions made after such date, other than contributions to fund past service credits.

The assets of a pension plan may not be transferred to a section 401(h) account without disqualifying the pension plan and subjecting the amounts transferred to income tax and the excise tax.

Reasons for Change

The committee believes it is appropriate to provide a temporary rule allowing employers to transfer assets set aside for pension benefits to a section 401(h) account for retiree health benefits as long as the security of employees' pension benefits is not thereby threatened.

Explanation of Provision

Permitted transfer of certain excess assets

Under the provision, a transfer of certain assets is permitted from the pension assets in a defined benefit pension plan to the section 401(h) account that is a part of such plan. The assets transferred are not includible in the gross income of the employer and are not subject to the excise tax on reversions. The defined benefit pension plan does not fail to satisfy the qualification requirements (sec. 401(a)) or violate the present-law requirement that medical benefits under a section 401(h) account be subordinate to the retirement benefits under the plan solely on account of the transfer or by reason of other actions permitted under the provision. Except as expressly provided by the provision, the provision does not override any present-law requirement under section 401(h).

The transfer of assets to a section 401(h) account may be made only once in any taxable year of the employer. Transfers may be made in taxable years beginning after December 31, 1989, and before December 31, 1994.

Under the provision, accrued retirement benefits under the plan are required to be nonforfeitable (i.e., vested) as if the plan had terminated immediately before the transfer. Participants whose benefits are to vest under this provision include all those who separate from service prior to the transfer but in the year in which the transfer occurs. The benefits of such participants are to vest as if the plan had terminated immediately prior to the separation.

The amount of excess pension assets that may be transferred and used for retiree health benefits is limited to the amount reasonably estimated to be the amount the employer will pay for qualified current retiree health liabilities. "Excess pension assets" are those assets in excess of those necessary to meet the full funding limitation. That is, excess pension assets are those in excess of the lesser of (1) 150 percent of the plan's current liability, or (2) the accrued liability (including normal cost) under the plan (as determined under sec. 412(c)(7)).

The amount transferred under this provision is treated as a contribution except that no deduction is available with respect to the transfer. Under the provision, for purposes of determining the maximum deductible contribution to the defined benefit pension plan, the amounts transferred under this provision are considered in determining whether the plan is at the full funding limitation.

Qualified current retiree health liabilities are defined as the amount of retiree health benefits (including administrative expenses) expended by the employer or reasonably estimated to be paid by the employer during the employer's taxable year in which such transfer occurs and with respect to those employees who have retired on or before the date of the transfer. In determining the maximum amount that may be transferred, the employer is to consider earnings that will be attributable to such assets subsequent to the transfer. The maximum amount of qualified current retiree health liabilities is also reduced to the extent that the employer has previously made a contribution to a section 401(h) account or a welfare benefit fund (e.g., voluntary employees' beneficiary association (VEBA)) relating to the same liabilities. No deduction is allowed with respect to amounts expended by the employer and subsequently reimbursed from the section 401(h) account.

The retired employees who may be taken into account in calculating qualified current retiree health liabilities are limited to those who are eligible for retirement benefits under the defined benefit pension plan containing the separate account. Retiree health benefits of key employees (sec. 416(i)(1)) may not be considered for purposes of determining qualified current retiree health liabilities and may not be paid out of transferred assets.

In estimating current retiree health liabilities, an employer is required to assume that the medical benefits provided during the taxable year of the transfer will have the same cost as the average cost of medical benefits provided to covered retirees for the preceding taxable year. Therefore, for example, medical cost inflation, changes in the level of utilization, or changes in coverage provided or funded through the account cannot be taken into account unless such changes occur prior to the date of the transfer.

Transferred amounts are required to benefit all participants in the pension plan who are entitled upon retirement to receive retiree medical benefits (other than key employees) through the section 401(h) account.

A special rule applies with respect to an employer's taxable year beginning in 1989. Under this rule, an employer may transfer to a section 401(h) account the amount expended by the employer for qualified retiree health benefits during the employer's 1989 taxable year. The transfer may be made after the end of the 1989 taxable year and before the time for filing the employer's tax return for such year (including extensions). The employer may make a single transfer for both 1989 and 1990 qualified current retiree health benefits. Alternatively, an employer may make 2 transfers in the employer's 1990 taxable year, if one of the transfers is made to reimburse 1989 qualified current retiree health liabilities. Solely for purposes of this special rule, the maximum amount of assets that may be transferred for 1989 liabilities shall not be reduced by a contribution to any VEBA in 1989 to fund retiree health benefits for participants in the section 401(h) account. Of course, no deduction is allowed with respect to such contributions to the extent the employer is reimbursed under this provision.

If an employer transfers assets under the special rule for 1989, the benefits of participants who separate from service in 1989 are to vest as if the plan had terminated immediately prior to the separation from service.

An employer that makes a transfer to a section 401(h) account under the provision is to maintain the level of employer-provided retiree health expenditures for covered employees of the section 401(h) account at a minimum dollar level for the taxable year in which the transfer occurs and the following 4 taxable years. The minimum level is equal to the highest average employer cost per employee for retiree health benefits for the pension plan participants in the 2 years preceding the year of the transfer. The minimum dollar level is to be determined by looking at all employer-provided retiree health benefits of the retired participants (and their beneficiaries) of the plan funded through the section 401(h) account that receives the transfer. Thus, all retiree health benefits provided to such individuals are considered, not only those benefits provided through the section 401(h) account. The level of benefit required under this rule is not reduced solely because the employer transfers a lesser amount of assets than the maximum permitted under this provision.

The employer is to recalculate the minimum dollar level if there is a subsequent transfer of assets during the 5-year period for which the rule is in effect. In the event of such a subsequent transfer, the 5-year period is extended so that the rule applies for the taxable year of the subsequent transfer and for the following 4 taxable years. In addition, if at the time of the subsequent transfer, the minimum dollar level as determined at that time would be higher than that level determined at the time of the preceding transfer, then the higher level of benefit shall apply for the duration of the new 5-year period.

The amounts transferred to the section 401(h) account are required to be paid out for, or to reimburse the previous payment of, qualified current retiree health liabilities. Amounts that are not expended from the account within the taxable year of the employer

22-661 O—89——4

in which the transfer occurs are to be returned at the end of such year to the general assets of the plan.

The employer is not entitled to a deduction when amounts are transferred into the section 401(h) account or when such amounts (or income on such amounts) are used to pay retiree health benefits. No deduction or contribution is allowed the employer for the provision of retiree health benefits (whether directly, through a section 401(h) account, or a welfare benefit fund) except to the extent that the total of such payments for qualified current retiree health liabilities exceed the amount transferred to the section 401(h) account (including any income thereon).

Special rule for certain negotiated plans

The provision provides that certain surplus assets in specified retirement plans may be transferred to retiree health benefit plans. Assets so transferred are not includible in the income of the employer, nor are they subject to the excise tax on reversions. A plan qualifies as a transferor plan under the proposal if it is a plan described in section 404(c) or a continuation of such a plan and participation in the plan is substantially limited to individuals who retired before January 1, 1976. A plan qualifies as a transferee plan under the provision if it is a plan described in section 404(c) or a continuation of such a plan and it provides health benefits to retirees and beneficiaries of the industry that maintained the transferor plan.

In addition, the provision provides that any employer that had an obligation to contribute to a plan that qualifies as a transferee plan under the provision as of January 1, 1988, (including a contingent obligation to contribute) shall have a continuing obligation to contribute to the plan.

Requirement that medical benefits be incidental or subordinate

Under the provision, the medical benefits described in section 401(h) are considered subordinate to the retirement benefits only if the aggregate of actual contributions (made after the date on which the plan first includes such medical benefits) to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions actually made after such date (rather than the cost related to benefit accruals) other than contributions to fund past service credits. This rule does not apply to a transfer of excess assets permitted under the temporary rule described above.

Under this rule, for example, if a section 401(h) retiree medical benefits plan was established at a time when the plan was fully funded (as determined under section 412), the employer is precluded from making contributions to fund the section 401(h) account unless and until the plan falls below the full funding limit. This is because the permissible level of contributions is measured by actual contributions to the pension plan after the date the retiree medical benefits plan is established.

Internal Revenue Service General Counsel Memorandum, 39785, issued on April 3, 1989, is rejected to the extent it concludes that contributions to a section 401(h) account may be based on plan costs rather than actual contributions to the plan.

No inference is intended as to whether a contribution to a section 401(h) account prior to the effective date of this proposal met the requirement that the medical benefits be subordinate to the retirement benefits of the plan where the determination as to whether such requirement was met was based on plan costs rather than on actual contributions to the plan.

Effective Date

The proposal is generally applicable to years beginning after December 31, 1989. However, no transfer under the general rule is allowed with respect to any year beginning after December 31, 1994.

The special rule applicable to certain negotiated plans is effective on the date of enactment, except that the continuing obligation to contribute is effective as of January 1, 1988.

The proposal relating to the subordination requirement (i.e., the 25-percent rule) for purposes of determining the permissible contribution to a section 401(h) account is effective with respect to contributions paid to the plan after October 3, 1989.

5. Modification of full funding limitation (sec. 6331 of the bill and sec. 412 of the Code)

Present Law

Under present law, subject to certain limitations, an employer may make deductible contributions to a defined benefit pension plan up to the full funding limitation. The full funding limitation is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 150 percent of the plan's current liability, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets (sec. 412(c)(7)). For plan years beginning before January 1, 1988, the 150 percent of current liability limitation did not apply.

The Secretary may, under regulations, adjust the 150-percent figure contained in the full funding limitation to take into account the average age (and length of service, if appropriate) of the participants in the plan (weighted by the value of their benefits under the plan). In addition, the Secretary is authorized to prescribe regulations that apply, in lieu of the 150 percent of current liability limitation, a different full funding limitation based on factors other than current liability. The Secretary may exercise this authority only in a manner so that in the aggregate, the effect on Federal budget receipts is substantially identical to the effect of the 150-percent full funding limitation.

Reasons for Change

To date, the Secretary has not exercised the authority granted with respect to modifying the 150-percent full funding limitation. The committee believes such a modification is warranted in certain circumstances in order to permit employers with younger work forces to make increased contributions to their defined pension benefit plans to provide for anticipated future benefit accruals. However, in light of the committee's commitment to deficit reduction, such a modification is appropriate only if accomplished in a revenue neutral manner. Thus, the provision directs the Secretary to increase the full funding limitation in situations where employees are more likely to accrue significant benefits in the future, and to decrease the full funding limitation in situations where fewer future accruals are likely to occur (i.e., plans with a greater percentage of retirees), provided that it has no effect on Federal budget receipts.

Explanation of Provision

In general

The provision allows certain employers to elect to apply the present-law full funding limitation without regard to the 150 percent of current liability limitation. The Secretary is required under the provision to adjust the full funding limitation for all plans (other than those subject to such an election) in response to employer elections under the provision so that the provision has a negligible effect on Federal budget receipts.

Employers eligible to elect alternative full funding limitation

An employer may elect to use the alternative full funding limitation if (1) as of the first day of the plan year in which the election is made the accrued liability of participants accruing benefits under all defined pension benefit plans of the employer (and controlled group members) is at least 90 percent of the aggregate total accrued liability under all such plans; (2) no defined benefit pension plan maintained by the employer (or by any controlled group member) is a top-heavy plan (within the meaning of section 416(g)) for the plan year in which such election is made and the immediately preceding 2 plan years; and (3) the plan has more than 100 participants at all times during the plan year in which the election is made and the immediately preceding 2 plan years.

If the accrued liability ratio described above falls below 90 percent for any plan year for which the election is in effect, the alternative full funding limitation is phased out for the remainder of the period for which the election is in effect under rules to be prescribed by the Secretary. If a plan becomes a top-heavy plan or fails to meet the 100-participant requirement during any plan year in the period for which the election is in effect, the alternative full funding limitation ceases to apply. In addition, if the 90-percent requirement, top-heavy restriction, or 100-participant restriction is violated during the election period, the employer is precluded from making a subsequent election to use the alternative full funding limitation for 10 plan years following the election period.

Requirements with respect to election of alternative limitation

The election to use the modified full funding limitation is subject to the following requirements:

(1) the election is to apply for a 5-plan year period beginning with the first plan year for which the election is effective;

(2) the election is to be made by application to the Secretary filed 60 days prior to the first day of the plan year immediately preceding the first plan year for which the election is effective;

(3) the election application is to include actuarial information (for each plan to be covered by the election) indicating the full funding limitation that will apply under each year of the period for which the election is in effect, and the full funding limitation that would apply in each of the years covered by the period in the absence of an election (in each case, based on reasonable estimates) as well as such other information as may be required by the Secretary; and

(4) the election is to be made for all defined benefit pension plans maintained by the controlled group of which the employer is a part.

An election may be made for successive 5-plan year periods upon application to the Secretary in accordance with the above criteria. If the employer does not choose to make a subsequent election after the expiration of any 5-plan year period, the employer may not make an election under the provision until 10 plan years after the expiration of such 5-plan year period.

An employer that makes an election may not be granted a minimum funding waiver for the period beginning after the election is made and ending at the expiration of the 5-plan year period. The Secretary may prescribe additional rules and requirements with respect to whether an employer is eligible to make an election.

In determining whether the accrued liability with respect to a participant may be aggregated with the accrued liability of other participants in order to meet the 90-percent requirement (i.e., whether the participant is accruing benefits under the plan), only active employees who have accrued benefits in the current year may be considered. Specifically, the Secretary is to issue guidance with respect to determining when a participant has accrued a benefit in the current year. Under such guidance, for example, for purposes of this provision, a participant in a plan where the employer has frozen accruals will not be considered to accrue benefits in the current year. In addition, a participant is not considered to accrue benefits solely because the participant's accrued benefit is increased by reason of a cost-of-living increase or similar feature in the plan.

It is intended that the Secretary limit the availability of this provision where one or more plans of the employer have been terminated or amended in a manner that significantly increases the likelihood that the employer will be eligible to make an election under this provision (e.g., where a plan has undergone a termination/reestablishment or a spin-off/termination within the preceding 10 plan years).

Required adjustment of full funding limitation

The provision requires the Secretary to adjust the full funding limitation applicable to other defined benefit pension plans on an annual basis in response to the elections under this provision so that the provision has a negligible affect on net Federal budget receipts.

Any adjustment to the full funding limitation required to be made under the provision is to be made with respect to all plans (other than those subject to the alternative limitation) and by reducing the full funding limitation with respect to participants who are not accruing benefits under the plan. This modification is made by substituting, with respect to these participants, a percentage between 140 percent and 150 percent for "150 percent" in the 150-percent full funding limitation. Thus, the full funding limit will be applied to the plan by multiplying the current liability attributable to active participants accruing benefits by 150 percent and by multiplying the current liability attributable to other participants by a percentage between 140 and 150 percent as determined by the Secretary.

To the extent that net Federal budget receipts require additional adjustments to the full funding limitation, the full funding limitation is to be adjusted by multiplying the accrued liability of the plan (sec. 412(c)(7)(A)(i)(II)) for all participants in the plan by a percentage less than 100 percent, but in no event by reducing this liability below 140 percent of current liability (as current liability is defined for purposes of the full funding limitation).

Effective Date

The provision is effective on the date of enactment.

6. Repeal of limitation on ability of tax-exempt employers to maintain cash or deferred arrangements (sec. 6341 of the bill and sec. 401(k) of the Code)

Present Law

Under present law, if a tax qualified profit-sharing or stock bonus plan meets certain requirements, then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash (sec. 401(k)). Tax-exempt organizations are generally prohibited from establishing qualified cash or deferred arrangements, except for certain plans that were in existence on July 2, 1986.

Reasons for Change

Under present law, many tax-exempt entities are not permitted to maintain elective deferral arrangements for their employees. The committee believes that tax-exempt entities should be permitted to maintain cash or deferred arrangements for their employees on the same basis as other employers.

Explanation of Provision

The provision allows tax-exempt organizations to maintain cash or deferred arrangements for their employees. As under present law, the limitation on the amount that may be deferred by an individual participating in both a cash and deferred arrangement and a tax-sheltered annuity (or other elective deferral arrangement) applies.

Effective Date

The provision is effective with respect to plans established after December 31, 1989.

7. Modify geographic locale limitation on voluntary employees' beneficiary associations (VEBAs) (sec. 6342 of the bill and sec. 501(c)(9) of the Code)

Present Law

A voluntary employees' beneficiary association ("VEBA") that provides for the payment of life, sick, accident or other similar benefits to its members, their dependents or designated beneficiaries may qualify for exemption from income taxation if certain requirements are met (sec. 501(c)(9)). Under Treasury regulations, one of these requirements is that the members have an employment-related common bond determined by reference to objective standards.

Under the regulations, employees of one or more employers engaged in the same line of business in the same geographic locale will be considered to have an employment-related bond. The Internal Revenue Service has taken the position that the geographic locale requirement is not met if membership in a VEBA is available on a nationwide basis to employees whose sole common bond is their employment with unaffiliated employers that are members of a nationallly-based trade association.

Reasons for Change

The committee is concerned that the geographic locale restriction may have unintended results where, for example, employers in the same line of business maintain places of business in an area where employees may reasonably be expected to work in more than one state. Therefore, the committee believes that a limited expansion of the geographic locale rule is warranted as long as the VEBA does not serve too wide an area.

Explanation of Provision

The provision adopts the position taken in the Treasury regulations requiring that the membership of a VEBA consist of individuals who become entitled to participate by reason of their being employees and whose eligibility for membership is defined by reference to objective standards that constitute an employment-related common bond among such individuals. In addition, employees of one or more employers engaged in the same line of business in the same geographic locale will be considered to share an employment-related common bond. The committee does not intend the provision to alter the present-law rules relating to the membership of labor unions or employees of affiliated employers and their participation in VEBAs. Nor are other rules relating to VEBAs affected.

The provision clarifies that the geographic locale requirement may be met by a VEBA that provides benefits to employees in a clearly defined geographic region that may include more than one state. A VEBA will meet the geographic locale requirement if it provides benefits to the employees who are located in no more than 3 contiguous states. Thus, the provision adopts the position of the Internal Revenue Service that an exempt multiple employer VEBA may not provide benefits to employees over a wide geographic area.

The committee does not intend to limit the authority of the Secretary to permit a VEBA to operate in a wider geographic locale even if the area of operation exceeds the 3-state limitation described above.

Effective Date

The provision is effective for years beginning on or after October 3, 1989. No inference is intended with respect to the application of the geographic locale restriction under present law.

8. Excise tax on reversions of qualified plan assets (sec. 6343 of the bill and sec. 4980 of the Code)

Present Law

A nondeductible 15-percent excise tax is imposed on employer reversions from qualified plans (sec. 4980).

Reasons for Change

The excise tax on reversions was originally enacted because Congress believed that it was appropriate to limit the tax incentives available to an employer that maintains a pension plan. Congress recognized that contributions to such plans, as well as the earnings on such contributions, are intended to provide for the retirement benefits of plan participants. To the extent that amounts in such plans are not used for retirement purposes, Congress believed that the tax treatment of reversions should recognize that the tax on earnings on pension funds is deferred and, thus, the benefits of this treatment should be recaptured. In many cases, a 15-percent excise tax is not sufficient to recapture the tax benefits received. Therefore, the committee believes it is appropriate to increase the excise tax to better approximate the tax benefits of the income deferral.

Explanation of Provision

The provision increases the 15-percent excise tax to 20 percent.

Effective Date

The provision generally applies to reversions occurring after October 3, 1989. The provision does not apply to a reversion after such date if (1) with respect to plans subject to title IV of the Employee Retirement Income Security Act of 1974 (ERISA), a notice of intent to terminate required under such title was provided before October 4, 1989, or (2) with respect to plans subject to title I of ERISA, a notice of intent to reduce future accruals required under section 204(h) of ERISA was provided to participants in connection with the plan termination with respect to which the reversion is received before October 4, 1989.

9. Qualified transportation benefits (sec. 6344 of the bill and sec. 132 of the Code)

Present Law

Under present law, gross income does not include a fringe benefit that qualifies as a de minimis fringe (sec. 132). In general, a de minimis fringe is any property or service the value of which (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) is so small as to make accounting for it unreasonable or administratively impracticable. Under Treasury regulations, employer-provided transit passes, tokens, fare cards, etc., are considered a de mimimis fringe if the employer-provided value of the benefit does not exceed $15 per month. This exclusion does not apply to the provision of any benefit to defray public transit expenses incurred for personal travel other than commuting. If the benefit exceeds $15 per month, then the total value of the benefit is includible in income.

Under prior law, certain employer-provided transportation between an employee's residence and place of work was excludable from gross income. This exclusion expired for taxable years beginning after December 31, 1985.

Reasons for Change

The committee believes it is appropriate to provide a limited tax subsidy for employer-provided commuting transportation that fosters the use of mass transit and van-pooling. The committee also believes that the tax treatment of such benefits should be covered under a single tax provision.

Explanation of Provision

Under the provision, gross income does not include a fringe benefit that qualifies as a qualified transportation fringe. In general, a qualified transportation fringe is (1) transportation in a commuter highway vehicle between the employee's residence and place of employment and (2) any transit pass. The maximum exclusion for transit passes provided or subsidized by the employer is $15 per month. Up to $15 per month is excludable even if the total value of the benefit exceeds $15 per month.

The exclusion is available only if the benefit is provided under a separate written plan of the employer and the benefits satisfy the nondiscrimination rules applicable to no-additional-cost services and qualified employee discounts (sec. 132(h)). In addition, the plan must provide that the benefit is provided in addition to (and not in lieu of) any compensation otherwise payable to the employee. The exclusion is not available to self-employed individuals.

A transit pass includes any pass, token, farecard, voucher, or similar item entitling a person to transportation on mass transit facilities (whether or not publicly owned). A commuter highway vehicle is a highway vehicle the seating capacity of which is at least 7 adults (not including the driver) and at least 80 percent of the mileage use of which can reasonably be expected to be for purposes of transporting employees between their residences and their place of employment and on trips during which the number of employees transported for such purpose is at least one-half of the adult seating capacity of the vehicle (not including the driver). Transportation is considered provided by the employer if the transportation is furnished in a commuter highway vehicle operated by or for the employer. The committee intends that the Secretary may require such substantiation as is necessary to demonstrate compliance with the conditions of the exclusion.

Employer-provided transit passes, vouchers, etc., are no longer excludable as a de minimis fringe benefit. The committee intends that the Secretary revise the regulations to the extent that they are inconsistent with the provision.

Effective Date

The provision is effective for taxable years beginning after December 31, 1989.

10. Personal use of airplanes (sec. 6345 of the bill and sec. 61 of the Code)

Present Law

In general under present law, the value of personal use of an employer-provided aircraft is includible in the gross income of the employee. Under Treasury regulations, where 50 percent or more of the regular seating capacity of an aircraft (as used by the employer) is occupied by individuals whose flights are primarily for the employer's business, the value of a flight on that aircraft by any employee who is not flying primarily for the employer's business is deemed to be zero.

Reasons for Change

The committee believes it is appropriate to measure the value of flights for personal reasons by reference to occupied seats rather than seating capacity of the airplane.

Explanation of Provision

Under the provision, the value of a flight by an individual who is not flying primarily for an employer's business is to be determined on the basis of the percentage of occupied seats (other than crew) which are occupied by individuals whose flights are primarily for the employer's business. This rule does not apply in the case of a flight that is subject to the rules relating to no-additional-cost services.

Effective Date

The provision is effective for taxable years beginning after December 31, 1989.

Subtitle D. Foreign Provisions

1. Taxable year of certain foreign corporations (sec. 6401 of the bill, sec. 563(c) and new sec. 898 of the Code)

Present Law

The taxable year of a controlled foreign corporation or a foreign personal holding company is generally its annual accounting period, which means the annual period utilized by the corporation for the purpose of computing its income in keeping its books and records (sec. 441 (b)(1) and (c)). Such taxable year may be either the calendar year or a fiscal year. Generally, neither a controlled foreign corporation nor a foreign personal holding company is required to use the same taxable year as its shareholders who are U.S. persons. An exception to this rule applies in the case of a foreign sales corporation (FSC), which generally must have the same taxable year as that shareholder (or group of shareholders with a common taxable year) who has the highest percentage of voting power (sec. 441(h)).

A controlled foreign corporation is deemed to distribute certain of its income, such as its "subpart F income," to its "U.S. shareholders" [34] on the last day of the controlled foreign corporation's taxable year (sec. 951(a)(1)). To the extent that the taxable years of the U.S. shareholder and the controlled foreign corporation differ, a deferral of income can result. For example, assume a controlled foreign corporation has a taxable year ending on January 31, while its U.S. shareholder uses the calendar year as its taxable year. Any subpart F income earned by the controlled foreign corporation is deemed distributed to the U.S. shareholder on January 31, thus allowing the U.S. shareholder to defer tax on eleven months' worth of current subpart F income.

A similar deferral is available to U.S. persons who are shareholders of a foreign personal holding company.[35] Generally, a foreign

[34] Generally, a controlled foreign corporation is any foreign corporation, more than 50 percent of the stock of which is owned (by vote or value) by U.S. shareholders (sec. 957(a)). For this purpose, a U.S. shareholder is any U.S. person who owns directly or indirectly at least 10 percent of the voting power of the outstanding stock of the foreign corporation (sec. 951(b)). Special definitions apply, however, for purposes of taking into account certain foreign insurance income. For example, for purposes of taking into account related person insurance income, the term controlled foreign corporation means any foreign corporation, more than 25 percent of the stock of which is owned (by vote or value) by U.S. shareholders (sec. 953(c)(1)(B)). Additionally, any U.S. person who owns stock of such a foreign corporation is considered to be a U.S. shareholder (sec. 953(c)(1)(A)).

[35] A foreign personal holding company is generally any foreign corporation, more than 50 percent of the stock of which is owned (by vote or value) directly or indirectly by 5 or fewer individuals who are citizens or residents of the United States, and at least 60 percent (50 percent in certain years following a year in which the corporation was a foreign personal holding company) of the gross income of which for a taxable year consists of certain items of passive income classified as foreign personal holding company income by section 553(a) (sec. 552(a)). In the case of a foreign personal holding company, any U.S. person who owns shares in such company is considered a U.S. shareholder (sec. 551(a)).

personal holding company is deemed to distribute all of its undistributed foreign personal holding company income allocable to its U.S. shareholders on the last day of the taxable year of the foreign personal holding company (sec. 551(b)). If a foreign personal holding company has a taxable year ending January 31, a calendar year U.S. shareholder each year would be able to defer tax on eleven months' worth of undistributed foreign personal holding company income since such income is deemed distributed to the shareholder after the close of the shareholder's taxable year during which the eleven months' worth of foreign personal holding company income was actually earned.

By contrast, the ability of taxpayers to defer income inclusions by manipulating the taxable years of other pass-through entities is severely limited by statutory rules, most significantly by rules adopted in the 1986 Act. For example, a partnership must generally adopt the same taxable year as its partners who own an aggregate majority interest in partnership profits and capital. If partners owning a majority of partnership profits and capital do not have the same taxable year, the partnership must adopt the taxable year of all partners who own an interest of at least 5 percent of the profits or capital of the partnership. Finally, if all 5 percent partners of the partnership do not have the same taxable year, then the partnership must adopt the calendar year as its taxable year. Domestic International Sales Corporations (DISCs), S corporations, and personal service corporations must also generally adopt the taxable year of their shareholders.

Generally under present law, a U.S. shareholder of a foreign personal holding company is required to include as dividend income for the taxable year in which or with which the taxable year of the foreign personal holding company ends, his pro-rata share of the company's undistributed foreign personal holding company income earned during the taxable year. The amount of undistributed foreign personal holding company income that is recognized as dividend income by the shareholder is deemed to be contributed by the shareholder to the capital of the company, and the accumulated earnings and profits of the company as of the end of the taxable year are correspondingly reduced. Any distributions made by the company subsequent to the end of such taxable year are considered to first be derived from its current earnings and profits for the year during which the distribution is made, and then from accumulated earnings and profits.[36] If the amount of the distribution exceeds both current and accumulated earnings and profits, such excess is generally treated as a return of capital.

Under present law, certain taxpayers can avoid the result described in the preceding paragraph by utilizing a foreign corporation with a different taxable year end than the foreign personal holding company as the shareholder of such company. To illustrate this point, consider the following example. Assume that a U.S. citizen owns 100 percent of the stock of a foreign corporation that uses

---

[36] As such, the distribution will generally constitute taxable income to the recipient shareholder. This is in contrast to the case of a controlled foreign corporation, whose distributions are considered to be made first from earnings and profits which were previously taxed to the U.S. shareholder under subpart F, and are thus not again included in the gross income of the shareholder.

June 30 as its taxable year end, and that this first corporation owns 100 percent of the stock of a foreign personal holding company that has a December 31 taxable year end. Assume that the second corporation does not have any accumulated earnings and profits. If the first corporation also qualifies as a foreign personal holding company, then the second corporation could distribute by December 31 an amount which is clearly sufficient to eliminate its undistributed foreign personal holding company income for the year. On or before the following June 30, when the second corporation's actual income has been accurately calculated, the first corporation can then make a distribution to the individual in an amount equal to 100 percent of its earnings for that year (namely the amount of the distribution from the second corporation that constituted a dividend) and thus ensure that it has no undistributed foreign personal holding company income for that year.

Reasons for Change

The committee believes that present law allows an improper deferral of income to U.S. shareholders of certain controlled foreign corporations and foreign personal holding companies. Where present law allows subpart F income earned by a controlled foreign corporation, or undistributed foreign personal holding company income earned by a foreign personal holding company, to be subjected to Federal income tax in a taxable year later than that in which it was earned, the value of the income earned is understated. Such a deferral of income generally is only available to certain taxpayers, resulting in preferential treatment of those taxpayers at the overall expense of others. The committee believes that requiring certain controlled foreign corporations and foreign personal holding companies to generally conform their taxable years to the taxable years of their U.S. shareholders will impose less of a burden on such corporations and their shareholders than other methods of eliminating the deferral.

The committee understands that a foreign personal holding company may prefer to distribute to its shareholders all current earnings and profits annually so as to avoid having any undistributed foreign personal holding company income for the year. The committee is informed that prior to the close of a taxable year, however, it may be difficult for a foreign personal holding company to accurately compute the amount of the distribution necessary to eliminate all of its current undistributed foreign personal holding company income. In order to alleviate this difficulty, the committee believes that it is appropriate to allow certain distributions which are made by a foreign personal holding company within a short period after the close of its taxable year to be treated as having been made during its prior taxable year, thus allowing the company to eliminate its undistributed foreign personal holding company income for the year, without permitting deferral that would be possible absent the conforming taxable year provision.

Explanation of Provision

The bill generally requires the taxable year of a controlled foreign corporation or a foreign personal holding company, more than

50 percent of the total voting power or value of the stock of which is treated as owned by a U.S. shareholder (referred to collectively as "specified foreign corporations" in the bill), to conform to the taxable year of such U.S. shareholder (as that term is defined with respect to the particular type of specified foreign corporation at issue). However, in the case of a specified foreign corporation which is a controlled foreign corporation, such corporation may elect to use as its taxable year, a taxable year that begins one month earlier than the taxable year of the majority U.S. shareholder. The taxable year of a specified foreign corporation generally must be the same as the taxable year of each U.S. shareholder who on each testing day during the taxable year is considered to own more than fifty percent of the total voting power or value of the outstanding stock of the specified foreign corporation (as well as the taxable year of each U.S. shareholder who is not considered to own more than 50 percent of the stock of the specified foreign corporation, but whose stock is treated as owned under the applicable attribution rules by a more than 50 percent U.S. shareholder).[37] If more than one U.S. shareholder is considered to own such a majority of the stock of the specified foreign corporation (or if a U.S. shareholder who is not a more than 50 percent shareholder owns stock which is treated as owned by a more than 50 percent U.S. shareholder), and all such U.S. shareholders do not have the same taxable year, then the specified foreign corporation is required to adopt the required taxable year as the Secretary may prescribe by regulations. The committee anticipates that the regulations will provide that such required taxable year shall be the taxable year that results in the least aggregate deferral of income to the such U.S. shareholders. Generally, the aggregate deferral of income for a particular year is equal to the sum of the products determined by multiplying the month(s) of deferral for each such U.S. shareholder that would be generated by that year end, times each such shareholder's percentage stock interest for purposes of determining its pro-rata share of any deemed distribution by the corporation. The corporate tax year that produces the lowest such sum is the taxable year that results in the least aggregate deferral of income to such U.S. shareholders. The committee intends that if the calculation results in more than one taxable year qualifying as the taxable year with the least aggregate deferral, then the corporation may select any one of those taxable years as its taxable year (unless its current taxable year is one of those years, in which case the corporation would be required to maintain its current taxable year).

To illustrate the operation of the preceding paragraph, consider the following situations. Any specified foreign corporation, over 50 percent of the value of whose stock is considered owned by a single U.S. shareholder, generally must adopt the taxable year of that shareholder as its taxable year.[38] Alternatively, if a specified for-

[37] More than one majority U.S. shareholder can exist with respect to a specified foreign corporation as a result of the particular stock ownership attribution rules which are applicable to such corporation.

[38] If the specified foreign corporation is a controlled foreign corporation, it may alternatively use as its taxable year, a year which begins one month earlier than the taxable year of the majority U.S. shareholder.

eign corporation has two more than fifty percent U.S. shareholders, the specified foreign corporation must adopt the taxable year of those shareholders if the shareholders both use the same taxable year (subject to the one-month exception in the case of a controlled foreign corporation). However, if one more than fifty percent U.S. shareholder has an October 31 year end and the other has a November 30 year end, and each shareholder has an equal percentage stock interest in the controlled foreign corporation for purposes of determining its pro-rata share of any deemed distribution by the corporation, then the committee intends that the specified foreign corporation would be required to adopt October 31 as its taxable year end since that is the taxable year that will result in the least aggregate deferral of income to the more than 50 percent U.S. shareholders of the corporation.

The bill provides that specified foreign corporations generally must test to determine whether they are using the required taxable year on the first day of each new taxable year determined prior to the application of this provision for the current taxable year. For example, a specified foreign corporation that has historically used the calendar year as its taxable year must perform the test on January 1, 1990 to determine whether a taxable year change is required. If based on this test the corporation is required to change its taxable year end to June 30, it will determine its income for the short period beginning on January 1, 1990 and ending on June 30, 1990. On July 1, 1990, the corporation will again be required to perform the test, since that date is the first day of the corporation's new taxable year.

Additionally, the bill provides the Treasury authority to prescribe by regulations another day or days during a taxable year on which the test must be performed. The committee contemplates that such additional testing days may include days on which a substantial change in U.S. ownership of the stock of a controlled foreign corporation or a foreign personal holding company occurs. For example, in the case of a controlled foreign corporation, the committee anticipates that the regulations might provide that a testing day will include any day on which either a person obtains a sufficient amount of the stock of such corporation to cause such person to qualify as a U.S. shareholder for purposes of applying the applicable subpart F income rules, or when a current U.S. shareholder acquires or disposes of any stock of the controlled foreign corporation.

The present law rules which determine whether a person is a U.S. shareholder of a controlled foreign corporation or a foreign personal holding company are not changed by the bill. Under those rules, stock of a foreign corporation that is owned by parties related to a U.S. person is attributed to that person under the rules of section 318(a) (with certain modifications as set forth in section 958(b)) in the case of a controlled foreign corporation, and under the rules of section 554 in the case of a foreign personal holding company. The bill provides that in determining stock ownership for purposes of ascertaining the required taxable year of a specified foreign corporation, a U.S. shareholder shall be considered as owning any stock of a controlled foreign corporation which it owns directly or indirectly through the use of a foreign entity. For example, a shareholder shall be considered to own its proportionate share of stock of a controlled foreign corporation which is owned by a foreign corporation, foreign partnership, foreign trust, or foreign estate in which that shareholder owns an interest. A similar rule applies in the case of stock of a foreign personal holding company, except that stock owned indirectly through a foreign corporation which itself is a foreign personal holding company is not treated as being owned proportionately by a U.S. shareholder.

The bill grants the Treasury authority to prescribe regulations to address the application of this provision to foreign corporations that earn related person insurance income. In the case of such a corporation, the determination of whether certain shareholders will be considered U.S. shareholders, and as a result, the corporation will be considered a controlled foreign corporation for the taxable year, is dependent upon the proportion of related person insurance income to total insurance income earned by the corporation during the taxable year.[39] This determination cannot be made until the close of the corporation's taxable year. The committee anticipates that the regulations will provide that a foreign corporation that earns related person insurance income will generally not be required to take into account non-10-percent U.S. shareholders (i.e., persons who are only U.S. shareholders by virtue of the special captive insurance rules (sec. 953(c)) to test on the first day of its taxable year to determine its required taxable year unless the corporation was treated as a controlled foreign corporation under the captive insurance rules for the immediately preceding taxable year. If for a taxable year, a corporation qualified as a controlled foreign corporation under the special captive insurance rule, the committee anticipates that the regulations will generally require such corporation to perform the test on the first day of its next taxable year taking into account as U.S. shareholders those persons who would be treated as such with respect to related person insurance income earned by the corporation under the assumption that it will again qualify as a controlled foreign corporation under this special rule.

For example, assume that a foreign corporation has twenty equal shareholders, all of whom are unrelated U.S. persons. The corporation would not qualify as a controlled foreign corporation under the general rule applicable to foreign companies (or foreign insurance companies) because no U.S. persons are considered U.S. shareholders. However, if the corporation earned related person insurance income, then it would be considered a controlled foreign corporation unless the amount of related person insurance income it earned was de minimis (less than 20 percent of total insurance income). If in taxable year 1, the company earned a de minimis amount of related person insurance income (and thus the company was not considered a controlled foreign corporation with respect to such income), then on the first day of taxable year 2, the corporation would not be required to test to determine its required taxable year. Alternatively, if the related person insurance income earned in taxable year 1 was not de minimis (thus causing the company to

---

[39] If related person insurance income is less than 20 percent of total insurance income for the year, then the special rule related to captive insurance companies will not apply.

be a controlled foreign corporation), then the company would be required to determine whether it is a specified foreign corporation on the first day of taxable year 2, and in making such determination, would be required to treat all U.S. persons owning its stock as U.S. shareholders.

The committee anticipates that the regulations will provide guidance for companies that are controlled foreign corporations under both the generally applicable rule (including the general rule for insurance companies) and the special captive insurance company rule. In such an instance, the committee generally intends that in determining whether a company is a specified foreign corporation, the company must take into account all persons who would be U.S. shareholders under either rule.

The committee understands that certain corporations that are required to change their taxable years for U.S. tax purposes may not be able to make a conforming change of their taxable years for purposes of reporting taxable income in foreign countries. The committee anticipates that the Treasury will exercise its authority to promulgate regulations necessary to address problems which may arise as a result of nonconforming tax years, including issues related to the determination of creditable foreign taxes for purposes of the deemed paid foreign tax credit, the high tax exception to the inclusion of subpart F income, the foreign tax credit separate limitation high-tax kick out rules, and the foreign tax redetermination rules.

Additionally, the bill allows a foreign personal holding company to treat a distribution that is made on or before the fifteenth day of the third month after the close of its taxable year as having been made during such taxable year, but only to the extent that such distribution would offset its undistributed foreign personal holding company income for such year. Furthermore, this rule applies only if the distribution is made to a person who was a shareholder of record as of the last day of the foreign personal holding company's taxable year with respect to the stock for which such distribution is made. The amount of such distribution which under this provision is deemed to have been made during the previous taxable year of the foreign personal holding company is to be included in the gross income of the person treated as recipient shareholder under the principles of section 551(f) of the Code, as well as in the gross or distributable net income of any foreign entity described in section 551(f) which actually receives such distribution from the foreign personal holding company, for such person's taxable year in which the taxable year of the foreign personal holding company ends.

For example, assume that a U.S citizen owns 100 percent of the stock of a foreign personal holding company that has $100 of undistributed foreign personal holding company income as of the end of its taxable year. Under this provision, the company is allowed to make a distribution of up to $100 on or before the fifteenth day of the third month following the close of such taxable year, which distribution will be treated as made during its previous taxable year, thus eliminating its undistributed foreign personal holding company income for such year. The distribution will be included in the income of the U.S. citizen in his taxable year which includes the final day of the foreign personal holding company's taxable year during which such distribution is deemed to occur under this rule.

Effective Date

The provision is effective for taxable years of controlled foreign corporations and foreign personal holding companies beginning after July 10, 1989. Information returns which are generally required to be filed by certain U.S. shareholders of a specified foreign corporation will be required to be filed with respect to such a corporation for the short taxable year of the corporation resulting from this provision that begins with the first day of the first taxable year beginning after July 10, 1989, and ending in accordance with the taxable year to which the corporation changes.

The bill provides that a controlled foreign corporation or a foreign personal holding company that changes to a taxable year required by this provision will be treated as having made the change with the consent of the Secretary of the Treasury. Certain U.S. shareholders of a specified foreign corporation shall take the income that is deemed distributed to such shareholder for such short taxable year into account ratably over the first four taxable years (including the shareholder's year which would otherwise include all the income from the entity's short taxable year) beginning after July 10, 1989. The ratable four year inclusion applies only in cases where the U.S. shareholder would otherwise be required to include deemed distributions of income from more than one taxable year of the specified foreign corporation in any one of its own taxable years, and only if the short taxable year of such corporation is its first taxable year beginning after July 10, 1989.

2. Resourcing income to prevent avoidance of foreign tax credit limitation rules (sec. 6402 of the bill and sec. 904 of the Code)

Present Law

Consolidation in general

Members of an affiliated group of corporations may file (or be required to file) a consolidated return. To be a member of an affiliated group for this purpose, a corporation must be an "includible corporation," and a controlling percentage of the stock of the corporation (unless it is the common parent) must be owned directly by an "includible corporation." Under section 1504(b), certain types of corporations do not qualify as includible corporations. Subject to certain exceptions, corporations that do not so qualify include generally corporations exempt from tax under section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), insurance companies subject to taxation under the special rules applicable to life insurance companies, foreign corporations, corporations electing the possession tax credit, regulated investment companies, real estate investment trusts, and domestic international sales corporations.

Foreign tax credit rules

The United States taxes U.S. corporations (including affiliated groups filing consolidated returns) and other U.S. persons on their worldwide income, including foreign income. U.S. persons may choose to reduce the U.S. tax on their foreign income by the amount of the foreign income taxes they pay on that foreign income. In order to prevent the use of foreign tax credits to offset U.S. tax on U.S. income, taxpayers are subject to foreign tax credit limitations in several separate categories, each of which generally varies directly with the ratio of foreign source taxable income subject to that limitation to entire taxable income. If the foreign source taxable income in a particular foreign tax credit limitation category is zero or negative for a particular taxable year, then the foreign taxes on income subject to that limitation cannot be credited against U.S. tax liability in that year.

Where a U.S. person sustains an overall foreign loss in a taxable year, net tax on U.S. income will generally be less than the U.S. tax rate times U.S. income. Under the overall foreign loss recapture rule, a portion of foreign taxable income earned after an overall foreign loss year is treated as U.S. taxable income for foreign tax credit purposes (sec. 904(f)(1)-(4)). This rule is designed to prevent taxpayers from obtaining the double benefit of forgiveness of U.S. tax on a portion of current U.S. income, plus an allowance of a foreign tax credit with respect to the full amount of subsequent years' foreign income. In addition, the 1986 Act clarified that a net loss in a separate foreign tax credit limitation category, or in the general limitation category, would reduce any positive foreign source taxable income in each of the other categories. In effect, this means that foreign losses in a particular limitation category cannot reduce current U.S. tax on U.S. source income in a taxable year unless the aggregate of foreign source taxable income and foreign source losses in all limitation categories is negative.

For any taxable year a U.S. person may forego any benefits of the foreign tax credit and instead take deductions for foreign income taxes. A taxpayer typically may find this alternative preferable when it has paid income taxes to a particular foreign country but has relatively little or no foreign tax credit limitation. This might be the case where, for example, the taxpayer incurs losses from operations in a different foreign country, and these losses are both (a) equal to or greater than the income on which the taxpayer paid the tax to the first foreign country, and (b) subject to the same limitation as the income on which the tax was paid to the first foreign country. Under these circumstances the taxpayer could get no current year benefit from the foreign tax credit with respect to that income category. Depending upon the taxpayer's income, losses, and foreign taxes subject to other foreign tax credit limitations, the usability of any foreign tax credit carryovers generated by electing the benefits of the credit provisions, and the anticipated future effect of the overall loss recapture rules, the taxpayer may find it preferable in this instance to elect the deduction.

The taxpayer might also find it beneficial to forego the benefits of the credit provisions if the foreign losses in the above example are less than the income on which the taxpayer paid the tax to the first foreign country, but the combined foreign losses and foreign income taxes are greater than the income that can be sheltered using foreign tax credits. For example, assume that a U.S. corporation pays U.S. federal income tax at a 34 percent rate and has manufacturing operations in the United States and two other countries. Assume one foreign operation earns $100 subject to $50 of foreign income tax, and the other foreign operation loses $75. Assume the U.S. operation earns $25. Using the credit, the taxpayer would eliminate any net U.S. tax liability on its foreign income and would obtain a $41.50 foreign tax credit carryover, but would owe $8.50 of U.S. tax on its current U.S. income. Using the deduction, the taxpayer would reduce its taxable income to zero and thus incur no U.S. tax liability in the current year. Again depending on numerous past, present, and anticipated future factors, it may be preferable for the taxpayer to forego the benefits of the credit and take the deduction instead.

Interaction of consolidation and foreign tax credit rules

An affiliated group filing a consolidated return (hereinafter referred to as a "consolidated group") must choose the benefits of the foreign tax credit (as opposed to taking deductions for foreign income taxes) on a group-wide basis (Treas. Reg. sec. 1.1502-4(a)). Each foreign tax credit limitation to which a consolidated group is subject varies directly with the ratio of the foreign source taxable income of the group subject to that limitation to the entire taxable income of the group (Treas. Reg. sec. 1.1502-4(c) and (d)).

For example, assume that one member of an affiliated group that files a consolidated return is a domestic corporation with a net foreign source loss of $100 from manufacturing, and U.S. source taxable income from manufacturing of $200. Assume that the income of the other members of the group consists of $100 of foreign source shipping income subject to $34 of foreign income tax. This group has no net foreign source taxable income, no current foreign tax credit, and, assuming that the relevant U.S. rate is 34 percent, a U.S. tax liability of $68 which is equal to, appropriately, the amount of its U.S. source taxable income ($200) times its U.S. tax rate.

Now assume that the members of the affiliated group own all of the stock of a foreign corporation or all of the interests in a partnership. Assume that 21 percent of the stock of a domestic corporation with a foreign loss is owned by this foreign corporation or partnership. Under this assumption, then, the domestic corporation is still wholly owned by the affiliated group, albeit indirectly through a controlled entity that is not an includible corporation, but the domestic corporation with the foreign loss is *not* a member of the affiliated group for purposes of filing a consolidated return. The consolidated return filed by the remaining group of corporations would show $100 of passive foreign source income and $34 of creditable foreign income tax subject to the separate foreign tax credit limitation on passive income, resulting in no net U.S. tax. The nonaffiliated domestic corporation with $200 of U.S. source income and $100 of foreign loss would pay only $34 of U.S. tax. That is, until there is a foreign loss recapture in a subsequent taxable year, the controlled group pays half the U.S. tax that would be owed in the case where 80 percent or more of stock of the domestic corporation with the foreign loss is owned directly by an includible corporation.

Expense allocations

The 1986 Act provided, in general, that the taxable income of an affiliated group is to be determined by allocating and apportioning all interest expenses as if all members of the group were a single corporation (Code sec. 864(e)). As is true of the tax liabilities resulting from allocating separate limitation foreign losses among foreign tax credit limitation categories, the tax liabilities resulting from allocating expenses using a one-taxpayer approach can change depending upon whether 80 percent or more of the stock of an "includible" corporation controlled by an affiliated group is owned directly by includible corporations or indirectly through entities other than includible corporations.

The 1986 Act gave the Treasury authority to resource the income of any member of an affiliated group or modify the consolidated return regulations to the extent such resourcing or modification is necessary to carry out the purposes of section 864. In addition, the 1984 Act gave the Treasury authority to prescribe such regulations as may be necessary or appropriate to prevent the avoidance of Code provisions dealing with the linking of borrowing to investment, or diminishing risks, through the use of related persons, pass-thru entities, or other intermediaries (Code sec. 7701(f)). The temporary and proposed regulations under section 864(e) provide that certain corporations not within the general definition of an affiliated group, such as any includible corporation if 80 percent of its stock is owned directly *or indirectly* by an includible corporation or by members of an affiliated group, will be considered to constitute affiliated corporations for purposes of the interest expense allocation rules (Treas. Reg. sec. 1.861-11T(d)(6)(i)).

Reasons for Change

The committee believes that techniques for avoiding or lessening the impact of the foreign tax credit limitation and related rules have been eliminated over the past years, in particular in the 1986 Act and the regulations issued thereunder, and believes that it would be inappropriate to allow taxpayers to negate the effects of the 1986 Act and prior acts merely by using the expedient of interposing entities other than includible corporations into the chain of ownership of includible corporations. To permit the use of such techniques might reward diligent tax planning, but promotes no arguably important policy objective, in the committee's view. While regulations issued under section 864(e)(7) have appropriately prohibited the use of deconsolidation techniques to manipulate the interest allocation rules, the committee is concerned that the Secretary's authority to issue comparable regulations under the foreign tax credit rules is somewhat less clear.

Explanation of Provision

The bill gives the Treasury authority to issue regulations that would require a taxpayer to resource the income of any member of an affiliated group of corporations (as that term would be modified for these purposes by the bill), or to modify the consolidated return regulations, to the extent such resourcing or modification is necessary to prevent avoidance of the purposes of the foreign tax credit rules. Under the bill, generally only the income of includible corporations (as that term is defined under current law) is subject to resourcing. However, under the bill the determination whether an includible corporation is part of an affiliated group would be made by treating stock owned by attribution under the rules of section 1563 as owned directly, and by disregarding the exclusions from the definition of "includible corporation" listed in section 1504(b). For example, where an includible corporation indirectly controls another includible corporation through an entity that is not an includible corporation, the Treasury is authorized to recharacterize by regulation foreign source income of the includible corporations as U.S. source income, so that the aggregate U.S. tax liability of those corporations is no less than the tax that would be imposed if, for foreign tax credit purposes, the includible corporations had joined in filing a consolidated return. In addition, the bill authorizes the Secretary to prescribe regulations preventing the avoidance (through disaffiliation) of other provisions relating to the proper calculation of the foreign tax credit, such as the limitation imposed under section 907 with respect to certain oil and gas extraction taxes.

As an example of a case that the regulations contemplated by the committee would reach, assume that a domestic parent corporation owns indirectly (through entities that are not includible corporations) 80 percent or more of the stock of two domestic subsidiary corporations. One such domestic subsidiary corporation has $200 of U.S. source income and $100 of foreign source loss. The second has $100 of pre-tax foreign source taxable income, and has paid $34 of foreign income taxes. Assume that all income of the above domestic corporations is subject to U.S. tax at the 34 percent rate. Under the bill Treasury is authorized to recharacterize the income of the second domestic subsidiary corporation as U.S. source income, resulting in an aggregate U.S. tax liability of the two corporations of $68, which would be their tax liability if the parent corporation had owned the stock of the two subsidiaries directly and the three corporations had been required to file a consolidated return. (Under this example, the bill also eliminates the need to resource as domestic, under section 904(f), any foreign source income earned by the first domestic subsidiary corporation in a later year to account for its overall foreign loss described above.)

As another example, assume that in the above case the first domestic subsidiary corporation has $200 of U.S. source income, $100 of foreign source loss from operations in one foreign country, and $100 of pre-tax foreign source income from operations in another foreign country, on which the corporation has paid $34 in foreign income tax. As in the above example, assume that the second domestic subsidiary corporation has $100 of pre-tax foreign income, and has paid $34 of foreign income taxes. Were the first subsidiary corporation permitted to separately elect to deduct its foreign income taxes while the second corporation took the credit, the combined U.S. tax liabilities of the two would be $56.44, or 34 percent of $166 (the U.S. tax liability of the first corporation) plus zero (the U.S. tax liability of the second corporation). By contrast, if both corporations were required to jointly elect either to deduct or credit foreign taxes, then their combined current year U.S. tax liabilities would be $78.88 (using the deduction),[40] or $68 (using the credit). Under the bill, the Treasury is authorized to preclude either domestic subsidiary corporation in such a situation from electing to deduct its foreign taxes at the same time that the other domestic subsidiary corporation takes the benefit of the foreign tax credit provisions.

Effective Date

The provision is effective for taxable years beginning after July 10, 1989.

3. Improve information reporting by U.S. subsidiaries and branches of foreign corporations (sec. 6403 of the bill and sec. 6038A of the Code)

Present Law

The Treasury is authorized to distribute, apportion or allocate gross income, deductions, credits, or allowances between or among commonly controlled organizations, trades, or businesses as necessary to prevent the evasion of taxes or clearly to reflect income (Code sec. 482). Any corporation (U.S. or foreign) that conducts a trade or business in the United States and that is controlled by a foreign person must file an information return reporting all transactions with related foreign persons (sec. 6038A). "Control" for purposes of section 6038A requires 50-percent stock ownership by a single foreign person (including stock attributed to that person). Failure to comply with this reporting requirement carries an initial monetary penalty of $1,000, and additional penalties are imposed if the failure continues more than 90 days after the IRS notifies the taxpayer of the failure. The additional penalties are imposed at the rate of $1,000 for each 30-day period (or fraction thereof) during which the failure continues after the 90th day after IRS notification, up to a maximum additional penalty of $24,000. Thus, the total penalty for each failure to comply with the requirements of section 6038A cannot exceed $25,000.

Similarly, U.S. shareholders that control foreign corporations are required to report certain information with respect to such foreign corporations and all transactions with such foreign corporations. (sec. 6038). In addition to monetary penalties, noncompliance with the requirements of section 6038 can be sanctioned by the reduction or elimination of foreign tax credits allowed to U.S. shareholders that fail to report the required information (sec. 6038(c)).

For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the IRS is authorized (1) to examine any books, papers, records, and other data that may be relevant or material to such inquiry,

---

[40] The combined tax liabilities would be $56.44 for the first corporation (computed as above) plus $22.44, or 34 percent of $66, for the second corporation.

(2) to summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries related to the business of the person liable for tax or required to perform the act, or any other person the IRS may deem proper, to appear before the IRS at a time and place named in the summons and to produce such books, papers, records, or other data and to give such testimony, under oath, as may be relevant or material to such inquiry, and (3) to take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry (sec. 7602(a)). Thus, the statutory scope of IRS summons authority extends to certain persons that are not themselves subject to tax in the United States. Moreover, regarding constitutional due process limitations, a court in the United States may subject a foreign person to personal jurisdiction in connection with the commercial activities the person has purposefully caused within the court's jurisdiction. See, e.g., *World-Wide Volkswagen Corp.* v. *Woodson*, 444 U.S. 286 (1980).

A foreign corporation that is engaged in trade or business within the United States is subject to U.S. corporate income tax on its taxable income that is effectively connected with the conduct of a trade or business within the United States (sec. 882(a)). However, the deductions and credits available to a foreign corporation in connection with its corporate income tax liability are generally allowed only if the corporation files a timely, true, accurate, and complete income tax return (sec. 882(c)(2)). Similar rules apply to the deductions and credits of nonresident alien individuals (sec. 874).

Reasons for Change

IRS access to foreign materials

In order to determine whether adjustments under section 482 (or otherwise) are appropriate in the course of a tax audit of a U.S. taxpayer controlled by a foreign person, it may be necessary for the IRS to examine books, records or other data in the custody of the foreign person. Summonses for such materials have been enforced in U.S. courts against a foreign parent that sells goods in the United States through a U.S. subsidiary (*United States v. Toyota Motor Corp.*, 561 F.Supp. 354 (C.D. Cal.) (memorandum opinion), 569 F.Supp. 1158 (C.D. Cal. 1983)). However, such summonses may not be practically or legally enforceable in all appropriate cases, especially where summoned materials are in the possession of a foreign person. For example, enforcement of the summonses in *Toyota* was based on several factors including the fact that the boards of directors of the foreign parent and the U.S. subsidiary had interlocking membership, and the fact that the foreign parent itself had significant business activities in the United States. In the absence of such factors, the courts have not clearly determined the standards for enforcement of summonses against foreign parents of U.S. subsidiaries.

In addition, establishing jurisdiction to enforce a summons against a foreign parent may not be sufficient to obtain the summoned materials. One significant practical obstacle is that standards of recordkeeping and preservation of documents vary from country to country, and enterprises of many countries do not observe recordkeeping and document-preservation standards as rigorous as those imposed on U.S. taxpayers. Accordingly, documents or materials summoned from foreign parties may not exist by the time a summons is enforced. The committee believes that the unavailability of such documents and materials has substantially interfered with the ability of the Internal Revenue Service to administer the U.S. tax laws.

Reporting of transactions

The committee believes that the reporting requirements of section 6038A should apply to a U.S. corporation or a foreign corporation engaged in trade or business in the United States where such a corporation engages in transactions with substantial foreign stockholders, regardless of whether such stockholders own, directly or indirectly, 50 percent or more of the corporation's stock. For example, the committee is concerned that there may be U.S. corporations owned by groups of unrelated foreign persons that may find it beneficial, for tax reasons, to engage in transactions with those substantial foreign stockholders that are not at arm's length. The committee believes that the IRS should have the same enforcement tools in examining transactions with such stockholders as are available in connection with transactions involving 50-percent or greater foreign stockholders, and as are generally available in connection with purely domestic transactions.

Sanctions

Congress has long recognized that international transactions and foreign taxpayers present difficult tax administration problems. The particular circumstances of foreign taxpayers may make it difficult to detect failures to comply with tax reporting and payment obligations. For this reason, the committee believes that strong and effective sanctions must apply to failures to comply with reporting obligations related to foreign taxpayers. The committee believes that a penalty of only $25,000 may not be sufficiently meaningful to encourage adequate compliance.

Moreover, on the same principle that sections 882(c)(2) and 874 have conditioned the allowance of ordinary deductions and credits on full compliance with applicable reporting requirements, the committee believes that similar sanctions should apply in cases where the taxpayer fails to comply with applicable requirements to support the correctness of the amounts shown on the return in the course of examination.

Finally, the committee believes that after these new provisions have been in operation for some reasonable period, it will be necessary to determine, based on the enforcement experience of the IRS, whether the bill's new rules are adequate to address the committee's present concerns or whether additional legislative steps will be necessary.

Explanation of Provisions

Requirements imposed on taxpayers

The bill expands the application of section 6038A, such that the reporting requirements of that section apply to those corporations ("reporting corporations") that are owned by 25-percent foreign shareholders, and to those transactions ("reportable transactions") by such corporations that involve such shareholders or persons related to such shareholders. The bill defines a 25-percent foreign shareholder as any foreign person that owns 25 percent or more of the total combined voting power of all classes of stock of the reporting corporation that are entitled to vote, or 25 percent of the total value of all classes of stock. The bill also adds any 25-percent foreign shareholder to the definition of a related party under section 6038A.

In addition, the bill provides that each reporting corporation shall maintain, in the location, in the manner, and to the extent prescribed by regulations, such records as the Secretary shall by regulations prescribe as being appropriate to determine the correct treatment of transactions of the reporting corporation with related parties (or shall cause another person to maintain such records as prescribed). The committee anticipates that under this provision, the Secretary may prescribe rules under which the reporting corporation (or another person as directed by the reporting corporation) is required to obtain and compile, as well as maintain, such books, papers, and other records that are not already in its possession.

The committee anticipates that the regulations will generally require such maintenance in the United States. However, the committee also intends by this provision to give the Secretary flexibility in prescribing which records must be maintained in the United States and which may be maintained elsewhere. The Secretary will also have flexibility in identifying those classes of supporting documentation relating to related party transactions that are sufficiently important to warrant maintenance in the United States in the general case, and that therefore will be generally required by regulation to be maintained in the United States. In the case of records so identified, the committee anticipates that regulations will permit the U.S. maintenance requirements to be satisfied by duplicate as well as original documents. Moreover, the committee anticipates that translation into English of any documents required to be maintained in the United States might not be required simultaneously with the appearance of such documents in the United States, but only when specified in regulations.

On the other hand, the committee anticipates that there may be classes of supporting documentation that do not warrant a general regulatory U.S. maintenance requirement. Moreover, even where a class of records is generally required to be maintained in the United States, the committee anticipates that there may be particular circumstances that would warrant exceptions to the general rules. For example, the Treasury may permit certain records to be maintained outside the United States where it is satisfied that any such records would be submitted to the Internal Revenue Service promptly upon request. In addition, the committee anticipates that the Treasury might modify the level of required U.S. record maintenance on a country-by-country or case-by-case basis, by agreement or otherwise, for example by entering into agreements under which taxpayers would be obligated to preserve specified records but not maintain them in the United States, and make them available to the IRS promptly upon request. The committee also anticipates that the Treasury may determine that the information exchange procedures in place between the IRS and the tax authorities of a particular foreign country are operating in such a way as to assure ready access by the IRS to all relevant documents in the possession of related parties in that foreign country, and that as a result the Treasury may grant country-based exceptions to the general U.S. record maintenance rules. Finally, the committee anticipates that even where the general U.S. record-maintenance requirements do not require the maintenance in the United States of a particular class of documents, the Treasury may identify specific circumstances where, because of enforcement problems, that class must be maintained in the United States by a particular reporting corporation or a particular class of reporting corporations.

The committee recognizes that some related foreign corporations may consider such materials to be confidential with respect to the reporting corporation. Accordingly, the committee intends to make reporting corporations responsible to ensure that the specified materials are maintained in the United States, but not to require that such materials be placed under the control of the reporting corporation. Similarly, the committee intends that any such materials would be treated as present in the United States solely for the purpose of determining the tax consequences of transactions involving the reporting corporation, and would not be subject (solely by reason of its presence for U.S tax purposes) to legal process in connection with nontax litigation involving a related foreign corporation that is not otherwise present in the United States.

In addition, the bill provides that in order to avoid the consequences of the noncompliance rules (discussed below) with respect to certain transactions between any reporting corporation and any related party, each foreign person that is a related party of a reporting corporation must agree (in such manner and at such time as Treasury rules or regulations may specify) to authorize such corporation to accept service of process as its agent in connection with any request or summons by the IRS to examine books, records, or other materials, to produce such materials, or to take testimony related to any reportable transaction, solely for the purpose of determining the tax liability of the reporting corporation.[41] This requirement will ensure that IRS examination requests and summonses with respect to related-party transactions involving U.S. taxpayers can be served on related foreign persons that do not directly engage in trades or businesses in the United States.

It is expected that where records of a related party are obtainable on a timely and efficient basis under information-exchange procedures provided under a tax treaty, the Internal Revenue Service generally would make use of such procedures before issuing a summons to the designated agent on behalf of the related party.

[41] The committee intends that the agency relationship specified in the bill will not constitute an agency relationship for any other purpose under Federal or State law.

However, the committee is cognizant of undue audit delays that have been caused by the Service's inability to quickly obtain relevant information through treaty procedures, and recognizes that exigent circumstances (for example, the imminent expiration of the limitations period) may arise that would make the use of a treaty procedure undesirable. Thus, as is the case currently, the committee does not intend that the Service be required to attempt to use a treaty procedure before issuing a summons with respect to information that might be obtained under that treaty.

The committee understands that a reporting corporation may not always be aware that a transaction involves a related party. Such cases may occur, for example, where a reporting corporation engages in a small or brief transaction on arm's length terms with a person that is related to a related party, but with no involvement of any person that is directly related to the reporting corporation. The committee expects that Treasury regulations, in such circumstances, will allow a related party to retroactively authorize the reporting corporation to accept service of process on its behalf with respect to such a transaction. However, if the related party involved in such a transaction refuses to retroactively authorize the reporting corporation to accept service of process on its behalf, the reporting corporation would generally be subject to the noncompliance rule with respect to transactions prior to which the reporting corporation was not aware that the requirements of section 6038A would apply.

To relieve such a harsh result, the committee anticipates that Treasury regulations may allow a reporting corporation to be treated as retroactively authorized to accept service of process on behalf of a related party (and thus in compliance with this requirement), solely for the purpose of avoiding the application of the noncompliance rule with respect to certain transactions, in exceptional circumstances. Such circumstances may include a situation in which (1) neither the reporting corporation nor the other party to the transactions knew or had reason to know that the two parties were related at the time of the transactions, and (2) the taxpayer establishes to the satisfaction of the Secretary that all transactions between the reporting corporation and the related party were on uncontrolled, arm's-length terms that did not involve the participation of any known related party. The committee views common control (at a 50-percent level) as one reason to know that two parties are related under the bill, except where the common control is sufficiently attenuated. Such deemed compliance would apply only to reportable transactions entered into prior to the time when the reportable corporation knew or had reason to know that the related party was related. The noncompliance rule would apply to any transaction subsequent to that time with the same related party unless there was actual authorization to accept service of process.

Applicable sanctions

Enhancement of monetary penalty

The bill increases the existing $1,000 penalty for failure to meet the requirements of section 6038A (as expanded by the bill) to $10,000, increases the amount of each addition to such penalty from the existing $1,000 to $10,000 per applicable 30-day period, and removes the ceiling (currently $24,000) on additions to such penalty.

The bill provides an exception from liability for this monetary penalty, imposed for failure to comply with the reporting requirements of section 6038A, in cases where the taxpayer demonstrates to the satisfaction of the Secretary that reasonable cause exists for the failure to furnish required information or maintain required records. The committee expects that such reasonable cause exceptions will be allowed liberally in cases of small corporations that (1) had no knowledge of the requirements imposed by section 6038A, (2) have limited presence in and contact with the United States, and (3) promptly, fully and completely comply with all IRS requests (including requests to the corporation on behalf of any related foreign party) to furnish books, papers, records, and other data that may be relevant or material to any reportable transaction. The committee intends that the fact that a foreign jurisdiction would impose a civil or criminal penalty on the reporting corporation (or any other person) for disclosing the required or requested materials shall not constitute reasonable cause.

Noncompliance rule

In addition to the enhanced monetary penalty, the bill provides for a new noncompliance rule designed to match more closely the degree of noncompliance with the stakes involved. This rule authorizes the Secretary to allow only the amount of (1) any deductions otherwise allowable to the reporting corporation for amounts paid or incurred to the related party in connection with reportable transactions, and (2) the cost (including all components of the cost of goods sold) to the reporting corporation of any property acquired from the related party or transferred to the related party in connection with reportable transactions, as shall be determined by the Secretary in the Secretary's sole discretion, based on any information in the knowledge or possession of the Secretary or on any information that the Secretary may choose to obtain. Thus under the bill the Secretary may conclude, in a case where the noncompliance rule applies, that claimed deductions or costs have not been sufficiently supported and may consequently disallow any amount (including all) of those claimed amounts. The committee intends that in such a case, where the IRS has been denied the requested access to records or testimony that it chooses to consider in the course of an examination, the Secretary may disregard any information or materials that *have* been submitted by the reporting corporation or the related party where, in the Secretary's sole discretion, such information or materials are insufficiently probative of the relevant facts.

The noncompliance rule applies with respect to all transactions with a related party whenever a reporting corporation is not designated by a related foreign person as its agent in applying sections 7602, 7603, and 7604 with respect to any IRS request or summons within the authority provided by such Code sections, in connection with any reportable transaction.

The bill also provides the IRS with authority to apply the noncompliance rule in the event that a reporting corporation and a foreign person related thereto fail to substantially comply in a timely manner with an IRS summons to produce any books, papers, records, or other data, or to take testimony, or for any other purpose authorized by section 7602 of the Code, in connection with the examination of a reportable transaction. Because the amount of the noncompliance penalty that may apply in such a case is determined largely based on the Secretary's discretion, and because the amount of any disallowance may properly be limited to the deductions or costs related to the particular records or testimony which are the subject of the summons which has not been complied with (and may in some cases be affected by other factors that the Service chooses to take into consideration), the committee anticipates that the Service may, in its discretion, choose to forego application of the penalty in de minimis cases of noncompliance.

The bill also provides the IRS with authority to apply the noncompliance rule in the event that (1) a reporting corporation fails to maintain (or cause another to maintain), any records required to be maintained under the record-maintenence requirements described above, and (2) by reason of that failure, the reporting corporation does not comply with a summons for such record (or such a summons is quashed). In such an event, the noncompliance rule may be applied to any transaction to which such records relate.

The committee intends that the noncompliance rules of the bill be applied separately with respect to each related party of a reporting corporation that is not itself related to other related parties of the reporting corporation. For example, a reporting corporation is related to two foreign corporations, and these two foreign corporations are not related to each other. In the event that the reporting corporation and one of the related parties fail to comply with a summons for the production of certain records of that related party, the noncompliance rules may be applied to all reportable transactions between the reporting corporation and that related party. However, such failure to comply will not cause the noncompliance rules to apply to reportable transactions between the reporting corporation and the other related party.

Judicial review

To ensure that the noncompliance rules with respect to a summons are only applied when the summons is properly issued by the IRS, the bill permits prompt judicial review of a summons (waiving the sovereign immunity and anti-injunction act defenses that would generally bar such review). The bill thus permits persons that receive a summons related to the examination of a reportable transaction to petition a federal court to quash the summons, not later than the 90th day after such summons is mailed. In the event that the recipient does not file such a petition and also fails to comply with the summons, the IRS (as under present law) may bring an action to enforce the summons. If a summons in connection with an IRS examination of any reportable transaction is subject to a timely petition to quash, the statute of limitations on the taxable year(s) at issue will be suspended during the pendency of the judicial action to quash the summons, and will expire not earlier than 90 days after the conclusion of such action.

In order to establish with finality the validity of a summons, the obligations imposed on the recipient by the summons, and the applicability of sanctions for noncompliance with the summons, a taxpayer may file a timely petition to quash the summons or defend an IRS action to enforce the summons. Under the bill, these are a taxpayer's sole methods of preventing application of the noncompliance rule for noncompliance with a summons. Therefore, if a summons is not quashed (whether because a petition to quash was unsuccessful, an action to enforce was successful, or simply because no judicial action was initiated), the noncompliance rule may be applied by the IRS irrespective of any collateral or subsequent judicial opinion (e.g., in the U.S. Tax Court) concerning the validity of the summons.

The fact that compliance with the summons would lead to the imposition of civil or criminal penalties on the reporting corporation (or a related party) under any foreign law will not constitute grounds for either quashing or refusing to enforce the summons.[42]

Interaction with treaties

The provisions of the bill will enable the IRS to gather the same type of information with respect to foreign-owned corporations as current law permits with respect to corporations controlled by U.S. persons. Accordingly, inasmuch as the purpose of the bill is to impose equivalent reporting obligations on U.S. corporations irrespective of capital ownership, while recognizing the unique tax administration problems presented where corporate stock is held by nonresidents, the committee believes that the provision does not discriminate against foreign-controlled U.S. corporations in violation of any treaties. If the committee should be incorrect in its technical interpretation of the interaction between these provisions and U.S. treaties, however, it does not intend that any contrary treaty provision defeat its purpose in enacting these provisions.

Report to Congress

The bill requires the IRS to report to Congress on its efforts to audit U.S. taxpayers that are subsidiaries of or otherwise related to foreign corporations. The committee expects that this report, which

---

[42] Courts have taken several factors into consideration in determining whether an IRS summons may be enforced in a case where compliance may violate foreign civil or criminal laws. *See, e.g., United States v. Vetco, Inc.*, 691 F.2d 1281 (9th Cir.), *cert. denied*, 454 U.S. 1098 (1981); *United States v. First National Bank of Chicago*, 699 F.2d 341 (7th Cir. 1983). Courts similarly have considered under what circumstances discovery sanctions may be appropriate where compliance with the discovery order may violate foreign civil or criminal laws. *See, e.g., Societe Internationale pour Participations Industrielles et Commerciales v. Rogers*, 357 U.S. 197 (1958). Notwithstanding any such cases or any factors or considerations relevant thereto, the committee intends that the fact that compliance with the summons may lead to the imposition of civil or criminal penalties on the reporting corporation (or a related party) under any foreign law will not constitute grounds for either quashing or refusing to enforce the summons.

In addition, the committee understands that courts have not yet determined whether, or to what extent, the holding of *First Security Bank of Utah v. Commissioner*, 405 U.S. 394 (1972), may apply to laws or other legal pronouncements made by foreign governments. For example, courts have not yet considered the validity of Rev. Rul. 82-45, 1982-1 C.B. 89 (foreign law prohibiting the payment of technical assistance fees above a stated amount does not foreclose the IRS from treating the taxpayer, under section 482, as if technical assistance fees above the stated amount were paid). No inference is intended as to the validity of that ruling. The committee intends, however, that the holding of *First Security Bank of Utah v. Commissioner*, even if it is determined to be applicable to the laws or legal pronouncements of foreign governments, will not support quashing or refusing to enforce the summons.

must be submitted to Congress within five years after these provisions take effect, will include discussions of (a) compliance with the requirements of section 6038A as expanded by the bill; (b) the availability of related-party materials requested or summoned by the IRS, (c) the quality of the examination process respecting issues involving related foreign parties, (d) the application and effectiveness of the sanctions provided by the bill, and (e) recommendations for further improvements.

Effective Date

The provisions apply to taxable years of reporting corporations beginning after July 10, 1989.

4. Treatment of certain scholarship or fellowship grants to nonresident aliens (sec. 6404 of the bill and secs. 873 and 1441 of the Code)

Present Law

Generally under the Code, the United States imposes tax, at ordinary rates, on the taxable income of a nonresident alien individual that is effectively connected with the conduct of a trade or business in the United States. Generally, deductions are permitted in computing such U.S. taxable income only if and to the extent that they are connected with income which is so effectively connected.

A nonresident alien cannot use the standard deduction (sec. 63(c)(6)(B)). A nonresident alien is permitted a deduction for personal exemptions without regard to whether the deduction is connected with effectively connected income. However, a nonresident alien is generally allowed only one personal exemption unless he or she is a resident of a contiguous country or a national of the United States (sec. 873(b)). By contrast, a U.S. citizen or resident (hereinafter referred to as a "U.S. person") is entitled to an exemption for him- or herself; an additional exemption for a spouse if a joint return is not made and the spouse, for the year in which the taxable year of taxpayer begins, has no gross income and is not the dependent of another taxpayer; and further additional exemptions for certain dependents (sec. 151). The term "dependent" excludes a spouse and generally also excludes any individual who is not a citizen or national of the United States unless the individual is a U.S. resident or a resident of a contiguous country (sec. 152(a)(9) and (b)(3)). In addition, no joint return may be made by a husband and wife if either is at any time during the year a nonresident alien, unless one spouse is a U.S. person, and the other elects to be taxed as a U.S. resident on all of his or her worldwide income (sec. 6013(a) and (g)). Thus, while a married U.S. person whose spouse is also a U.S. person can either file a joint return claiming personal exemptions for both him- or herself and the spouse, or may file a separate return claiming personal exemptions for both where the spouse has no gross income (and may claim more exemptions if there are dependents), a married nonresident alien with U.S. effectively connected income generally must take no more than one personal exemption in all cases (unless the spouse is a U.S. person and the nonresident alien subjects his or her worldwide income to U.S. tax jurisdiction).

Under the Code, a nonresident alien is generally subject to a 30-percent tax on gross amounts of fixed or determinable, annual or periodical income from U.S. sources that is not effectively connected with the conduct of a trade or business in the United States. The payor of income subject to this gross-basis tax is generally required to collect the tax by withholding at the full 30-percent rate.

Generally gross income excludes certain amounts received as a qualified scholarship by an individual who is a candidate for a degree at an educational institution (sec. 117(a)). (Prior to the Tax Reform Act of 1986, the Code contained a broader exclusion concerning scholarship-related income.) In addition, U.S. source amounts that are received by a nonresident alien individual who is temporarily present in the United States under an F, J or M visa, and that are either (1) incident to a qualified scholarship to which section 117(a) applies (but includible in gross income), or (2) a scholarship or fellowship for study, training, or research in the United States and received from a government, a 501(c)(3) organization, or certain types of international, binational, or multinational organizations, are treated as effectively connected with the conduct of a trade or business within the United States and eligible for withholding at a 14-percent rate.[43] Finally, some U.S. income tax treaties provide for reductions in the U.S. tax that would otherwise be imposed under the Code on certain income of foreign persons, including the income of certain visiting foreign individuals such as scholars.

Reasons for Change

The committee believes that the general rule differentiating between resident aliens and U.S. citizens, on the one hand, and nonresident aliens, on the other, in the allowance of the standard deduction and personal exemption is appropriate in light of the fact that the United States exerts jurisdiction over the worldwide income of persons in the former group, but only over the U.S. income of persons in the latter group.[44] However, the committee believes that, following the changes to the scholarship exclusion rules in the 1986 Act, there may be cases where a visiting foreign recipient of a scholarship or fellowship is subject to U.S. tax on the scholarship or fellowship provided by a federal, state, or local government or public charity, yet in computing the tax on that income, the individual may be unable, as a nonresident alien, to take into account the deductions that a similarly situated U.S. person would be entitled to. The committee is concerned insofar as this may increase the cost of providing such scholarships or fellow-

[43] In Revenue Ruling 89-67, 1989-20 I.R.B. 4, the Service ruled that in certain circumstances, it would determine the source of income received to support or subsidize a recipient's research or study activities by reference to the residence of the payor.

[44] Compare section 2102(c)(2)(B), which provides a different unified credit against the U.S. tax on transfers of the taxable estate of a decedent nonresident alien than the unified credit against the U.S. tax on transfers of the taxable estate of a decedent U.S person, and provides that the credit in the nonresident alien case may in some cases be the credit applicable to the estates of U.S. decedents reduced to reflect the proportion of the decedent's entire estate that is situated in the United States.

ships, or reduce the value of such scholarships or fellowships to the individual, in cases where important national policies are served by providing such scholarships and fellowships. The committee is concerned that in some cases, the visitors subject to these rules may not be residents of countries that have entered into treaties that would relieve the current U.S. tax burden under the Code, and that such treaty relief may not realistically be foreseeable in the near future.

Explanation of Provision

The provision gives certain deductions, based on the standard deduction and multiple personal exemptions, to offset certain U.S. source gross income of visiting foreign individuals received in the form of certain scholarships and fellowships. Further, the bill provides that withholding on such income may be adjusted to take these deductions into account.

In the case of a nonresident alien individual who is temporarily present in the United States under an F, J or M visa who receives or accrues any qualified scholarship or fellowship grant during the taxable year (hereinafter referred to as a "qualified nonresident alien individual"), the provision permits that individual the benefit of certain deductions (regardless of whether those deductions are connected with income which is effectively connected with the conduct of a trade or business in the United States) up to the amount of the qualified scholarship or fellowship grants includible in gross income for the taxable year. Those deductions include the standard deduction and the personal exemptions allowed under the general personal exemption rules (i.e., the rules without regard to the one-exemption limitation in section 873(b)(3)), subject to two modifications. First, in determining who is a dependent of the nonresident alien, there will be no exclusion of a child or other individual, on the grounds of his or her failure to be a U.S. person or national, if that child or other individual is a member of the taxpayer's household in the United States. Second, no exemption will be allowed for a spouse unless the spouse is a member of the taxpayer's household in the United States.

As described above, the amount of the deductions allowed under the provision is limited by the amount of the nonresident alien's qualified scholarship or fellowship grants for the year. The term "qualified scholarship or fellowship grant" is defined as any amount which is includible in the gross income of the nonresident alien for the taxable year, and which is granted as a scholarship or fellowship for study, training, teaching, research, or career development in the United States by a federal, state, or local government agency, or a tax-exempt U.S. organization described in section 501(c)(3). Thus, for example, the term does not include amounts excluded from gross income under section 117(a) of the Code (e.g., certain scholarships, to the extent not exceeding tuition and fees, received by degree candidates) or under a treaty.

Finally, the bill provides that notwithstanding the 30-percent or 14-percent statutory withholding rates that may be generally applicable to U.S. source income of a nonresident alien under the Code, the Secretary shall have authority to provide for a reduction in the amount of withholding from any qualified scholarship or fellowship grant to take into account the reduction in a grant recipient's tax liability as a result of the provision.

Effective Date

The provision applies to taxable years beginning after December 31, 1989.

5. Modify definition of passive foreign investment company with regard to certain income of export trade corporations (sec. 6405(a) of the bill and sec. 1296 of the Code)

Present Law

Certain export-related income derived by a controlled foreign corporation that is an export trade corporation (ETC) is exempt from the current U.S. taxation that would otherwise be imposed under subpart F (sec. 970 of the Code). Under the special rules of subpart G, the subpart F income of an ETC is reduced by certain amounts that constitute export trade income (as defined in section 971).

No foreign corporation may qualify as an ETC unless it so qualified for a taxable year beginning prior to October 31, 1971, and has not failed to so qualify in any three consecutive years beginning after October 31, 1971 (sec. 971(a)(3)). Code provisions allowing special treatment of export-related income of Domestic International Sales Corporations (DISCs) were enacted in 1971. At that time, existing ETCs (and only existing ETCs) were permitted to continue using the rules of subpart G, and were also given the opportunity to transfer their assets (and the tax-deferred treatment of their accumulated earnings) to a DISC. In the Tax Reform Act of 1984, special provisions regarding the export-related income of Foreign Sales Corporations (FSCs) were enacted and the DISC rules were substantially modified. At that time, existing ETCs were again permitted to continue using the rules of subpart G, and were also given a time-limited opportunity to transfer their assets tax-free to a FSC or to elect FSC status. Upon such a transfer to a FSC, the tax-deferred accumulated earnings of an ETC were eligible to be treated as previously taxed income (in effect, forgiving all deferred U.S. tax on such income). No portion of the untaxed income of an ETC that continued to use the rules of subpart G could be treated as previously taxed income under the 1984 Act.

The Tax Reform Act of 1986 provided special rules to end deferral of U.S. tax on income earned through certain predominantly passive foreign corporations referred to as passive foreign investment companies (PFICs). A U.S. person's share of the income of any PFIC is generally subject either to current U.S taxation or to deferred taxation plus an interest charge attributable to the value of deferral (sec. 1291-1297). Generally, a PFIC is any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average fair market value (or adjusted basis) of its assets consists of assets that produce, or are held for the production of, passive income (sec. 1296).[45] For this purpose, passive income generally is defined as any income of a kind that would be foreign personal holding company income as defined in section 954(c), with certain exceptions relating to banking, insurance, and related-party income (sec. 1296(b)). Amounts that are passive income under the PFIC rules may also constitute export trade income under section 971.

Reasons for Change

In light of the fact that export trade corporations were permitted to retain their preexisting tax treatment upon the introduction of DISCs and FSCs, the committee believes that the tax benefits available to export trade corporations should be reinstated in cases where such corporations would lose those benefits through the application of the PFIC rules of present law.

Explanation of Provision

The bill modifies the definition of "passive income" as that term is applied in determining whether a foreign corporation is a PFIC. Under the bill, the passive income of a foreign corporation, solely for the purpose of determining whether that foreign corporation is a PFIC, generally does not include any export trade income. The amount so excluded, however, is limited to the excess (if any) of (i) the amount by which the subpart F income of the ETC is reduced by export trade income under section 970(a), over (ii) the amount by which the subpart F income of the ETC would be reduced under section 970(a) by taking into account only such amounts of export trade income that would not constitute passive income (without regard to the provisions of the bill) under section 1296(b).

For example, assume that a foreign corporation that qualifies as an ETC for the taxable year earns a total of $325 of income, all of which is subpart F income. The $325 total includes $200 of export trade income that is also classified under present law as passive income, $75 of export trade income that is not classified under present law as passive income, and $50 of passive income that does not qualify as export trade income. The total amount of export trade income ($275) does not exceed the limitation imposed by section 970(b) on the amount of export trade income that is permitted to reduce subpart F income. The corporation would be considered under present law to earn $250 of passive income as defined for PFIC purposes. Under the bill, such amount of passive income for PFIC purposes would be reduced by $200, namely, the excess of (a) the $275 of export trade income that reduces subpart F income, over (b) the $75 of export trade income that is not also passive income under present law. Thus, the passive income of the ETC for PFIC purposes would be $250 less $200, or $50.

[45] In addition, stock held by a taxpayer is generally treated as stock in a PFIC if, at any time during the holding period of the taxpayer with respect to such stock, the corporation (or any predecessor) was a PFIC which was not a qualified electing fund. By contrast, if the stock was the subject of an election to be treated as a qualified electing fund with respect to the taxpayer, that stock is only treated as PFIC stock, and the taxpayer is only subject to qualified electing fund inclusions with respect to that stock, for years during which the asset or income test set forth in the text were met.

Effective Date

The provision is effective for taxable years beginning after December 31, 1988, for which a foreign corporation is treated as an export trade corporation.

In addition, the bill provides an ETC that is a PFIC under present law additional time to elect to be treated as a qualified electing fund (under section 1295) and to elect to defer the payment of tax on the undistributed earnings of a qualified electing fund (under section 1294). Under the bill, the time for making either such election would not expire until at least 60 days after the enactment of the bill. Thus, such an ETC may make an election under section 1295 at any time up to 60 days after the date of enactment of the bill and, accordingly, avoid any treatment as a PFIC (with respect to years beginning after December 31, 1988) as a result of its PFIC status in prior years.

In conjunction with the extension of time to make elections under sections 1295 and 1294, the bill extends the limitations period for assessing or collecting any underpayment of tax resulting from such an election. In the case of either election, under the bill, the limitations period for such purposes will expire no earlier than the day which is three years after the date on which such election is made.

6. Treatment of certain leased property under passive foreign investment company rules (sec. 6405(b) of the bill and sec. 1296(e) of the Code)

Present Law

Generally a passive foreign investment company (PFIC) is any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average fair market value (or at the election of the foreign corporation, the average adjusted bases) of its assets consists of assets that produce, or are held for the production of, passive income.[46] Passive income generally is defined as any income of a kind that would be foreign personal holding company income as defined in section 954(c), with certain exceptions relating to banking, insurance, and related-party income (sec. 1296(b)).

In 1988, the Internal Revenue Service in Notice 88-22, 1988-1 C.B. 489, provided certain guidance regarding the computation of the PFIC asset test. For purposes of this test, asset value (or basis) is determined on a gross basis, without taking into account liabilities. The average fair market values (or bases) of assets for the taxable year of the foreign corporation are the average of the values (or bases) of the assets determined as of the end of each quarterly period during the corporation's taxable year. Generally, an asset is characterized as passive if it has generated (or is reasonably expect-

[46] In addition, stock held by a taxpayer is generally treated as stock in a PFIC if, at any time during the holding period of the taxpayer with respect to such stock, the corporation (or any predecessor) was a PFIC which was not a qualified electing fund. By contrast, if the stock was the subject of an election to be treated as a qualified electing fund with respect to the taxpayer, that stock is only treated as PFIC stock, and the taxpayer is only subject to qualified electing fund inclusions with respect to that stock, for years during which the asset or income test set forth in the text were met.

ed to generate in the reasonably foreseeable future) passive income. Assets which generate both passive and nonpassive income in a taxable year are treated as partly passive and partly nonpassive assets in proportion to the relative amounts of income generated by those assets in that year.

For purposes of performing the PFIC asset test, assets in which the foreign corporation holds a leasehold interest are not taken into consideration.

Reasons for Change

The committee understands that many service and certain other companies use few of their own assets in their active business operations. It is common for these companies to lease rather than buy the physical assets necessary for operations. The committee has been informed that computer and peripheral equipment are assets frequently leased in these industries.

The committee is concerned that the asset test for classification as a PFIC did not adequately reflect the business requirements of many service companies. Therefore, the committee believes it is appropriate to allow foreign corporations to account for leased equipment when performing the asset test.

Explanation of Provision

Generally under the bill, any computer or related peripheral equipment with respect to which a foreign corporation is the lessee under a lease with a term of at least six months is considered to be an asset that is actually owned by such corporation for purposes of applying the PFIC asset test.[47] Thus, when applying the asset test, a foreign corporation will include the fair market value of any computer or related peripheral equipment in which it holds such a leasehold interest as of the end of each quarterly period of the corporation's taxable year. The leased asset's characterization as passive, nonpassive, or partly passive and partly nonpassive is based on whether the asset produces passive income, or is held for the production of passive income, in the same manner as assets actually owned by the corporation are so characterized.

For example, assume that at the end of each quarter of a foreign corporation's taxable year, the corporation has $100 of passive assets and is the lessee of computer or related peripheral equipment (subject to a lease term of at least six months) that has a fair market value of $200. Further, assume that the leased equipment produces active income. In this case, the average value for the taxable year of the corporation's passive assets constitutes only one-third of the average value of all of the assets of the corporation ($100 divided by $300). Therefore, the corporation would not be a PFIC under the asset test for the taxable year.[48]

As another example, consider the same facts as above, except that the corporation holds an interest in the leased assets at the

---

[47] Renewal options are disregarded in determining whether an asset has been leased for a period of at least six months.

[48] Of course, the corporation would still have to test for PFIC status under the PFIC income test.

end of the first quarter of its taxable year, and not at the end of the other three quarters. In this case, the average value for the taxable year of the corporation's passive assets constitutes 67 percent of the average value of all of the assets of the corporation ($100 divided by $150). Therefore, the corporation would qualify as a PFIC under the asset test for the taxable year.

Under the bill, the term computer or related peripheral equipment has the same meaning as provided in section 168(i)(2)(B). Under that section, a computer means a programmable electronically activated device which (1) is capable of accepting information, applying prescribed processes to the information, and supplying the results of these processes without human intervention, and (2) consists of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities. Related peripheral equipment includes any auxiliary machine (whether on-line or off-line) which is designed to be placed under the control of the central processing unit of the computer. The term computer or related peripheral equipment specifically does not include (1) any equipment which is an integral part of other property which is not a computer, (2) typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, and (3) equipment of a kind used primarily for amusement or entertainment of the user.

Under the bill, certain exceptions apply to preclude foreign corporations from taking certain leased equipment into account in applying the PFIC asset test. First, in situations where the lessor of equipment is related to the lessee foreign corporation under the related person rules of section 1296(b)(2), such leased equipment will be disregarded. Second, if the lessee foreign corporation is also a sublessor of the leased equipment, such equipment will be disregarded. Finally, a foreign corporation will be precluded from taking leased equipment into consideration if a principal purpose of leasing the equipment was to avoid treatment as a PFIC.

Effective Date

The provision is effective for taxable years beginning after December 31, 1988.

7. Treatment of certain stock held by controlled foreign corporations (sec. 6405(c) of the bill and section 958 of the Code)

Present Law

When a controlled foreign corporation earns subpart F income, including foreign personal holding company income or any other tax haven income, the corporation's U.S. shareholders generally are subject to current U.S. taxation on their pro rata shares of the subpart F income. The term foreign personal holding company income is defined generally to include, among other things, investment-type income. The term controlled foreign corporation includes a foreign corporation more than 50 percent of either the voting power or the value of the stock of which is owned, directly, indirectly, or by attribution (within the meaning of Code section 958), by U.S. persons that each own (directly, indirectly, or by attribution) at least 10 percent of the voting power on any day during the taxable year of the foreign corporation (sec. 957).

Reasons for Change

The committee understands that there may be an issue whether, and if so the extent to which, present law permits regulations to be issued regarding the definition or tax treatment of contracts that may be variable contracts, issued by controlled foreign corporations to nonresident aliens or other foreign persons. The committee believes that if present law does provide such authority, it would also be appropriate for the Treasury to have the authority to issue certain regulations under subpart F. These regulations might clarify the tax treatment under subpart F of an investment company, the shares of which are held by a controlled foreign corporation solely for the benefit of owners of such contracts, in a way that would be consistent with regulations (if any) regarding the definition or tax treatment of such contracts.

The committee does not intend, however, to take a position on (a) whether regulations should be issued under this provision or other statutory provisions, or (b) whether regulations under other statutory provisions would be authorized under present law. Thus, to the extent that such regulations are not so authorized, the bill provides no additional authority to issue them, nor does the committee intend to imply that the Treasury has no such authority.

Explanation of Provision

The bill provides that, solely for purposes of subpart F, the Secretary may, under regulations, provide that stock of an investment company shall not be treated as owned by a controlled foreign corporation to the extent that stock is held solely for the benefit of the foreign persons that are owners of variable contracts issued by the controlled foreign corporation.

Either issuance or nonissuance of regulations under this provision would be consistent with the committee's intent. The committee intends that if regulations are issued, they may be limited in scope as the Secretary deems appropriate. For example, regulations need not apply to investment company stocks held for the benefit of all types of foreign persons that own contracts issued by the controlled foreign corporation, but could be limited, for example, to stock held for the benefit of one or more particular types of foreign persons, such as nonresident alien individuals. No inference is intended concerning whether (1) any controlled foreign corporation affected by any regulations is a life insurance company, (2) the income of such a controlled foreign corporation is life insurance income, or (3) any variable contracts affected by any regulations meet the definition of life insurance contract. Moreover, it is not intended that the regulatory authority granted by the provision extend to the resolution of the issues in the previous sentence; rather, this authority is limited only to the issue of ownership for purposes of subpart F if the Treasury Department, through an exercise of existing regulatory authority, should reach this issue.

Effective Date

The provision applies to taxable years of foreign corporations beginning after December 31, 1989.

8. Exclusion for certain overseas allowances received by certain Department of Defense personnel (sec. 6406 of the bill and sec. 912 of the Code)

Present Law

Civilian officers and employees of the State Department and Central Intelligence Agency (CIA) are exempt from tax on certain amounts received as allowances or otherwise (but not amounts received as post differentials) related to their overseas assignments (sec. 912(1)(A) and (B)). The benefits entitled to tax exemption are those set forth in chapter 9 of title I of the Foreign Service Act of 1980 (22 U.S.C. secs. 4081-4086), in the case of State Department officers and employees, and in section 4 of the Central Intelligence Agency Act of 1949, as amended (50 U.S.C. sec. 403e), in the case of CIA officers and employees. Such benefits may include loans of household effects, health care, payment of certain work-related entertainment and representational expenses, and the payment of certain travel and related expenses of employees and their families, including expenses for travel and moving to and from assigned posts of duty, and travel for home leave, medical care, family visits, and the evacuation of families from dangerous foreign areas.

Beginning with Intelligence Authorization Acts for fiscal years 1982 and 1984 (Pub. Laws No. 97-89 and 98-215), the law has provided that comparable benefits could be given to civilian Defense Department employees assigned to Defense Attache Offices and Defense Intelligence Agency Liaison Offices outside the United States (10 U.S.C. sec. 1605) and to certain designated civilian and military Defense Department employees (generally National Security Agency personnel) assigned to special cryptologic activities outside the United States (section 9(b) of the National Security Agency Act of 1959, as amended (50 U.S.C. sec. 402 note)). The Code does not provide tax exemptions for these Defense Department employee benefits.

Reasons for Change

Insofar as civilian Defense Department officers and employees assigned to Defense Attache Offices and Defense Intelligence Agency Liaison Offices outside the United States, and to special cryptologic activities outside the United States, may receive benefits intended to be comparable to the benefits such employees would receive were they engaged in similar activities in the employ of the State Department or the CIA, the committee believes that it is appropriate to provide tax treatment of such benefits similar to the tax treatment they would receive were such benefits received by employees of the State Department or the CIA.

Explanation of Provision

The bill provides a tax exemption for those allowances and other items, comparable to the allowances and other items provided to civilian State Department and CIA employees, which are provided (under 10 U.S.C. sec. 1605 or sec. 9(b) of the National Security Agency Act of 1959, as amended) to civilian employees and officers of the Defense Department assigned to Defense Attache Offices and Defense Intelligence Agency Liaison Offices outside the United States, or to special cryptologic activities outside the United States, in cases where such allowances or other items would be exempt under current law if received by civilian State Department or CIA employees.

Effective Date

The provision is effective for allowances received after December 31, 1988, in taxable years ending after that date.

Subtitle E. Excise Tax Provisions

1. Aviation excise taxes

a. Repeal of reduction in aviation-related excise taxes (sec. 6501 of the bill and sec. 4283 of the Code)

Present Law

The tax rates of certain of the excise taxes which fund the Airport and Airway Trust Fund (AATF) generally will be reduced by 50 percent as of January 1, 1990, because AATF appropriations for fiscal years 1989 and 1990 for airport improvement, facilities and equipment, and research, engineering and development programs were 79 percent, instead of at least 85 percent, of the amounts authorized for those fiscal years. The tax rate reductions are required under provisions of the Airport and Airway Revenue Act of 1987, because of the expressed concern by the Congress that the trust fund programs cited above were not being funded adequately.

The present AATF excise taxes are scheduled to expire after December 31, 1990.

The AATF excise tax rates which are scheduled to be reduced by 50 percent are: (1) 8 percent tax on air passenger transportation; (2) 5 percent tax on air freight; and (3) 14 cents-per-gallon tax on jet fuel used in noncommercial aviation. The 3 cents-per-gallon additional tax on gasoline used in noncommercial aviation (in addition to the basic 9 cents-per-gallon tax under sec. 4081) would be eliminated and 3 cents of the 9 cents-per-gallon gasoline tax would be refunded or credited to ultimate purchasers using the gasoline in noncommercial aviation. The $3 per person international departure tax is not scheduled to be reduced under present law.[49]

Reasons for Change

The Administration proposed, in its budget recommendations, that the aviation tax reduction trigger be repealed. It also indicated, in a letter to the Chairman of the Committee on Ways and Means of the House of Representatives, its support for increased spending for the airport improvement program, with expressed concern for capacity and security projects. The Committee on Finance understands that the Administration continues to endorse that position.

[49] See, however, section 6502 of the bill (item 2, following), which increases the air passenger international departure tax to $6 per person, effective on January 1, 1990.

Explanation of Provision

Repeal of tax reduction

The 1990 reduction in AATF excise tax rates is repealed. Present-law excise tax rates relating to air passenger transportation, air freight transportation, and gasoline and other fuels used in noncommercial aviation will therefore remain unchanged through 1990.

Administration position

The Administration proposed, in its budget recommendations, that the aviation tax reduction trigger be repealed. It also indicated, in a letter to the Chairman of the Committee on Ways and Means of the House of Representatives, its support for increased spending for the airport improvement program, with expressed concern for capacity and security projects. The Committee on Finance understands that the Administration continues to endorse that position.

Effective Date

The provision is effective on January 1, 1990.

b. Modification of collection period for air passenger ticket tax (sec. 6504(a) of the bill and new sec. 6302(e) of the Code)

Present Law

An 8-percent excise tax is imposed on the value of air passenger transportation. Revenues collected under this and other aviation taxes are deposited in the Airport and Airway Trust Fund. This tax is effective through December 31, 1990.

The air passenger tax is billed to the customer with the charge for air transportation and is considered to be collected from the customer during the second following semi-monthly period. The tax is collected by the air carrier (or its agent) which provides the transportation. The tax must be deposited in a Federal Reserve Bank or other authorized depository within 3 banking days after the end of the semi-monthly period for which the tax is considered to be collected.

Reasons for Change

The committee believes that it is important to have timely deposit of tax receipts, and acceleration of the payment of AATF excise tax receipts imposes no additional cost burden on the service providers charged with collecting the tax.

Explanation of Provision

Under the bill, the air passenger tax collected during a semi-monthly period will be considered as collected during the first week of the second following semi-monthly period. The bill requires that the tax be deposited within 3 banking days after the end of the week for which such tax is considered to be collected.

Effective Date

The provision is effective with respect to taxes considered collected for semi-monthly periods beginning after June 30, 1990.

c. Increase in international air passenger departure tax (sec. 6502 of the bill and sec. 4261(c) of the Code)

Present Law

The international air passenger departure tax is $3 per person. The tax is imposed when the air passenger ticket is purchased.

Revenues from this tax are deposited in the Airport and Airway Trust Fund. The tax is scheduled to expire after December 31, 1990.

Reasons for Change

The cost of providing air navigation, safety, and other aviation-related services to international air passengers has more than doubled since the international air departures tax was imposed. The committee believes that this is a modest, and only partial, recovery of the costs incurred by the United States for these purposes.

Explanation of Provision

The departure tax on international air passenger transportation is increased by $3 per person to $6 per person.

Effective Date

The provision is effective on January 1, 1990, with respect to international departures on and after that date.

2. International departure tax on ship passengers (sec. 6503 of the bill and new secs. 4471 and 4472 of the Code)

Present Law

There are no Federal taxes or fees currently imposed on cruise or other ship passengers. Cruise ships using U.S. ports are subject to a .04 percent excise tax on the value of commercial cargo and passenger fares (sec. 4461). Revenues from this tax are deposited in the Harbor Maintenance Trust Fund.

Under special rules, no harbor maintenance tax applies to cruise ships loading or unloading with respect to cruises to or from Alaska, Hawaii, or a U.S. possession, unless the Alaska, Hawaii, or U.S. possession port is only a stopover to a foreign destination.

Reasons for Change

The tax will meet partially the expenses incurred by the United States in providing navigation, safety and other services to cruise ships and their passengers.

Explanation of Provision

The bill imposes a tax of $3 per passenger on a covered voyage on a commercial passenger vessel having berth or stateroom accommodations for more than 16 passengers that embarks from a United States port on a voyage that extends over one or more nights. The tax also is imposed on a vessel transporting passengers engaged in gambling aboard the vessel beyond the territorial sea of the United States. The tax is assessed only once for each passenger on a covered voyage, either when a passenger first embarks or disembarks in the U.S.

The tax is not imposed on a vessel on a voyage of less than 12 hours between two points in the United States, or a vessel owned and operated by a State or a political subdivision of a State.

Effective Date

The provision is effective on January 1, 1990.

3. Extension of the telephone excise tax (sec. 6505 of the bill and sec. 4251 of the Code); Modify collection period for the telephone excise tax (sec. 6504 of the bill and sec. 6302 of the Code); Telephone tax exemption certificates (sec. 6504 of the bill and sec. 4253 of the Code)

Present Law

Imposition of tax

A 3-percent excise tax is imposed on amounts paid for local and toll (long-distance) telephone service and teletypewriter exchange service. The tax is collected by the provider of the service from the consumer (business and personal service). The tax is scheduled to expire after December 31, 1990.

Collection of tax

Under present law, the telephone tax billed to the customer in a semi-monthly period is considered to be collected from the customer during the second following semi-monthly period. Such tax must be deposited in a Federal Reserve Bank or other authorized depository within 3 banking days after the end of the semi-monthly period for which the tax is considered collected. (Rev. Proc. 76-45, 1976-2 C.B. 668).

Telephone tax exemption certificates

Exemptions from the telephone excise tax are provided for international organizations, the American Red Cross, servicemen in combat zones, nonprofit hospitals and educational organizations, State and local governments, and certain communications services furnished to news services for use in collection or dissemination of news services (except local telephone service to news services). Other exemptions include amounts paid for installations charges, certain calls from coin-operated telephones, and private communications systems (*e.g.*, certain dedicated lines leased to a single business user (sec. 4253).

Under regulations, those claiming exemption are generally required to file annual exemption certificates (Treas. Reg. 49.4253-11).

Reasons for Change

The committee believes it is inappropriate to permit an existing revenue source to expire when the Federal government's financing needs are great. In addition, the committee believes it is important to have timely deposit of tax receipts and that accelerating collection of the telephone excise tax imposes no additional cost burden on the service providers charged with collecting the tax.

Elimination of the requirement for certain exempt organizations to file annual exemption certificates will reduce the administrative burden of filing the exemption certificates.

Explanation of Provisions

Extension of tax

The 3-percent telephone excise tax is permanently extended.

Collection of tax

Under the bill, the tax for a semi-monthly period is considered collected during the first week of the second following semi-monthly period. The tax is required to be deposited within 3 banking days after the end of the week for which such tax is considered to be collected.

Telephone tax exemption certificates

Under the provision, those communications service recipients exempt from the tax on communications (telephone) services by reason of being a qualified international organization, nonprofit hospital, nonprofit educational organization, or a State or local government are relieved of having to file a certificate of exemption annually. Instead, such communications service recipients are granted a continuing exemption. However, should the service recipient no longer qualify for exemption or should the information on which the original exemption was based change, the service recipient must inform the service provider (who would collect the tax) within 30 days of such change in circumstances.

Effective Dates

The extension of the tax is effective on January 1, 1991. The change in the collection of the tax is effective with respect to taxes considered collected for semi-monthly periods beginning after June 30, 1990. The change in filing of exemption certificates is effective to any claim for exemption made after the date of enactment. (Any annual exemption certificate effective on the date of enactment remains effective until the end of its annual period.)

4. Petroleum excise tax for Oil Spill Liability Trust Fund (sec. 6506 of the bill and sec. 4611 of the Code)

Present Law

The Internal Revenue Code establishes an excise tax of 1.3 cents per barrel on domestic crude oil and imported petroleum products (including imported crude oil) for the purpose of funding the Oil Spill Liability Trust Fund. However, the tax has not been imposed because qualified legislation authorizing expenditures from the Trust Fund has not yet been enacted.[50]

The excise tax on domestic crude oil would be imposed on the operator of any United States refinery receiving such crude oil, while the tax on imported petroleum products would be imposed on the person entering the product into the United States for consumption, use, or warehousing. If domestic crude oil were used in, or exported from, the United States before imposition of the tax on the operator of a refinery, the tax would be imposed on the user or exporter of the oil.

Repayable advances could be made to the Trust Fund from the general fund of the Treasury in a maximum outstanding amount of $500 million. The maximum amount which could be paid from the Trust Fund for any single incident is $500 million, no more than $250 million of which could be used to pay for natural resource damage claims (sec. 9509(c)). Certain costs incurred by the Federal Government for oil spill removal are authorized by the Federal Water Pollution Control Act and the Intervention on the High Seas Act, and therefore are permissible Trust Fund expenditures. Although these expenditures are subject to appropriation, they do not require the enactment of the qualified authorizing legislation which is necessary to commence collection of the 1.3-cents-per-barrel excise tax.

The Oil Spill Liability Trust Fund excise tax is scheduled to expire on December 31, 1991. The tax will terminate earlier than that date if the Secretary of the Treasury estimates that $300 million will be credited to the Trust Fund before January 1, 1992.

Reasons for Change

The committee believes it is important to begin to collect the petroleum excise tax to provide the necessary funds to clean up future oil spills. Because recent events have demonstrated the magnitude of such costs, the committee further believes it is appropriate to accelerate collection of the Trust Fund tax, so that funds are available to meet any significant future contingencies.

Explanation of Provision

The provision modifies present law to impose the petroleum excise tax at a rate of 3 cents per barrel, and to commence collection of the tax. The balances accruing to the Trust Fund may be used for those expenditure purposes which do not require the enactment of qualified authorizing legislation under present law. Upon the enactment of qualified authorizing legislation, Trust Fund amounts will be available for additional expenditure purposes. The bill also provides that, for the purpose of making available additional expenditure purposes, qualified authorizing legislation includes S. 686, "The Oil Pollution Liability and Compensation Act of 1989," as passed by the Senate on August 4, 1989. As under present law, collection of the tax will cease December 31, 1991, or

---

[50] The Code (sec. 4611(f)) requires that the authorizing legislation must be substantially identical to subtitle E of title VI, or subtitle D of title VIII, of H.R. 5300 of the 99th Congress as passed the House of Representatives.

earlier if the Secretary of the Treasury estimates that $300 million will be credited to the Trust Fund before that date.

Effective Date

The provision authorizes the collection of the excise tax to commence on January 1, 1990, with respect to domestic crude oil received at a refinery and with respect to imported crude oil and imported petroleum products entering into the United States.

5. Excise tax on ozone-depleting chemicals (sec. 6507 of the bill and new secs. 4681 and 4682 of the Code)

Present Law

The use or manufacture of chemicals which deplete the earth's ozone layer is not subject to Federal tax under present law.

Reasons for Change

The committee finds compelling the growing evidence of depletion of the earth's ozone layer. The committee recognizes that the United States is a signatory to the Montreal protocol in which many industrialized nations have agreed to reduce their production and consumption of ozone-depleting chemicals. The committee believes that economic incentives can enhance the conservation effort and speed the search for safe substitutes. Therefore, the committee believes it is important to complement the objectives of the Montreal protocol by taxing ozone-depleting chemicals (in proportion to the harm they cause the ozone layer) and to, thereby, permit market forces to aid the work of finding substitutes and fostering reduced use of ozone-depleting chemicals. In addition, the committee believes the revenues raised are important in an era of large Federal budget deficits.

Explanation of Provision

In general

The provision assesses an excise tax on the sale or use by a producer, manufacturer, or importer of certain ozone-depleting chemicals. The amount of tax is determined by multiplying a base tax amount by an "ozone-depleting factor."

Ozone-depleting chemicals

Ozone-depleting chemicals include: chlorofluorocarbons ("CFCs") (which generally are used as refrigerants, foam blowing agents, and solvents) and halons. The specific chemicals subject to tax are listed below.

Ozone-depleting chemicals subject to tax

CFC-11
CFC-12
CFC-113
CFC-114
CFC-115
Halon-1211
Halon-1301
Halon-2402

The chemicals subject to tax are those identified as ozone-depleting under the Montreal protocol as in effect on the date of committee action. Subsequent changes to the list of ozone-depleting chemicals under the Montreal protocol will not change the list of chemicals subject to tax without further Congressional action.

Base tax amount

For calendar year 1990, the base tax amount is $1.07 per pound of ozone-depleting chemical; for 1991, the base tax amount is $1.12 per pound; for 1992, the base tax amount is $1.67 per pound; and for 1993 and beyond, the base tax amount is $3.15 per pound.

Ozone-depleting factor

The ozone-depleting factor reflects the potential ozone depletion which results from one kilogram of a given chemical compared to the ozone depletion which results from one kilogram of CFC-11 (trichlorofluoromethane).[51] The table below lists the ozone-depleting factors for the ozone-depleting chemicals identified in the bill.

Ozone-depleting chemical	Ozone-depleting factor:
CFC-11	1.0
CFC-12	1.0
CFC-113	0.8
CFC-114	1.0
CFC-115	0.6
Halon-1211	3.0
Halon-1301	10.0
Halon-2402	6.0

The ozone-depleting factors are those identified in the Montreal protocol as in effect on the date of committee action. Subsequent changes to the list of ozone-depleting factors under the Montreal protocol will not change the list of ozone-depleting factors for purpose of computation of the tax without further Congressional action.

Exemptions and reduced rate of tax for certain chemicals or certain uses

1990 exemption for production of rigid foam insulation and production of halons.—The bill provides that for calendar year 1990, the sale or use by a producer, manufacturer, or importer of halons or ozone-depleting chemicals used in the production of rigid foam insulation is exempt from the tax.

Reduced rate of tax for ozone-depleting chemicals used in the production of rigid foam insulation.—The bill provides a reduced rate of tax for calendar years 1991 through 1993 for any ozone-depleting

[51] CFC-11 is assigned an ozone depleting factor of 1.0.

chemical which is otherwise subject to tax and used in the production of rigid foam insulation. The tax applicable to such chemicals is determined by multiplying the otherwise applicable tax rate by the applicable percentage. The applicable percentage is 23 percent for calendar year 1991; 16 percent for calendar year 1992; and 8 percent for calendar year 1993.

Reduced rate of tax for Halon 1211, Halon 1301, and Halon 2402.—The bill provides a reduced rate of tax for calendar years 1991 through 1993 for Halon 1211, Halon 1301, and Halon 2402. The tax applicable to such chemicals is determined by multiplying the otherwise applicable tax rate by the applicable percentage. The table below presents the applicable percentages.

Chemical	Applicable percentage		
	1991	1992	1993
Halon-1211	7	5	3
Halon-1301	2	1	1
Halon-2402	4	2	1

Exemption from tax for feedstock chemicals. The bill provides that ozone-depleting chemicals which are used as feedstock for the manufacture or production of other ozone-depleting or non-ozone-depleting chemicals will not be subject to the tax. The committee intends that this exemption apply only to ozone-depleting chemicals used as feedstock in such a way that the ozone-depleting chemical is used and entirely consumed in the production of another chemical. If production of another chemical involves releasing an ozone-depleting chemical into the atmosphere, this exception does not apply.

Application for refund of overpayment of tax. If tax has been paid on ozone-depleting chemicals used in the production of rigid foam insulation or used in the production of another chemical at a rate higher than that required, the excess is credited or refunded (without interest) to the producer of such rigid foam insulation or other chemical.

Imports

The tax applies to any taxable ozone-depleting chemical which is imported into the United States and to any product or substance imported into the United States in which a taxable ozone-depleting chemical was used in the manufacture or production. The amount of tax imposed on such imported products is the amount of tax which would have been imposed on the ozone-depleting chemicals used in the manufacture or production of the product had the product been manufactured in the United States.

For example, if each widget contains 15 ounces of CFC-11 and if in the production of each widget an additional ounce of CFC-11 escapes into the atmosphere, then the widget upon its import is taxed as though it represents one pound of CFC–11.[52] In circumstances where the importer provides insufficient information to determine the amount of ozone-depleting chemicals in a product, the Secretary shall impose a tax equal to 5 percent of the appraised value of the product.

The bill provides that the Secretary may prescribe regulations exempting *de minimis* amounts of ozone-depleting chemicals from tax upon import. However, this *de minimis* exception does not apply with respect to any product in which any ozone-depleting chemical is used for purposes of refrigeration or air conditioning, creation of an aerosol or foam, or in the manufacture of electronic components.

The committee understands that the following commonly imported products may contain ozone-depleting chemicals or may have ozone-depleting chemicals used in their manufacture: automobiles and light trucks; home refrigerators and home freezers; home air conditioners and air conditioner compressors; video cassette recorders; radios; televisions; electronic typewriters; stereo tapes; stereo amplifiers; electronic calculators; copiers; telephones; clothes washers and dryers; microwave ovens; electronic toys and games; cameras; computers; audio tape recorders; contact lenses; lenses for glasses; sterile packaging; dialysis components; artificial limbs and joints; circuit boards; semiconductors; silicon wafers; ball bearings; polyethylene sheets; and molded plastic parts.

Exceptions

Exception for recycling.—The tax imposed does not apply to any ozone-depleting chemical which is diverted or recovered in the United States as part of a recycling process. This exception does not apply to any ozone-depleting chemical recovered by the manufacturer as part of the original manufacturing process.

Exception for exported chemicals.—The bill provides that each producer of ozone-depleting chemicals may export a percentage of annual production tax-free. The percentage permitted is equal to that percentage of the producer's 1986 production of ozone-depleting chemicals which was exported in 1986. The percentage for any year and that for 1986 is to be calculated as the ozone-depleting factor adjusted pounds of export divided by the ozone-depleting factor adjusted pounds of production. For example, if, in 1986, XYZ Company produced 100 pounds of CFC–12 (ozone-depleting factor of 1.0) and 200 pounds of CFC–113 (ozone-depleting factor of 0.8) and exported 20 pounds of each chemical, the percentage of annual production which was exported in 1986 is determined as 20 pounds multiplied by 1.0 plus 20 pounds multiplied by 0.8, divided by 100 pounds multiplied by 1.0 plus 200 pounds multiplied by 0.8, which equals 13.8 percent.[53] If, in 1990, XYZ Company produces 100

---

[52] If the importer can certify to the Secretary that the imported product was manufactured with recycled ozone-depleting chemicals, the committee intends that the Secretary provide relief consistent with that provided for ozone-depleting chemicals recycled in the United States. See below for exception granted for recycling.

[53] With this computation of percentage of exports, the committee intends to conform with the Environmental Protection Agency ("EPA") regulations implementing the Montreal protocol (see, 40 CFR part 82).

pounds of CFC–12 and 100 pounds of CFC–113 and the company may export 24.84 ozone-depleting factor adjusted pounds of ozone-depleting chemicals free of tax.[54] This means XYZ Company could export 24.84 pounds of CFC–12 free of tax, or it could export 31.05 (24.84 divided by 0.8) pounds of CFC–113 free of tax, or it could export 18 pounds of CFC–12 and 8.55 pounds of CFC–113 free of tax, or any other combination such that the ozone-depleting factor adjusted weight equals 24.84 pounds.

In addition, any additional production allowance granted by the EPA (under existing regulations) under the condition that it will be exported [55] will be exempt from the tax upon export.

Review of tax rates for 1993 and beyond

The committee's goal is to induce conservation in the use of ozone-depleting chemicals and to speed the search for safe substitutes, as well as to raise revenue. The committee understands that with any new tax much uncertainty may surround the economic effects of the tax. Consequently, the committee invites the Treasury to monitor the economic effects of the tax and make recommendations for changes in the tax, either in chemicals subject to tax, the base rate of tax, or ozone-depleting factors. However, the committee also believes that it is important to give the marketplace some time to respond to the incentives the tax creates. Year-to-year alterations in the tax would confound the workings of the marketplace. Since the provision would raise the base tax rate from $1.67 per pound in 1992 to $3.15 per pound in 1993, any recommendations the Secretary might care to make would be most useful if transmitted to the Committee on Ways and Means and the Committee on Finance between April 1, 1992 and October 1, 1992. The committee also invites the Secretary to report on whether additional changes in the tax are needed to conform to the Montreal protocol if subsequent amendments are made to that agreement.

Effective Date

The provision is effective for ozone-depleting chemicals sold or used after December 31, 1989. In addition, a floor stocks tax is imposed on ozone-depleting chemicals held by a person other than the manufacturer or importer for sale or use on January 1, 1990. However, the initial deposits of taxes due need not be made until April 1, 1990. A floor stocks tax is also imposed on each subsequent change in the tax rate for any taxable chemical.

---

[54] XYZ Company's 1990 production adjusted for the ozone-depleting factors of its products is 100 pounds multiplied by 1.0 plus 100 pounds multiplied by 0.8, which equals 180 pounds. XYZ Company's 1986 export percentage was 13.8, as determined above. Consequently, they may export 0.138 multiplied by 180 pounds, or 24.84 ozone-depleting factor adjusted pounds, free of tax.

[55] See, sec. 82.9 of the EPA regulations.

6. Excise tax for Wetlands Trust Fund (sec. 6508 of the bill and new secs. 4691, 4692, and 9511 of the Code)

Present Law

Excise taxes are imposed under present law with respect to certain substances, such as crude oil, feedstock chemicals, and chemical derivatives. Receipts from these excise taxes are appropriated to trust funds to pay costs incurred in the cleanup of hazardous wastes, oil spills, and leaking underground storage facilities.

Internal Revenue Code section 4611 establishes an excise tax of 1.3 cents per barrel on domestic crude oil and imported petroleum products (including imported crude oil) for the purpose of funding the Oil Spill Liability Trust Fund (the "Oil Spill Fund"). However, under present law, the tax will not be imposed until qualified authorizing legislation is enacted.[56] Oil Spill Fund expenditure purposes would include payment of removal costs of an oil spill and certain otherwise uncompensated claims. In addition, funds would be available to carry out specific provisions of other legislation relating to oil discharges and pollution. The Oil Spill Fund excise tax currently is scheduled to expire on December 31, 1991, or on an earlier date if the Secretary of the Treasury estimates that $300,000,000 will be credited to the Fund before January 1, 1992.

The Offshore Oil Pollution Compensation Fund (the "Offshore Pollution Fund") is established by Title 43 U.S.C. section 1812. The Offshore Pollution Fund is financed by a fee not to exceed 3 cents per barrel on oil obtained from the outer Continental Shelf, which is imposed on the owner of the oil when it is produced, and by monies recovered by the Fund in actions against polluters. The Offshore Pollution Fund is available to pay for offshore (and adjoining shoreline) cleanups and for damages resulting from an oil spill where the owner or operator of a vessel or offshore facility is incapable of meeting its obligation. The fee authorized by 43 U.S.C. section 1812 may be modified to insure that the Offshore Pollution Fund is maintained at a level between $100,000,000 and $200,000,000.[57]

Reasons for Change

The committee believes it is appropriate to provide for the imposition of excise taxes on oil and natural gas obtained from the outer Continental Shelf in order to fund a Wetlands Trust Fund to be used to preserve, protect, enhance, and restore wetlands.

Explanation of Provision

An excise tax of 3 cents per barrel is imposed on oil obtained from the outer Continental Shelf (i.e., from offshore drilling)[58] for the purpose of financing a Wetlands Trust Fund. In addition, an excise tax of 2 cents per thousand cubic feet is imposed on natural gas obtained from the outer Continental Shelf, also for the purpose

---

[56] See separate provision in this bill, item 4 above.

[57] Pursuant to this discretion, the fee currently is not being imposed.

[58] For purposes of the provision, the term "outer Continental Shelf" has the meaning given such term by section 2(a) of the Outer Continental Shelf Lands Act (43 U.S.C. sec. 1331(a)).

of financing the Wetlands Trust Fund. The person who owns the oil or natural gas at the time it is produced is liable for the payment of the excise taxes imposed by the provision.

Receipts collected from excise taxes imposed under this provision will be appropriated to the Wetlands Trust Fund and made available for making expenditures to carry out the creation, restoration, protection, enhancement, and conservation of wetlands upon enactment of, and as provided in, qualified authorizing legislation substantially similar to S. 1731 of the 101st Congress, as introduced in the Senate and, if necessary, any appropriations Acts. The excise taxes provided for by this provision will expire after December 31, 1994.

Effective Date

The excise taxes provided for by the provision are effective on January 1, 1990.

7. Acceleration of deposit requirement for gasoline excise tax (sec. 6509 of the bill and secs. 6302(f) and 6504 of the Code)

Present Law

Deposits of gasoline excise tax liability are made monthly or semi-monthly, depending on the amount of tax to be deposited.

Taxpayers must make monthly deposits of tax for any month in which they are liable for more than $100 of taxes, and the monthly deposits are due by the last day of the following month. Taxpayers liable for more than $2,000 of excise taxes for any month of a calendar quarter must make semi-monthly deposits in the following quarter 9 days after the end of a semi-monthly period which ends on the 15th or last day of a month. Taxpayers who deposit by electronic wire transfers to a government depositary have until 14 days after the end of a semi-monthly period to make the transfer.

Reasons for Change

The committee believes that large depositors of excise tax collections are able to make more frequent deposits of excise taxes without any harmful commercial effects.

Explanation of Provision

Taxpayers which have more than $100 in any month of a calendar quarter of gasoline excise tax liability will make tax deposits four times in a month.

Nine day and 14 day depositors will make tax deposits at those same intervals after the end of the tax period, but there will be four tax periods in each month. The tax periods will end on the 7th, 14th, 21st, and last days of the month. Nine day taxpayers will deposit tax liabilities, with respect to the weekly tax periods on the 16th, 23rd, 30th days, respectively, of the same month and on the 9th day of the succeeding month. For the same tax periods, 14 day taxpayers will make their deposits on the 21st and 28th days, respectively, of the current month and on the 7th and 14th days of the succeeding month.

The following table also sets forth the payment schedules provided in the bill.

Days in tax period	9 day payers	14 day payers
1st–7th	16th day current month.	21st day current month.
8th–14th	23rd day current month.	28th day current month.
15th–21st	30th day current month.	7th day current month.
22nd–last	9th day next month	14th day next month.

Effective Date

The provision is effective on January 1, 1990.

8. Definition of wholesale distributors of diesel fuel (sec. 6510 of the bill and secs. 4092 and 4093 of the Code)

Present Law

The excise tax on diesel and special fuels was imposed at the producer or importer level under the Omnibus Budget Reconciliation Act of 1987 (OBRA), beginning on April 1, 1988. As a result, retail distributors would not be able to purchase the fuels tax-free, and off-highway users of the fuels (e.g., business, farmers, State and local governments, and airlines) would purchase the fuels tax-paid and apply for refunds.

Congress amended the locus of tax imposition in the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), and restored the ability of off-highway fuels users to purchase fuels tax-free.

Under OBRA, the definition of a wholesale distributor was revised to include distributors who sell taxable fuels in bulk quantities. In Notice 89–38, the Internal Revenue Service provided that a person who sells 70 percent or more of its fuel to tax-exempt users would qualify as a wholesale distributor who would be entitled to purchase and sell fuel tax free.

In the course of the legislative process in 1988, Congress intended to revise how exempt diesel fuel users could purchase tax-free fuel.

Reasons for Change

There was some uncertainty about the timing of the changes that Congress was in the process of making in 1988 to the rules governing the imposition of the diesel fuel excise tax. The amendment is intended to make administrative allowances for dealers and distributors for the period from April 1, 1988, through December 31, 1988.

Explanation of Provision

The bill provides that a sale of taxable fuel by a registered producer to a qualified person shall be exempt from the tax imposed by section 4091. A qualified person is liable for tax on its sales of taxable fuel for uses which are not described as exempt uses in section 4093(c), i.e., diesel powered trains, aircraft, and certain bus uses, as that provision was in effect on April 1, 1988, and aviation fuel sold for use, or used as, supples for vessels or aircraft.

The term qualified person means any person who (1) elects to be treated as a qualified person, and (2) who meets the definition of wholesale distributor as in effect on January 1, 1989, for the purposes of section 4092(b). Section 4101 shall not apply to any qualified person.

Effective Date

The provision is effective as if included in the Omnibus Budget Reconciliation Act of 1987.

9. Reduction in occupational tax on small retail alcoholic beverage distributors (sec. 6511 of the bill and sec. 5121 of the Code)

Present Law

The occupational tax on retail dealers which sell alcoholic beverages is $250 per year. The occupational tax was increased from $54 per year in the Omnibus Budget Reconciliation Act of 1987, and became effective on January 1, 1988.

Reasons for Change

The committee has learned that the $250 retail occupational tax is too high for certain small retail dealers, and the change is made to provide a slightly more articulated structure of occupational taxes which recognizes the proportionate burden of the tax on different size business.

Explanation of Provision

The provision reduces the occupational tax on certain retail dealers which sell alcoholic beverages from $250 to $150 per year. The reduction applies to a dealer with annual gross receipts from the sale of alcoholic beverages less than $250,000 and in which at least one-third of the alcoholic beverages sold are consumed on the premises of the dealer.

Effective Date

The amendment providing for a reduced occupational tax for certain small alcoholic dealers is effective for taxable years beginning after December 31, 1989.

10. Prohibition on assessments or collections of occupational tax for taxable periods beginning before July 1, 1985 (sec. 6512 of the bill and sec. 5121 of the Code)

Present Law

The occupational tax on retail establishments which sell alcoholic beverages is $250 per year. The occupational tax was increased from $54 per year in the Omnibus Budget Reconciliation Act of 1987, and became effective on January 1, 1980.

Since the increase in the occupational tax and transfer of responsibility for administration of alcohol taxes to the Bureau of Alcohol, Tobacco and Firearms (BATF), enforcement activities have been intensified in a systematic manner. As a result, some taxpayers were located who had not paid occupational taxes for a number of years, some for a large number of years. Many taxpayers accused of tax delinquency claim to have not been aware of the existence of the occupational tax. Nevertheless, they have been assessed for back taxes plus interest and penalties on the back taxes.

Reasons for Change

The committee believes that a three-year statute of limitations should apply.

Explanation of Provision

The bill establishes that payments due on unpaid occupational taxes arising from taxable periods beginning before July 1, 1985, will not be pursued. If such tax—due from taxable periods before July 1, 1985—was collected after December 31, 1987, the amount shall be credited or refunded.

Effective Date

The proposal is effective on the date of enactment.

11. Allow expenditures from the Airport and Airway Trust Fund for essential air services (sec. 6513 of the bill and sec. 9502 of the Code)

Present Law

Excise tax receipts appropriated to the Airport and Airway Trust Fund (AATF) may be spent only for statutory purposes specified in section 9502 of the Internal Revenue Code. Generally, these purposes are (1) airport improvement, which includes airport development and planning, noise abatement at airports, and enhancing airport capacity; (2) airway systems improvement, which includes air navigation and communications facilities and equipment, and instrument landing systems; (3) portions of administrative expenses which are attributable to activities under points (1) and (2); and (4) research, engineering and development, and demonstrations, which include projects relating to such activities as air traffic control, air navigation, aviation weather, aviation medicine, aircraft safety, environmental problems, and human factors.

Section 419 of the Federal Aviation Act of 1958, as amended, provides for subsidization of essential air services to an eligible point which is more than 45 highway miles from an airport hub and which has lost what is determined by the Secretary of Transportation to be essential air service. The Secretary is authorized to provide a reasonable amount of compensation to an air carrier which is selected to provide air services to an eligible point. Guidelines for determining compensation are to "include expense elements based upon representative costs of air carriers providing scheduled air transportation of persons, property, and mail, using aircraft of the type determined by the Secretary to be appropriate for providing such service."

Reasons for Change

The committee believes that Airport and Airway Trust Fund expenditure purposes should reflect current provisions in the Federal Aviation Act of 1958, as amended to date.

Explanation of Provision

The bill amends the expenditure purposes of the Airport and Airway Trust Fund to include the essential air services program which is authorized in section 419 of the Federal Aviation Act of 1958, as amended.

Effective Date

The provision applies to obligations incurred in fiscal years beginning after September 30, 1989.

12. Providing tolerance limits for blending of gasohol (sec. 6514 of the bill and sec. 4081 of the Code)

Present Law

Gasohol blenders which produce a blend containing 10 percent alcohol and 90 percent gasoline may receive a credit or refund of 6 cents per gallon of the 9 cents per gallon gasoline excise tax which is dedicated to the Highway Trust Fund.

Blenders have found in practise that it is difficult to achieve precisely the 10 percent alcohol content in a gasohol blend because of (1) mechanical imprecision in metering alcohol into a tankload of gasoline which can occur because the calibration of dispensing equipment may have become inexact during usage and (2) cut-off valves which do not respond instantaneously to mechanical or electronic signals to cease dispensing.

Reasons for Change

The committee believes that providing an allowance for error in mechanical and electronic delivery and blending devices recognizes the imprecision that characterizes those aspects of the gasohol industry.

Explanation of Provision

A range of tolerance of plus-or-minus one-tenth of one percent (+/– 0.1%) is considered as meeting the requirements of a gasohol blend of 10 percent alcohol, so long as over a reasonable period of time the average ratio of alcohol to gasoline is 10.0 percent. The Secretary is instructed to provide regulations governing the administration of this provision.

Effective Date

The provision is effective on January 1, 1990.

13. Refund procedure for gasoline used on farms by crop dusters (sec. 6515 of the bill and sec. 6420 of the Code)

Present Law

Crop dusters, who make aerial applications to farmers' crops, do not have to pay the excise tax on gasoline because the gasoline is not used on highways. In order to avoid payment of the gasoline tax, however, crop dusters must obtain a waiver from the farmer which provides that the farmer does not want the excise tax exemption and that the crop duster may claim it, even though the off-highway use took place on the farmer's land.

Crop dusters have found this procedure to be both burdensome and cumbersome, and have sought relief in favor of a process which allows them to claim an exemption for off-highway gasoline use directly without having to involve farmers in the process.

Reasons for Change

The committee believes that allowing crop dusters to apply for gasoline refunds directly will simplify administration of the gasoline tax for crop dusters, farmers, and the Internal Revenue Service.

Explanation of Provision

The provision will allow crop dusters to apply for gasoline tax refunds or purchase tax-free gasoline for off-highway farm use in aerial applications without having first to receive a waiver from a farmer.

Effective Date

The provision applies to gasoline purchased after December 31, 1989.

14. Alcohol fuels credit extended to production of ETBE (sec. 6516 of the bill and sec. 40 of the Code)

Present Law and Background

Ethanol and methanol used in a mixture with gasoline or diesel or special fuels are eligible for a tax credit of 60 cents per gallon. The credit may be taken by a manufacturer who sells the alcohol for use as a fuel or uses the alcohol himself as a fuel. Alcohol qualifying for the credit must be at least 190 proof and produced from substances other than petroleum, natural gas, or coal (including peat). A reduced credit of 45 cents per gallon is allowed for alcohol at least 150 proof but less than 190 proof. Adding any denaturant to alcohol is not treated as production of a gasohol mixture. The alcohol fuel credit and the reduced excise tax rates on gasohol mixtures may not be taken with respect to the same gallon of alcohol.

ETBE (ethyl tertiary butyl ether) has been developed for use as an alternative blending agent with gasoline and special fuels to produce an efficient and environmentally benign fuel mixture.

Reasons for Change

The committee believes that serious concerns about the dangers of environmental deterioration and the increasing U.S. dependence on imported oil require it to make available existing incentives to new technologies.

Explanation of Provision

Manufacturers of ETBE for use in making mixtures with gasoline, diesel, and special fuels are eligible for the 60 cents per gallon alcohol credit. The credit is not available to blenders, and ETBE fuel mixtures are not eligible for the 6 cents per gallon excise tax credit or refund available for qualified gasohol mixtures.

Effective Date

The amendment applies to taxable years beginning after December 31, 1989.

15. Eliminate excise tax on inactivated polio vaccine (sec. 6517(a) of the bill and sec. 4132 of the Code)

Present Law

An excise tax is imposed on the sale of a taxable vaccine by a manufacturer, producer, or importer of such vaccine (sec. 4131). Four vaccines are subject to excise tax at different rates including polio vaccine which is subject to a tax of 29 cents per dose.

The net revenues received from the excise tax on vaccines are deposited into the Vaccine Injury Compensation Trust Fund. Amounts in the trust fund are available, as provided through appropriations, for payment of compensation for vaccine-related injury or death through the National Vaccine Injury Compensation program. In particular, injuries or death resulting from anaphylaxis or anaphylatic shock of which the first manifestation occurs within 24 hours of the administration of inactivated polio vaccine (IPV) may be eligible for compensation under the program.

Reasons for Change

The committee understands that the risk of injury resulting from the administration of IPV is significantly less than from other types of polio vaccine. Therefore, the committee believes that the excise tax on IPV should be eliminated. However, the committee recognizes the importance of maintaining the funding level in the

Vaccine Injury Compensation Trust Fund and assuring that the burden of the excise tax is allocated fairly among different types of vaccines. Thus, the elimination of tax on IPV is effective only upon the elimination of IPV from the list of vaccines for which compensation may be payable under the National Vaccine Injury Compensation program.

Explanation of Provision

Inactivated poliovirus vaccine is excluded from the definition of polio vaccine for purposes of the excise tax on vaccines.

Effective Date

The provision is effective for vaccine sold on or after the date upon which any injuries or death resulting from the administration of IPV on and after such date are no longer eligible for compensation under terms of the National Vaccine Injury Compensation program.

16. Permit appropriations for administrative expenses from the Vaccine Injury Compensation Trust Fund (sec. 6517(b) of the bill and sec. 9510 of the Code)

Present Law

Amounts equivalent to the net revenues received in the Treasury from the excise tax imposed on certain vaccines (sec. 4131) are appropriated to the Vaccine Injury Compensation Trust Fund. Amounts from the Trust Fund are available, as provided in appropriations Acts, for the payment of compensation for vaccine-related injury or death.

Explanation of Provision

The provision permits amounts (but not to exceed $6 million annually) from the Trust Fund to be available, as provided in appropriations Acts, for the payment of administrative expenses of the National Vaccine Injury Compensation Program. The provision is effective for fiscal years beginning after September 30, 1989; actual payments are subject to the enactment of authorizing appropriations legislation.

Subtitle F. Certain Other Provisions

A. Like-Kind Exchanges: Restrict certain like-kind exchanges involving related parties (sec. 6601 of the bill and sec. 1031 of the Code)

Present Law

An exchange of property, like a sale, generally is a taxable transaction. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a "like-kind" which is to be held either for productive use in a trade or business or for investment (sec. 1031).

If related parties engage in a like-kind exchange that qualifies for nonrecognition treatment under section 1031, a subsequent disposition of the property by the transferee generally will not affect the nonrecognition treatment of the original exchange. In contrast, present law prevents the use of related party sales to avoid current recognition of gain in the case of installment sales. Under section 453 (relating to the installment method of reporting gain), if an installment sale between related parties is followed by certain dispositions of the property by the transferee, the gain reportable by the original seller will be accelerated.

Reasons for Change

Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. Basis shifting also can be used to accelerate a loss on retained property. The committee believes that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, "cashed out" of the investment, and the original exchange should not be accorded nonrecognition treatment.

Explanation of Provision

If a taxpayer exchanges property with a related party (as defined for purposes of sec. 267) and the taxpayer would otherwise be eligible for nonrecognition treatment with respect to the exchange of such property under section 1031, and within two years of the date of the last transfer which was part of the exchange, either the related party disposes of such property or the taxpayer disposes of the like-kind property received in the exchange from the related party, then the original exchange will not qualify for nonrecognition under section 1031. Any gain or loss not recognized by the taxpayer as of the date of the original exchange will, subject to the loss limitation rules of section 267, be recognized as of the date of the subsequent disposition. Adjustments to the basis of the properties involved in the exchange also will be made as of the date of the subsequent disposition.

A disposition of the property will not invalidate the nonrecognition treatment of the original exchange if such disposition is due to the death of either party or the involuntary conversion of the property (within the meaning of section 1033), provided that the original exchange occurred before the threat or imminence of the conversion. A disposition also will not invalidate the nonrecognition treatment of the original exchange if it is established to the satisfaction of the Secretary of the Treasury that neither the exchange nor the disposition had as one of its principal purposes the avoidance of Federal income tax. It is intended that the non-tax avoidance exception generally will apply to: (i) a transaction involving an exchange of undivided interests in different properties that results in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of such properties; (ii) dispositions of property in nonrecognition transactions; and (iii) transactions that do not involve the shifting of basis between properties.

A disposition includes indirect dispositions of the property, such as by means of the disposition of the stock of a corporation or interests in a partnership that owns the property.

Nonrecognition will not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of the related party rules. For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within two years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031.

The running of the two-year holding period will be suspended during any period with respect to which a party's risk of loss with respect to the property is substantially diminished.

Effective Date

The provision applies to transfers after July 10, 1989, other than transfers pursuant to a written binding contract in effect on July 10, 1989 and at all times thereafter before the transfer. For this purpose, a written contract which, on July 10, 1989, and at all times thereafter before the transfer, obligates the taxpayer to transfer the property to another party will not fail to qualify as a binding contract solely because it provides in the alternative for an exchange or a sale, or solely because the property to be received in the exchange was not identified on or before July 10, 1989.

B. Modifications to the Alternative Minimum Tax (sec. 6611 of the bill and secs. 53, 55–59 of the Code)

Present Law

Under present law, taxpayers are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax liability. The tax is imposed at a flat rate of 21 percent (20 percent in the case of corporations) on alternative minimum taxable income in excess of a phased-out exemption amount. Alternative minimum taxable income is the taxpayer's taxable income increased by the taxpayer's tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the exclusion or deferral of income resulting from the regular tax treatment of those items.

Adjustments and preferences are provided for accelerated depreciation, mining exploration and development costs, certain long-term contracts, pollution control facilities, certain installment sales, certain itemized deductions, research expenses and circulation expenses of individuals, Merchant Marine Capital Construction Funds, special insurance deductions, percentage depletion, excess intangible drilling costs over 65 percent of oil and gas income, certain debt reserves of financial institutions, tax-exempt interest on certain newly issued private activity bonds, and charitable deductions of appreciated property.

In addition, in computing corporate alternative minimum taxable income, for taxable years beginning before 1990, alternative minimum taxable income is increased by one-half of the amount by which the corporation's pre-tax book income exceeds the corporation's alternative minimum taxable income (determined without regard to this adjustment and without regard to net operating losses). Book income generally is the amount that the corporation discloses on its financial statements prepared for creditors, shareholders, regulatory purposes, and so forth.

For taxable years beginning after 1989, the adjustment for book income no longer applies, and, instead, alternative minimum taxable income is increased by 75 percent of the amount by which adjusted current earnings (ACE) exceed alternative minimum taxable income (determined without regard to this adjustment and without regard to net operating losses). In general, adjusted current earnings means alternative minimum taxable income as computed above with additional adjustments. These adjustments generally follow the rules presently applicable to corporations in computing their earnings and profits.

Also, net operating losses, foreign tax credits, and investment tax credits cannot be used to offset, in the aggregate, more than 90 per-

22-661 O—89——6

cent of the pre-foreign tax credit tentative minimum tax which would otherwise be imposed.

Where a taxpayer pays the alternative minimum tax, the amount of tax paid (to the extent attributable to timing differences with the regular tax) is allowed as a credit against the regular tax in future years. This credit (known as the minimum tax credit) cannot be used to reduce tax below the tentative minimum tax in subsequent years.

Reasons for Change

The committee bill makes several modifications to improve and simplify the alternative minimum tax.

Explanation of Provisions

The committee bill makes the following changes to the alternative minimum tax:

(1) The dividends-received deduction under ACE is extended to dividends (other than 100-percent dividends) received from 20-percent owned corporations (as defined in sec. 243(c)(2)).

(2) Gain on installment sales with respect to which interest is paid at the tax underpayment rate is reported on the installment method for adjusted current earnings purposes because appropriate interest is being paid for the right to defer payment of the tax.[59]

(3) The bill provides that for corporate alternative minimum tax arising in taxable years beginning after December 31, 1989, the entire amount of alternative minimum tax (rather than only the amount of tax attributable to deferral preferences) may be taken into account in computing the amount of the alternative minimum tax credit available in future years.

(4) The bill provides that the preference for gifts of appreciated property will not apply to gifts made during the taxpayer's taxable year beginning in 1990. (The preference will continue to apply to gifts made in taxable years beginning after 1990.)

Effective Date

Except as otherwise described above, the provisions apply to taxable years beginning after December 31, 1989.

---

[59] In another provision of this bill, the regular tax treatment of installment sales of timeshares and residential lots by C corporations has been changed to provide for an interest charge at the tax underpayment rate for the right to defer the payment of tax on income from such sales.

C. Accounting Provisions

1. Long-term contracts

a. Repeal of the completed contract method of accounting for long-term contracts (sec. 6621 (a) 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 either the percentage of completion method or the percentage of completion-capitalized cost method. However, exceptions to these required accounting methods are provided for certain construction contracts of small businesses and certain home construction contracts.

Under the percentage of completion-capitalized cost method, a taxpayer generally must take into account 90 percent of the items under the contract under the percentage of completion method. The remaining 10 percent of the items under the contract must be taken into account under the taxpayer's normal method of accounting (e.g., the completed contract method of accounting). Exceptions to the 90/10 requirement are provided for certain ship construction contracts (40 percent under the percentage of completion method and 60 percent under the taxpayer's normal method of accounting) and certain residential construction contracts other than home construction contracts (70 percent under the percentage of completion method and 30 percent under the taxpayer's normal method of accounting).

Explanation of Proposal

The percentage of completion-capitalized cost method of accounting for long-term contracts would be repealed. The present-law special rules and exceptions for certain construction contracts of small businesses, qualified ship contracts, home construction contracts and residential construction contracts would be retained.

Effective Date

The proposal would apply to contracts entered into on or after July 11, 1989. However, the proposal would not apply to any contract entered into pursuant to a written bid or proposal submitted by a taxpayer to the other party to the contract before July 11, 1989, if the bid or proposal could not have been revoked or amended by the taxpayer at any time during the period after July 10, 1989, and ending on the date that the contract was entered into.

b. Modification of the percentage of completion method of accounting for long-term contracts and study of the treatment of long-term contracts (sec. 6621(b) of the bill and sec. 460 of the Code)

Present Law

Taxpayers engaged in the production of property under a long-term contract must compute income from the contract under either the percentage of completion method or the percentage of completion-capitalized cost method. Exceptions to these required accounting methods are provided for certain construction contracts of small businesses and certain home construction contracts.

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 (1) the gross contract price and (2) the percentage of the contract completed as of the end of the taxable year. The percentage of the contract completed as of the end of a taxable year is determined by comparing costs incurred with respect to the contract as of the end of the year with the estimated total contract costs. In addition, under the percentage of completion method, costs allocable to the contract generally are taken into account for the taxable year in which incurred.

Reasons for Change

The committee is concerned that the percentage of completion method of accounting may require taxpayers to recognize income under a long-term contract even though little, if any, progress has occurred in manufacturing or constructing the items required to be provided under the contract. For example, the committee is concerned that under the percentage of completion method of accounting, the mere delivery of materials or supplies that are to be used in manufacturing or constructing items under a long-term contract generally results in the recognition of income under the contract. To address this concern, the committee believes that taxpayers should be allowed to elect to postpone the recognition of income under a long-term contract and the deduction of costs allocable to the contract until the first taxable year as of the end of which at least 15 percent of the estimated total contract costs have been incurred.

In addition, the committee believes that the Treasury Department should be required to study the proper treatment of long-term contracts for Federal income tax purposes and to report the results of the study to the House Ways and Means Committee and the Senate Finance Committee by February 28, 1990.

Explanation of Provisions

Modification of the percentage of completion method of accounting for long-term contracts

For purposes of the percentage of completion method of accounting for long-term contracts, a taxpayer may elect not to recognize income under a long-term contract and not to take into account any costs allocable to such long-term contract for any taxable year if as of the end of the taxable year less than 15 percent of the estimated total contract costs have been incurred. For the first taxable year in which the 15-percent threshold is satisfied, all costs that have been incurred as of the end of the taxable year are to be taken into account in determining the percentage of the contract that has been completed and in determining the amount of allowable deductions under the contract.

The election not to recognize income under a long-term contract and not to take into account any costs allocable to such contract until the first taxable year as of the end of which at least 15 percent of the estimated total contract costs have been incurred is to apply for purposes of the look-back method,[60] in determining alternative minimum taxable income, and in determining adjusted current earnings under the alternative minimum tax. The election is not to apply, however, in determining whether an item normally requires more than 12 calendar months to complete for purposes of the definition of a long-term contract or in determining the production period for the allocation of interest.

The election is to apply to all long-term contracts of a taxpayer that are entered into during the taxable year that the election is made and any subsequent taxable year that the election is in effect.[61] The election, however, is not to apply to any long-term contract with respect to which the percentage of completion method of accounting is used only with respect to a portion of the items under the contract or with respect to which a simplified method of cost allocation is used. Once made, the election may be revoked only with the consent of the Secretary of the Treasury.

Study of the treatment of long-term contracts

The Treasury Department is required to study the revenue realization method of accounting for long-term contracts and possible improvements to the percentage of completion method of accounting for long-term contracts. A report on the results of the study are to be submitted to the House Ways and Means Committee and the Senate Finance Committee by February 28, 1990.

Effective Date

The provision applies to contracts that are entered into after December 31, 1989.

---

[60] Consequently, in allocating income under the contract on the basis of actual contract price and actual contract costs for purposes of the look-back method, costs are not to be taken into account for any taxable year if as of the end of the taxable year less than 15 percent of the actual total contract costs have been incurred. In addition, unlike present law, deductions under a contract are to be allocated to a different taxable year for purposes of the look-back method if the first taxable year as of the close of which 15 percent of the total actual contract costs have been incurred differs from the first taxable year as of the close of which 15 percent of the total estimated contract costs have been incurred.

[61] It is anticipated that the Treasury Department will provide guidance on the time and manner of making the election. In addition, it is anticipated that a taxpayer will be required to obtain the consent of the Internal Revenue Service in order to discontinue the use of the election for any taxable year for contracts entered into during such year and any subsequent year.

2. Treatment of franchises, trademarks, and trade names (sec. 6622 of the bill and sec. 1253(d) of the Code)

Present Law

A taxpayer that purchases an intangible asset (such as a patent, know-how, or a contract right) is generally allowed a deduction for the purchase price over a period no shorter than the useful life of the asset. If the life is not determinable or is perpetual, no deduction is generally permitted. The useful life of an asset is a question of fact. If payments are made on a recurring basis over the life of an asset in a manner that does not distort income (*e.g.*, contingent payments made under a fixed formula for the life of an asset), a deduction may be allowed as the payments are made.[62]

A taxpayer that leases an asset and pays continuing rents or royalties (*e.g.*, a recurring annual percentage of sales) is generally allowed a deduction as the rents or royalties are paid. If the lessee makes a payment of an initial fixed sum at the start of the lease, a deduction is generally allowed for the payment over the life of the lease. The life of the lease is also a question of fact.

Section 1253(d)(2) of the Code provides special rules for fixed-sum amounts paid to acquire a franchise, trademark, or trade name, in cases where the transferor is required to treat the payment as ordinary income (*i.e.*, as similar to a lease payment) rather than as capital gain (*i.e.*, as a sale payment). In the case of a single payment made in discharge of a fixed-sum amount, section 1253(d)(2)(A) permits such payment to be deducted ratably over no more than 10 taxable years, regardless of the life of the asset. As interpreted by the Internal Revenue Service,[63] this provision also applies to a franchise that is transferred by a franchisee to another person, even though the transfer is considered the sale of a capital asset. In the case of a series of payments made in discharge of a fixed-sum amount, section 1253(d)(2)(B) allows a deduction as the payments are made provided the payments are approximately equal and are made over the period of the transfer agreement or over a period of more than 10 taxable years.

Generally, amounts allowed as a deduction that reduce the basis of assets are recaptured as ordinary income if the asset is disposed of for an amount in excess of the reduced basis. Amounts allowed as a deduction under section 1253(d)(2) reduce basis under present law. However, it is unclear whether such deductions are required by the Code to be recaptured as ordinary income on disposition of the asset. It is also unclear to what extent judicially developed tax-benefit principles may require recapture.

Section 1253(d)(1) provides special rules for the deduction of certain contingent amounts that are paid or incurred on account of the transfer of a franchise, trademark, or trade name. Under these rules, any amount paid or incurred for the transfer, sale, or other disposition of a franchise, trademark, or trade name that is contingent on the productivity, use, or disposition of the asset transferred is allowed as an ordinary and necessary business expense deduc-

[62] *See, e.g., Associated Patentees, Inc.*, 4 T.C. 979 (1945).
[63] Rev. Rul. 88-24, 1988-1 C.B. 306.

tion. The transferor of the franchise, trademark, or trade name must treat such amount as an amount that is received from the sale of property that is not a capital asset (sec. 1253(c)).

Section 167(r), as added to the Code by the Technical and Miscellaneous Revenue Act of 1988, provides that no depreciation or amortization deduction is permitted for costs of acquiring trademarks or trade names. In addition, several courts have held that costs of creating or acquiring trademarks or trade names are not amortizable on the grounds that such assets are indistinguishable from goodwill and generally do not have a determinable useful life.[64]

Reasons for Change

The committee believes that permitting a deduction for the cost of acquiring a franchise, trademark, or trade name over a period that is no longer than 10 years may be too favorable for franchises, trademarks, and trade names that in many instances may have a perpetual of indefinite useful life.

Consequently, in the case of fixed-sum payments, the committee believes that the present-law 10-year rule is appropriate only in the case of a transfer where the fixed-sum amount is *de minimis* (for this purpose, under $100,000). In case of contingent payments, the committee believes it is appropriate to permit a deduction for such payments only if the payments are made over the period that the use of the franchise, trademark, or trade name occurs and only if the payments are made in a manner that does not distort income. The committee is concerned that some taxpayers may be deducting relatively short-term or front-loaded contingent payments in the year of payment rather than over the period that the use of the franchise, trademark, or trade name occurs.

Finally, the committee believes that all payments made on account of the transfer of a franchise, trademark, or trade name other than serial contingent payments that are allowed as a deduction for the taxable year in which paid or incurred should be subject to the recapture rules that generally apply upon the disposition of an asset.

Explanation of Provision

The bill modifies the special rules that apply to the deduction of fixed-sum payments and contingent payments that are made on account of the transfer of a franchise, trademark, or trade name. First, the bill repeals the special treatment accorded payments in discharge of a fixed-sum amount where the fixed-sum amount for any transaction exceeds $100,000. This repeal applies regardless of whether the payments are made to a franchisor that is required to treat the payments as ordinary income by reason of section 1253(a) or to any other person. For purposes of determining whether the $100,000 threshold has been exceeded, all payments that are part of the same transaction (or a series of related transactions) are aggregated.

---

[64] *See, e.g., Renziehausen* v. *Lucas*, 280 U.S. 387 (1930); *Norwich Pharmacal Co.*, 30 B.T.A. 326 (1934); *H.M. Stiles*, 26 T.C.M. 501 (1967); *see also, Illinois Cereal Mills, Inc.*, 46 T.C.M. 1001 (1983).

In addition, the bill modifies the rules that allow a deduction for contingent amounts that are paid or incurred on account of the transfer of a franchise, trademark, or trade name. Under the bill, a deduction is allowed for contingent amounts only if (1) the contingent amounts are paid as part of a series of payments that are payable at least annually throughout the term of the transfer agreement,[65] and (2) the payments are substantially equal in amount (*i.e.*, the agreement requires a continuing payment of a substantially equal amount annually throughout an unspecified period over which the use of the property will occur) or are payable under a fixed formula (*i.e.*, a formula that provides for payment of an unvarying percentage of receipts over the entire term of the transfer agreement).

Any fixed-sum or contingent amount that is not deductible under the foregoing rules is chargeable to capital account and is to be amortized over the useful life of the franchise, trademark, or trade name, to the extent otherwise allowed under present law.[66] Alternatively, a taxpayer may elect to amortize certain fixed-sum payments and contingent payments that are chargeable to capital account and that are part of the same transaction (or a series of related transactions) over a 20-year period that begins with the taxable year in which the transfer occurs. The fixed-sum payments that are eligible for 20-year amortization are to include only those payments that would be deductible under section 1253(d)(2) but for the $100,000 limitation.

The bill also provides that fixed-sum amounts that are allowed as a deduction under the special rules of section 1253(d)(2) and amounts with respect to which an amortization deduction is allowed are subject to recapture as ordinary income on disposition of the franchise, trademark, or trade name. No inference is intended as to the recapture requirements of prior law.

The term of the transfer agreement and the period of amortization is to be determined by taking into account all renewal options and any other period for which the parties reasonably expect the agreement to be renewed. No inference is intended as to the term of the transfer agreement or the period of amortization under prior law.

Finally, the bill repeals section 167(r). However, no inference is intended as to whether amortization or depreciation may be taken with respect to trademarks and trade names in the absence of that provision. It is expected that no deduction will be allowed for any amount chargeable to capital account for an asset that is indistinguishable from a payment for goodwill or, except as otherwise permitted under the provision, for any amount that is payment for an asset with an indeterminate useful life.

---

[65] The term of the transfer agreement for this purpose is the entire period over which the franchise, trademark, or trade name, or rights to use or benefit from the franchise, trademark, or trade name, are transferred. For example, if a trademark is transferred for an unlimited period pursuant to an agreement that requires contingent payments for a limited period, the term of the transfer agreement is the entire period for which the trademark is transferred and not the period over which contingent payments are to be made. In such a case, the contingent payments would not be deductible under section 1253(d)(1).

[66] Contingent payments that are not deductible under the foregoing rules are chargeable to capital account for the taxable year in which paid or incurred.

Effective Date

The provision applies to transfers that occur after October 2, 1989, unless pursuant to a binding written contract in effect on that date and at all times thereafter until the transfer occurs.

3. Treatment of certain payments received as a result of crop losses due to drought conditions (sec. 6623 of the bill and sec. 451(d) of the Code)

Present Law

A cash method taxpayer who receives insurance proceeds as a result of the destruction of, or damage to, crops may elect to include the proceeds in income for the taxable year following the year in which the destruction or damage occurs if, under the taxpayer's practice, income from such crops would have been included for a year following the year in which the destruction or damage occurred. For this purpose, payments received under the Agricultural Act of 1949, as amended, or Title II of the Disaster Assistance Act of 1988, as a result of the destruction of, or damage to, crops caused by drought, flood, or other natural disaster or the inability to plant crops because of such natural disaster are treated as insurance proceeds received as a result of the destruction of, or damage to, crops.

Reasons for Change

The committee understands that there is no significant economic difference between payments received under the Disaster Assistance Act of 1989 and payments received under the Agricultural Act of 1949 or Title II of the Disaster Assistance Act of 1988. The committee therefore believes that they should be treated in the same manner.

Explanation of Provision

Payments received under the Disaster Assistance Act of 1989 (P.L. 101-82) are treated in the same manner as payments received under the Agricultural Act of 1949 or Title II of the Disaster Assistance Act of 1988.

Effective Date

The provision applies to payments received before, on, or after the date of enactment.

4. Modify treatment of discharge of farm indebtedness for certain solvent farmers (sec. 6624 of the bill and sec. 108(g) of the Code)

Present Law

Gross income generally includes income from the discharge of indebtedness (sec. 61(a)(12)). If an insolvent taxpayer realizes income from discharge of indebtedness, however, the income is excluded and certain tax attributes of the taxpayer (including items such as net operating loss carryovers and basis in property) generally are reduced by the excluded amount. The exclusion is limited to the amount by which the taxpayer is insolvent. If an insolvent taxpayer's discharge of indebtedness income (not in excess of the amount by which the taxpayer is insolvent) exceeds these tax attributes, the excess is forgiven, i.e., is not includible in gross income (sec. 108).

In the case of a solvent taxpayer who realizes income from the discharge by a "qualified person" of "qualified farm indebtedness," [67] the taxpayer may exclude from gross income an amount of such discharge income not in excess of the sum of the taxpayer's loss and credit carryovers and the taxpayer's basis in property held for use in a trade or business or for the production of income. If there is any remaining discharge of indebtedness income after the taxpayer has reduced these tax attributes, income will be recognized.

The exclusion of discharge of indebtedness income generally is not limited in cases of bankruptcy. Any capital gain realized by a taxpayer, however, is not excluded by reason of bankruptcy.

Reasons for Change

The committee believes that, by permitting certain solvent farmers to exclude discharge of qualified farm indebtedness income up to a specified dollar amount (rather than to the extent of a farmer's tax attributes), such farmers will not be forced to declare bankruptcy solely to achieve more favorable tax treatment with respect to such discharge income.

Explanation of Provision

Farmers meeting certain requirements can exclude income from discharge of qualified farm indebtedness, but not in excess of $350,000. The provision applies to a taxpayer that meets all of the following requirements: (1) the taxpayer's adjusted gross income (with certain modifications) in 6 of the 10 taxable years preceding the year of discharge is less than the national median adjusted gross income for each of such years; (2) more than 50 percent of the taxpayer's gross receipts for 6 of the 10 taxable years preceding the year of discharge is attributable to the farming business, the sale or lease of assets used in farming, or both; (3) the taxpayer materially participated in the farming business at the time the farm indebtedness was incurred; (4) the amount of equity in all property held by the taxpayer after the discharge is less than the greater of (a) $25,000 or (b) 150 percent of the excess of the tax that would be due if section 108 of the Code did not apply, over the tax that would be due if section 108 did apply; (5) the taxpayer's indebtedness both before and after the discharge is equal to 70 percent or more of the equity in all property held by the taxpayer; and (6) if the taxpayer transfers property to discharge the qualified farm indebtedness, only farm property is transferred.

---

[67] Qualified farm indebtedness is indebtedness incurred directly in connection with the operation of a farming business by a taxpayer who satisfies a specified gross receipts test. A qualified person is one regularly engaged in the business of lending money and meeting certain other requirements.

Thus, for example, a solvent farmer satisfying the requirements described above who realizes $400,000 of discharge of qualified farm indebtedness income and who has $200,000 of tax attributes, can exclude $350,000 of the discharge income under the provision. The farmer's tax attributes would be reduced to zero, and the farmer would recognize $50,000 of discharge of indebtedness income.

The $350,000 limit is reduced by prior year exclusions of discharge of qualified farm indebtedness income under this provision.

The provision does not modify the present-law rule that generally limits the exclusion of discharge of qualified farm indebtedness income to the sum of the taxpayer's loss and credit carryovers and the taxpayer's basis in certain property, in the case of a solvent farmer who does not satisfy the requirements described above. In addition, the provision does not provide for an exclusion of capital gain that may be realized by a farmer who transfers property to a creditor in exchange for the satisfaction of an indebtedness.

Effective Date

The provision applies to discharges of indebtedness occurring after December 31, 1986, in taxable years ending after such date.

5. Contributions in aid of construction of alternative water supplies (sec. 6625 of the bill and sec. 118 of the Code)

Present Law

Contributions in aid of construction received by a public utility are treated as gross income of the utility and not as contributions to the capital of the utility. Consequently, a utility is required to include in gross income the value of any property (including money) that it receives to provide, or to encourage it to provide, services to, or for the benefit of, any person transferring property to the utility. A utility is considered as having received property to encourage the provision of services if the receipt of the property is a prerequisite to the provision of services, if the receipt of the property results in the provision of services earlier than would have been the case had the property not been received, or if the receipt of the property otherwise causes the transferor to be favored in any manner.

Reasons for Change

In order to encourage the provision of alternative water supplies as a means of remedying environmental contamination, the committee believes that it is appropriate to provide favorable income tax treatment with respect to certain amounts received by certain public utilities from a Federal, State or local government.

Explanation of Provision

A contribution of money or other property by a Federal, State or local government (or a political subdivision thereof) to a regulated public utility that provides water or sewage disposal services is treated as a contribution to capital and not as an item of gross income if the contribution is a contribution in aid of construction with respect to property that will be used predominantly in furnishing alternative water supplies for purposes of remedying environmental contamination or protecting the health of individuals threatened by environmental contamination. This treatment is to apply only if the contribution (or any property acquired or constructed with the contribution) is not included in the utility's rate base for ratemaking purposes and the contribution is used for the purposes specified above before the end of the second taxable year after the year in which the contribution is received.

No deduction or credit is allowed with respect to any expenditure that constitutes a contribution to capital under the provision and the adjusted basis of any property acquired by such an expenditure is zero. Finally, the Treasury Department is to issue regulations that define the term contribution in aid of construction, but in no event is such term to include amounts paid as customer connection fees.

Effective Date

The provision is effective as if included in the Tax Reform Act of 1986.

6. Modify material participation for certain timber activities of individuals under the passive loss rules (section 6626 of the bill)

Present Law

Present law, as amended by the 1986 Act, provides that deductions from passive trade or business activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income. Suspended losses are carried forward and treated as deductions from passive activities in the next year. Suspended losses are allowed in full when the taxpayer disposes of his entire interest in the activity to an unrelated party in a transaction in which all realized gain or loss is recognized. The provision applies to individuals, estates, trusts, and personal service corporations. A special rule limits the use of passive activity losses and credits against portfolio income and tax attributable to portfolio income in the case of closely held corporations.

An activity generally is treated as passive if it is a rental activity, or if the taxpayer does not materially participate in it, i.e., the taxpayer is not involved in the operations of the activity on a basis which is regular, continuous, and substantial.

Under temporary and proposed Treasury regulations, a taxpayer may meet any of several tests for material participation, including a test based on all of the facts and circumstances (Temp. Treas. Reg. Section 1.469-5T(a)(7)). If an individual participates in an activity for 100 hours or less during the taxable year, the regulations provide that such individual shall not be treated as materially participating under the facts and circumstances test (Temp. Treas. Reg. section 1.469-5T(b)(2)(iii)).

The regulations further provide that an individual's services performed in the management of an activity shall not be taken into account in determining whether such individual is treated as materially participating under the facts and circumstances test, unless, for such taxable year, (i) no person (other than such individual) who performs services in connection with the management of the activity receives compensation that is earned income in consideration for such services; and (ii) no individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual (Temp. Treas. Reg. section 1.469-5T(b)(2)(ii)). The fact that an individual satisfies the requirements of any participation standard under any provision other than section 469 and the regulations thereunder also is not taken into account (Temp. Treas. Reg. section 1.469-5T(b)(2)(i)).

Reasons for Change

The committee believes that the passive activity rules as described in Temp. Treas. Reg. Section 1.469-5T(b)(2)(iii) are not appropriate in the case of certain timber activities. The growing of timber is a long process, often spanning many decades. It is a common practice among small woodlot owners to hire independent contractors for their technical expertise, manpower or specialized equipment to perform certain tasks necessary for efficient woodlot operation. The owner's tasks may not consume as much as 100 hours in a particular year. Due to these special circumstances, the committee believes that individual woodlot owners should be permitted to determine material participation in a timber activity on the facts and circumstances basis regardless of whether they participate less than 100 hours during the year.

Explanation of Provision

Under the bill, an individual's material participation in certain timber activities may be determined under the facts and circumstances test in the regulations even though the individual participates in the activity for 100 hours or less during the taxable year.

For this purpose, a timber activity means any activity that consists predominantly of holding qualified timber property as defined in section 194(c)(1), i.e., a woodlot or other site located in the United States that will contain trees in significant commercial quantities and that is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products.

This provision may be illustrated as follows.

For example, an individual owns an 80-acre tract of timber near her home. She hires the services of a professional forester to whom she delegates all responsibility for managing the timber. These responsibilities include, from time to time, making and implementing decisions with respect to the harvest or sale of timber (including pricing and frequency of any sales), regeneration activities and protective fire and pest control procedures. The forester carries out these responsibilities. After doing so, the forester regularly informs the individual of his decisions. She pays the expenses relating to the actions undertaken by the forester. Based upon these facts, the individual is not considered to materially participate in the timber growing activity.

As an additional example, an individual owns 80 acres of timber. He is solely responsible for managing the timber property. His responsibilities include making decisions with respect to the harvest or sale of timber (including pricing and frequency of any sales), regeneration activities and protective fire and pest control procedures. He performs periodic inspections of his property; during some periods, these inspections occur annually, while at other times during the timber's growing cycle, they may occur more or less frequently, depending upon the requirements of the property. He maintains records with respect to his property, and pays various expenditures in connection with his timber over a period of years, such as those for construction of fire breaks and maintenance of boundary lines, as appropriate. This work is carried out by independent contractors selected by the individual. He is considered to materially participate with respect to the timber growing activity.

In another example, B owns 1,000 acres of timber. B enters into a long-term lease contract with X, a corporation dealing in timber products. Pursuant to this agreement, X has the exclusive right to manage the property. Under the arrangement, X has the right to cut timber as it sees fit. X promises to return the property to B at the end of the term and warrants that it shall then contain as much or more timber as it did at the beginning of the term. X agrees to pay annual rental to B. B agrees to remain liable for, and pays, property taxes with respect to the leased property. B is not considered to materially participate with respect to this timber growing activity.

Effective Date

The provision is effective for taxable years beginning after December 31, 1989.

7. Treatment of certain crops under the annual accrual method of accounting (sec. 6627 of the bill and sec. 447(g) of the Code)

Present Law

Present law provides an exception to the uniform cost capitalization rules for certain corporations and qualified partnerships that are permitted to use the annual accrual method of accounting with respect to the trade or business of farming sugar cane. Under the annual accrual method of accounting, revenues, costs, and expenses are determined under an accrual method of accounting and the preproductive period expenses incurred during any taxable year are charged to harvested crops or are deducted in determining taxable income for such year.

Reasons for Change

The committee believes that any taxpayer that has traditionally been allowed to use the annual accrual method of accounting with respect to any crop should be allowed to continue to use such method of accounting with respect to such crop.

Explanation of Provision

Any corporation or qualified partnership that, for its last taxable year ending before January 1, 1987, was allowed to use, and actually used, the annual accrual method of accounting with respect to any crop is allowed to continue to use such method of accounting with respect to such crop. It is anticipated that any corporation or qualified partnership that changed its method of accounting for its first taxable year ending after December 31, 1986, and is permitted to use the annual accrual method of accounting only by virtue of this provision will be allowed to use the annual accrual method of accounting for such year by filing an amended return before the date that is one year after the date of enactment of the bill.

Effective Date

The provision is effective as if included in the Tax Reform Act of 1986.

8. Installment sales treatment of timeshares and residential lots sold by C corporations (sec. 6628 of the bill and secs. 56, 453, and 453A of the Code)

Present Law

A taxpayer who disposes of a timeshare or a residential lot on the installment plan generally may report income derived from such a disposition on the installment method if the taxpayer elects to pay interest on the amount of deferred tax that is attributable to the use of the installment method. Under this election, interest is required to be paid for any taxable year that payments are received under the installment obligation (other than the taxable year in which the sale occurs). The interest is imposed for the period that begins on the date of the sale of the timeshare or the residential lot and ends on the date that each payment is received. The interest rate used for this purpose is the applicable Federal rate (compounded semiannually) in effect at the time of the sale for debt instruments with the same maturity as the installment obligation.

A taxpayer who elects to pay interest with respect to an installment sale of a timeshare or a residential lot may use the installment method in determining alternative minimum taxable income. However, for purposes of the adjusted current earnings provision of the alternative minimum tax, the installment method may not be used in determining income derived from an installment sale (including a nondealer installment sale of property) even though interest is required to be paid with respect to all or a portion of the deferred tax that is attributable to the use of the installment method. The adjusted current earnings provision of the alternative minimum tax applies to C corporations for taxable years beginning after December 31, 1989.

Reasons for Change

The committee believes that present law does not provide for an appropriate interest charge on the deferred tax that is attributable to the use of the installment method for dispositions of timeshares and residential lots. For this reason, the bill modifies the amount of interest that is payable by a C corporation that elects to use the installment method with respect to a disposition of a timeshare or a residential lot.

In addition, the committee believes that if a taxpayer pays an appropriate amount of interest on the amount of deferred tax that is attributable to the use of the installment method, then the installment method should be available for all purposes of the alternative minimum tax including the adjusted current earnings provision of the alternative minimum tax.

Explanation of Provision

The bill modifies the amount of interest that is payable by a C corporation that elects to use the installment method with respect to an installment sale of a timeshare or a residential lot. Under the bill, the amount of interest for any taxable year is determined for all outstanding installment obligations with respect to which an election was made by multiplying the deferred tax with respect to all such obligations by the underpayment rate in effect for the month with or within which the taxable year ends.

For any taxable year, the deferred tax for such obligations equals (1) the amount of gain under the obligations that has not been recognized as of the close of the taxable year, multiplied by (2) the maximum rate of tax in effect for such taxable year for C corporations.

A C corporation, however, may elect with respect to all such installments obligations to determine the deferred tax under an alternative procedure that is to be considered a method of accounting which must be consistently used from one taxable year to the next. Under this alternative procedure, the deferred tax is determined for a taxable year by first multiplying (1) the amount of gain under the obligations that has not been recognized as of the close of the taxable year reduced by the excess (if any) of the total allowable deductions for such year over the total income for such year, by (2) the maximum rate of tax in effect for such taxable year for C corporations. The result is then reduced by the excess (if any) of the amount of allowable nonrefundable income tax credits for such year over the amount of the regular tax liability for such year.

Net operating loss carrybacks and credit carrybacks are not taken into account in determining the amount of the deferred tax for any year. Net operating loss carryovers and credit carryforwards, however, are taken into account in determining the amount of the deferred tax for any year.

Any interest determined under the proposal is treated as a tax imposed for the taxable year following the year in which the interest is determined. The portion of the interest, however, that is allocable to installment obligations that have not been outstanding for a two-year period as of the close of the taxable year or that are in default as of the close of the taxable year is not to result in an increase in tax for such taxable year. Instead, if such installment obligations are not in default at the close of any taxable year after the end of the two-year period, the amount of interest that was determined under the proposal but was not added to tax is to be added to tax for the first taxable year following such year (together with additional interest at the underpayment rate for each year that the interest has not been added to tax). For this purpose, an installment obligation is to be considered in default if the installment obligation is considered to be wholly worthless under the bad debt provisions of section 166(a)(1) of the Code.

The interest determined under the proposal is treated as tax for purposes of the estimated tax provisions applicable to corporations. In addition, the interest is to be considered accrued for the taxable year in which the interest is added to tax and is to be treated as an allowable deduction for such year in determining the deferred tax under the elective procedure.

A C corporation that elects to pay interest under the proposal with respect to an installment sale of a timeshare or a residential lot is allowed to use the installment method for purposes of the adjusted current earnings provision of the alternative minimum tax. In addition, for purposes of the adjusted current earnings provision of the alternative minimum tax, a taxpayer that is required to pay interest with respect to a nondealer disposition of property is allowed to use the installment method for the portion of the gain with respect to which interest is required to be paid.

Effective Date

The provision applies to dispositions occurring in taxable years beginning after December 31, 1989.

9. Treatment of certain large family farm corporations (sec. 6629 of the bill and sec. 447(i) of the Code)

Present Law

The Revenue Act of 1987 required a family corporation (or a partnership with a family corporation as a partner) to use an accrual method of accounting with respect to its farming business unless, for each prior taxable year beginning after December 31, 1985, such corporation (and any predecessor corporation) did not have gross receipts exceeding $25 million.

A corporation or partnership that is required to change to an accrual method of accounting as a result of the Revenue Act of 1987 may establish a suspense account in lieu of taking the entire amount of the section 481 adjustment into income. The amount of the suspense account is limited to the lesser of (1) the section 481 adjustment otherwise required to be taken into income or (2) the section 481 adjustment computed as if the change in method of accounting had occurred as of the beginning of the taxable year preceding the year of change.

The balance of the suspense account is required to be included in income for the year that the corporation ceases to be a family corporation or the year that the required level of control of the corporation is transferred outside the family group that owned the corporation on December 15, 1987. Also, if the gross receipts of the corporation attributable to farming for any taxable year decline to an amount below the lesser of (1) the gross receipts attributable to farming for the last taxable year for which an accrual method of accounting was not required or (2) the gross receipts attributable to farming for the most recent taxable year for which a portion of the suspense account was required to be included in income, a portion of the suspense account proportionate to such decline is taken into income.

Reasons for Change

In order to address the possibility that a significant portion of the suspense account of a family farm corporation may be included in gross income due solely to farm price reductions, the committee believes that it is appropriate to provide an elective method of taking into account the amount of the section 481 adjustment that results from changing to an accrual method of accounting due to the family farm provisions of the 1987 Act.

Explanation of Provision

A corporation or partnership that is required to change to an accrual method of accounting by reason of the family farm provisions of the Revenue Act of 1987 may elect for its first taxable year that it is required to use an accrual method of accounting to include the amount of the section 481 adjustment in gross income ratably over a 10-year period beginning with such taxable year. In the case of a corporation or partnership that ceases to exist prior to the end of the 10-year period, the balance of the section 481 adjustment is to be included in gross income for the last taxable year of the corporation or partnership.

It is anticipated that a corporation or partnership that has already filed a return for the first taxable year that it is required to change to an accrual method of accounting by reason of the family farm provisions of the 1987 Act will be allowed to elect to include the amount of the section 481 adjustment in gross income over a 10-year period by filing an amended return for such year on or before the date that is one year after the date of enactment of the bill.

Effective Date

The provision is effective as if included in the Revenue Act of 1987.

10. Treatment of gain or loss on sale of assets by cooperative associations (sec. 6630 of the bill and sec. 1388 of the Code)

Present Law

In general

A cooperative association is a corporation operating on a cooperative basis and allocating amounts to patrons on the basis of the business done with or for such patrons (Code sec. 1381). Unlike other corporations, a cooperative association is allowed to exclude from its taxable income any amounts of patronage dividends paid to its members or patrons or in redemption of a nonqualified written notice of allocation (sec. 1382). Additionally, cooperative associations may exclude income attributable to qualified per-unit retain certificates and amounts paid for redemptions of nonqualified per-unit retain certificates. A per-unit retain allocation is, in general, an amount retained by the cooperative association with respect to goods marketed by the cooperative association for the patron.

Treatment of patronage dividends by members and patrons

Members of a cooperative association who receive patronage dividends must treat the dividends as income, reduction of basis, or some other treatment that is appropriately related to the type of transaction that gave rise to the dividend. For example, where the cooperative association markets a product for one of its members, patronage dividends attributable to the marketing are treated like additional proceeds from the sale of the product and are includible in the recipient's income. Where the cooperative association purchases equipment for its members, patronage dividends attributable to equipment purchases are treated as a reduction in the recipient's basis in the purchased equipment (provided the recipient still owns the equipment).

Definition of patronage dividend

In general, a patronage dividend means an amount paid to a patron (1) on the basis of the quantity or value of business done with or for such patron, (2) under an obligation of the cooperative association to pay such amount, which obligation existed before the association received the amount so paid, and (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons. ". . . Such term does not include any amount paid to a patron to the extent that such amount is out of earnings other than from business done with or for patrons, or such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. . . ." Sec. 1388(a)

Definition of income derived from sources other than patronage

The Treasury regulations provide that ". . .'income derived from sources other than patronage' means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes income derived from sources other than patronage." Treas. Reg. sec. 1.1382-3(c)(2).

Notwithstanding the language of the Treasury regulations, both the Internal Revenue Service and the courts have held that other types of income may constitute income derived from patronage sources. See, for example, Rev. Rul. 69-576, 1969-2 C.B. 166 (patronage dividend from cooperative bank on loans used for patronage business considered patronage source income because it ". . . facilitates the accomplishment of the cooperative's marketing, purchasing, and service activities. . . ."); *Linnton Plywood v. United States*, 410 F. Supp. 1100 (D. Ore. 1976) (dividends received from a subsidiary corporation that made glue for the parent cooperative's plywood operation held to be patronage source income); *Astoria Plywood Corporation v. United States*, 79-1 U.S.T.C. par. 9197 (D. Ore. 1979) (income received from cancellation of a lease on a building used by cooperative for patronage-sourced activities was patronage source income); *Land O'Lakes, Inc. v. United States*, 675 F. 2d 988 (8th Cir. 1982) (dividends from stock in bank whose purchase was necessary to receive financing for patronage activities held to be patronage source income); *St. Louis Bank for Cooperatives v. United States*, 624 F. 2d 1041 (Ct. Cl. 1980) (interest earned on short-term investment of temporary excess cash of a cooperative bank held to be patronage source income).

The Internal Revenue Service has ruled that any gain treated as ordinary income under the depreciation recapture rules of section 1245 is treated as patronage source income in the same portion that the depreciation deductions were taken. Rev. Rul. 74-84, 1974-1 C.B. 244. The ruling further held that any additional gain which is treated as capital gain is not patronage-sourced income. Notwithstanding the position of the Internal Revenue Service, the law remains unclear where the cooperative association has a gain from the sale of property.

Reasons for Change

The committee is concerned that the uncertainty of present law causes problems to both taxpayers and the Internal Revenue Service. Taxpayers need to know the amount of patronage-sourced income so that they can pay patronage dividends to patrons on a timely basis. Similarly, the Internal Revenue Service needs to know the amount of patronage-sourced income to insure that the income is properly taken into account in determining the taxable income of the cooperative and its patrons.

In general, the committee believes that patronage-sourced income includes a portion of the gains and losses from assets used to facilitate the cooperative's conduct of business done with, or for, its patrons. However, the committee recognizes that the cooperative and its patrons may agree to a different arrangement. Accordingly, the committee bill provides that cooperatives may elect to treat such gains and losses as patronage-sourced income. Nonetheless, the committee bill provides that the election is effective for the taxable year elected and the two succeeding years in order to prevent cooperatives from electing to treat gains as patronage-sourced, while treating losses as not patronage-sourced.

Explanation of Provision

In general

Under the bill, a cooperative may elect to treat gain or loss on the sale or other disposition of certain assets as ordinary income or loss and to include such gain or loss in the determination of net earnings done with or for patrons.

Assets to which provision applies

The provision applies to any asset (including stock or any other ownership or financial interest in another entity) if such asset was used by the cooperative to facilitate the conduct of business done with, or for, its patrons. Where an asset was not used exclusively to facilitate the conduct of business done with, or for, its patrons, the provision applies only to the extent that the asset was used to facilitate the conduct of business with, or for, its patrons. The method of allocating the usage of the asset between patronage and nonpatronage operations may be determined by any reasonable method.

Rules applicable to election

An election made under this provision applies to the year for which the election is made and the two succeeding taxable years.

Effective Date

In general, this provision of the bill is effective for taxable years ending after the date of enactment. In addition, the provision applies to all taxable years beginning on or before the date of enactment, if the taxpayer so elects in its return for its first taxable year beginning on or before the date of enactment and ending after such date.

11. Hedging transactions by real estate investment trusts (sec. 6630A of the bill and sec. 856(c)(6)(G) of the Code)

Present Law

In order for an entity to qualify as a real estate investment trust ("REIT"), at least 95 percent of its gross income generally must be derived from certain passive sources and real estate assets (the "95-percent test"). Also, with certain exceptions, less than 30 percent of the gross income of a REIT must be derived from the sale or exchange of certain assets, including real property held for less than four years (the "30-percent test").

For purposes of determining whether an entity qualifies as a REIT, the Code provides specific rules for the treatment of interest rate swap or cap agreements that protect the REIT from interest rate fluctuations on variable interest rate debt incurred to acquire or carry real estate assets. Such agreements are treated as securities under the 30-percent test and payments under them are treated as qualifying under the 95-percent test.

Reasons for Change

The committee believes that income from instruments that are similar to swap and cap agreements should be qualifying passive income for REIT qualification purposes. In addition, the committee believes that, for these purposes, the character of real estate mortgage investment conduit (REMIC) assets and indebtedness should pass through to the REIT.

Explanation of Provision

The present-law treatment of interest rate swap or cap agreements is extended to similar arrangements, such as forward rate agreements and futures contracts. In addition, in determining whether an arrangement hedges variable rate indebtedness, a REIT holding a residual interest in a real REMIC is treated as holding the REIT's proportionate share of the REMIC's assets and the REIT's proportionate share of the regular interests of the REMIC is treated as direct indebtedness of the REIT.

Effective Date

The provision is effective with respect to taxable years beginning after the date of enactment.

12. Alternative recapture method for mutual savings banks and other thrift institutions changing from the reserve method to the specific charge-off method for bad debts (sec. 6630B of the bill and sec. 593 of the Code)

Present Law

Thrift institutions

Under present law, a thrift institution (i.e., a building and loan association, mutual savings bank, or cooperative bank) is permitted a deduction for a reasonable addition to a reserve for bad debts if at least 60 percent of its assets are invested in qualified assets (including home mortgages) (Code secs. 593(a)(2) and 7701(a)(19)). The reasonable addition to the reserve for bad debts for a thrift institution is an amount computed under the experience method or an amount equal to 8 percent of its otherwise taxable income. The amount of bad debt reserves are recaptured if the thrift institution is liquidated in a taxable transaction or makes dividend distributions in excess of post-1951 earnings (Code sec. 593(e)).

Commercial banks

A commercial bank whose average adjusted bases of all assets does not exceed $500 million (i.e., a "small bank") also is allowed a deduction for a reasonable addition to a reserve for bad debts. The reasonable addition to the reserve is an amount computed under the experience method (Code sec. 585)).

A bank whose average adjusted bases of all assets exceeds $500 million (i.e., a "big bank") is not permitted any deduction for an addition to a reserve for bad debts (code sec. 585(c)). Instead, such banks may deduct specific bad debts only in the year in which they become worthless or partially worthless (the "specific charge-off method"). In addition, big banks are required to recapture their existing bad debt reserves under one of two methods. Under the first method (called the "4-year recapture method"), the balance of the reserve generally is recaptured at the following rates: 10 percent in the first year, 20 percent in the second year, 30 percent in the third year, and 40 percent in the fourth year (Code sec. 585(c)(3)(A)). Under the second method (called the "cut-off method"), specific bad debts on loans made before the change in method are charged to the reserve. Then, the balance of the reserve is recaptured as the reserve balance exceeds the amount of pre-change loans that remain outstanding (Code sec. 585(c)(4)).

Reasons for Change

The committee believes that the specific charge-off method is preferable to the use of the reserve method of accounting for bad debts. First, the use of the reserve method for determining losses on bad debts results in deductions being taken currently for tax purposes for losses that statistically are expected to occur in the future. In this regard, a reserve for bad debts is inconsistent with the treatment of other deductions under the all events test. Second, the use of the reserve method allows deductions to be taken prior to the time that the losses actually occur and, therefore, allows deductions larger than the actual present value of the losses.

To encourage the use of the specific charge-off method by thrift institutions, the committee believes it appropriate to afford such institutions a method of recapturing their reserves which is different from the recapture methods applicable to commercial banks.

Explanation of Provision

General recapture rule

A mutual savings bank or other thrift institution that changes from the reserve method of accounting for bad debts to the specific charge-off method (a "nonqualifying thrift institution") may elect to recapture the so-called "experience portion" of its bad debt reserves under the "4-year recapture method" applicable to commercial banks. If a nonqualifying thrift institution does not make an election under this provision, such institution will be subject to the rules of present law.

The experience portion of a nonqualifying thrift institution's bad debt reserves is based on the institution's actual bad debts as a percentage of its loans outstanding over a 6-year period, as calculated under sec. 585(b)(3) of the Code with respect to commercial banks. If a nonqualifying thrift institution makes an election pursuant to this provision, this amount is taken into account by the nonqualifying thrift institution over a 4-year period as follows: 10 percent in the "disqualification year," 20 percent in the first year following the disqualification year, 30 percent in the second year following the disqualification year, and 40 percent in the third year following the disqualification year.[68] A disqualification year means the first taxable year ending after the date of enactment of this provision in which an institution changes from the reserve method of accounting for bad debts to the specific charge-off method.

Subsequent losses

If a nonqualifying thrift institution makes an election pursuant to this provision, losses with respect to specific loans held by the

[68] An electing nonqualifying thrift institution may take into account more than 10 percent of the experience portion of its bad debt reserves in the disqualification year and make appropriate adjustments to the percentages taken into account in the following three years in accordance with rules similar to those set forth in section 585(c)(3)(A)(iii).

nonqualifying thrift institution before the accounting method change ("pre-change loans") are generally deductible (and any recoveries includible in income) under normal tax principles, subject to the restrictions set forth below.

In lieu of a deduction for bad debts, a charge is made to the unrecaptured portion of the bad debt reserves to the extent that (1) the excess, if any, of current losses (less recoveries) on pre-change loans over current recapture, exceeds (2) the excess, if any, of cumulative recapture (not including the current year) over cumulative losses (less reserves) (not including the current year) on pre-change loans.

Example

The experience portion of the bad debt reserves of an electing nonqualifying thrift institution is $100. This amount is recaptured $10 in the disqualification year, $20 in the year following the disqualification year, $30 in the second year following the disqualification year, and $40 in the third year following the disqualification year. The institution has actual bad debts on pre-change loans as follows: $0 in the disqualification year, $25 in the year following the disqualification year, $10 in the second year following the disqualification year, and $110 in the third year following the disqualification year. In the disqualification year, the institution is entitled to no deduction for bad debts and makes no charge-off against its bad debt reserves. In the year following the disqualification year, the institution is entitled to a bad debt deduction of $25 and makes no charge-off against its bad debt reserves. In the second year following the disqualification year, the institution is entitled to a bad debt deduction of $10 and makes no charge-off against its bad debt reserves. In the third year following the disqualification year, the institution is entitled to a bad debt deduction of $65 and makes a $45 charge-off against its bad debt reserves.

Any charge made to the bad debt reserves outlined above shall first reduce the nonexperience portion of the bad debt reserves. Any remaining amounts shall then be charged against any experience portion of the reserve that has not yet been recaptured, in the reverse order that such reserves would otherwise be subject to recapture. Finally, any such amounts in excess of total bad debt reserves of the taxpayer are deductible.

Other rules

Any remaining bad debt reserves of an electing nonqualifying thrift institution are recaptured when excessive dividends are paid by the nonqualifying thrift institution or upon partial or complete liquidation of the nonqualifying thrift institution (under the rules of Code sec. 593(e)).

An election made pursuant to this provision is irrevocable. Nonqualifying thrift institutions that make an election under this provision would not be permitted to use the reserve method of accounting for bad debts in any subsequent year.

Effective Date

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

13. Restoration of income averaging for certain farmers (sec. 6630C of the bill and sec. 1303 of the Code)

Present Law

Prior to the enactment of the Tax Reform Act of 1986, certain individuals could elect to compute their income tax liability for the current year based on a formula that took into account their income for the current year and their average income of the prior three years. This election was repealed by the Tax Reform Act of 1986, effective for tax years beginning after December 31, 1986.

Reasons for Change

The committee believes that income averaging is appropriate for certain qualified farmers who may have little or no taxable income in one or more taxable years in the averaging period.

Explanation of Provision

The bill restores the income averaging rules that were repealed by the Tax Reform Act of 1986 for certain qualified farmers. Qualified farmers means those individuals (1) who materially participate (within the meaning of sec. 469(h)) in the trade or business of farming (within the meaning of sec. 2032A(e)(4) and (5) of the Code) for each of the preceding three taxable years; and (2) whose total annual gross receipts (including nonfarm gross receipts) for each year of the averaging period does not exceed $5 million ($2.5 million for married individuals filing separately).

Effective Date

The provision is effective for taxable years of individuals beginning December 31, 1989.

D. Employment Tax Provisions

1. Income tax withholding on the wages of certain agricultural workers (sec. 6631 of the bill and sec. 3401(a)(2) of the Code)

Present Law

In general, wages paid by an employer to an employee are subject to income tax withholding. Wages paid for agricultural labor are, however, exempt from income tax withholding (sec. 3401(a)(2)).

Certain cash wages paid for agricultural labor are subject to withholding for Federal Insurance Contributions Act (FICA) taxes (sec. 3121(a)(8)). In general, agricultural workers are subject to FICA withholding if they earn at least $150 in annual cash remuneration or are covered because of the employer FICA withholding test. The employer FICA withholding test generally subjects employee wages to FICA withholding if the employer pays more than $2,500 during the year to all employees. Certain employees who are hand harvest laborers, are paid on a piece rate basis, commute daily to the farm from their permanent residence, and were employed in agriculture less than 13 weeks during the prior year, are exempt from FICA withholding.

Reasons for Change

The committee believes that agricultural workers generally should be subject to the same system of income tax withholding that applies to other workers.

Explanation of Provision

If an agricultural worker's cash wages are subject to FICA withholding, the agricultural worker's cash wages are also subject to income tax withholding. In addition, crew leader rules parallel to those utilized for FICA withholding purposes are to apply for income tax purposes (these rules specify who is the employer of certain agricultural workers).

Effective Date

The provision is effec ive for wages paid after December 31, 1989.

2. Payroll tax deposit speedup (sec. 6632 of the bill and sec. 6302 of the Code)

Present Law

Treasury regulations have established the system under which employers deposit income taxes withheld from employees' wages and FICA taxes. The frequency with which these taxes must be deposited increases as the amount required to be deposited increases.

Employers are required to deposit these taxes as frequently as eight times per month, provided that the amount to be deposited equals or exceeds $3,000. These deposits must be made within three banking days after the end of the eighth-monthly period.

Reasons for Change

The committee believes that it is appropriate for employers who are required to deposit large amounts of withheld income taxes and FICA taxes deposit those taxes more rapidly.

Explanation of Provision

Employers who are on the eighth-monthly system are required to deposit income taxes withheld from employees' wages and FICA taxes by the close of the next banking day (instead of by the close of the third banking day) after any day on which the business has an amount to be deposited equal to or greater than $250,000 (regardless of whether that day is the last day of an eighth-monthly period).

Effective Date

The provision is effective for amounts required to be deposited after July 31, 1990. A special rule is effective for 1991 and 1992. For 1991 and 1992, amounts required to be deposited under this provision must be deposited by the close of the third banking day (instead of the next banking day). The Treasury Department is given authority to issue regulations for 1995 and succeeding years to provide for similar modifications to the date by which deposits must be made in order to minimize unevenness in the receipts effects of the provision.

E. Tax-Exempt Bond Provisions

1. Modify rules concerning tax-exempt bonds issued by 501(c)(3) organizations (sec. 6641 of the bill and sec. 145 of the Code)

Present Law

The interest on State and local government bonds generally is exempt from tax if the bonds are issued to finance direct activities of these governments (Code sec. 103). Interest on bonds issued by these governments to finance activities of other persons, e.g., private activity bonds, is taxable unless a specific exception is included in the Code. One such exception is for private activity bonds issued to finance activities of charitable organizations described in Code section 501(c)(3) ("section 501(c)(3) organizations") when the activities do not constitute an unrelated trade or business (Code sec. 141(e)(1)(G)).[69]

Classification of section 501(c)(3) organization bonds as private activity bonds

Under present law, a bond is a private activity bond if its proceeds are used in a manner violating either (i) a private business test or (ii) a private loan test. The private business test is a conjunctive two-pronged test. First, the test limits private business use of government bonds to no more than 10 percent of the proceeds.[70] Second, no more than 10 percent of the debt service on the bonds may be derived from private business users of the proceeds. The private loan test limits to the lesser of five percent or $5 million the amount of governmental bond proceeds that may be used to finance loans to persons other than governmental units.

Special restrictions on tax-exemption for section 501(c) for organizations bonds

Present law treats section 501(c)(3) organizations as private persons. Thus, bonds for their use may only be issued as private activity "qualified 501(1)(3) bonds," subject to the restrictions of Code section 145. The most significant of these restrictions limits the amount of outstanding bonds from which a section 501(c)(3) organization may benefit to $150 million. In applying this "$150 million limit," all section 501(c)(3) organizations under common management or control are treated as a single organization. The limit does not apply to bonds for hospital facilities, defined to include only

---

[69] Prior to the enactment of the Tax Reform Act of 1986, States and local governments and 501(c)(3) organizations both were defined as "exempt persons," and their bonds generally were subject to the same requirements.

[70] No more than 5 percent of bond proceeds may be used in a private business use that is unrelated to the governmental purpose of the bond issue. The 10-percent debt service test, described below, likewise is reduced to 5 percent in the case of such "disproportionate" private business use.

acute care, primarily inpatient, organizations. A second restriction limits to no more than five percent the amount of the net proceeds of a bond issue that may be used to finance any activities (including all costs of issuing the bonds) other than the exempt purposes of the section (501)(c)(3) organization.

In addition, existing residential rental property that is acquired by section 501(c)(3) organizations with the proceeds of tax-exempt bonds must satisfy the same low-income tenant occupancy requirements which apply to for-profit developers receiving tax-exempt private activity bond financing (sec. 142(d)(1)).

Other restrictions

The Code imposes several restrictions on private activity bonds that do not apply to bonds used to finance direct State and local activities. Many of these restrictions also apply to qualified 501(c)(3) bonds.

No more than 2 percent of the net proceeds of a bond issue may be used to finance the costs of issuing the bonds, and these monies are not counted in determining whether the bonds satisfy the requirement that at least 95 percent of the net proceeds of each bond issue be used for the exempt activities qualifying the bonds for tax-exemption.

The weighted average maturity of a bond issue may not exceed 120 percent of the average economic life of the property financed with the proceeds.

A public hearing must be held and an elected public official must approve the bonds before they are issued (or the bonds must be approved by voter referendum).

If property financed with private activity bonds is converted to a use not qualifying for tax-exempt financing, certain loan interest penalties are imposed.

Both governmental and private activity bonds are subject to arbitrage and other restrictions.

Reasons for Change

The committee believes a distinguishing feature of American society is the singular degree to which we maintain an independent sector of private institutions in the public service. The committee believes it is important to assist these private institutions in their advancement of the public good. The committee finds particularly inappropriate the restrictions of present law which place 501(c)(3) organizations at a financial disadvantage to public institutions in providing essentially the same services. For example, a public university generally has unlimited access to tax-exempt finance, while a private university is subject to a $150 million limitation. The committee is concerned that this and other restrictions inhibit the ability of our great private institutions to modernize their research laboratories and libraries and other facilities. The committee believes it is appropriate to attempt to treat equally State and local governments and those private organizations which are engaged in the advancement of the public good.

Explanation of Provision

The bill amends the tax-exempt bond provisions of the Code to conform generally the treatment of section 501(c)(3) organization bonds to finance the exempt purpose of the organization to that provided for bonds issued to finance direct State or local government activities.[71] Certain restrictions, described below, that have been imposed on section 501(c)(3) organization bonds (but not on governmental bonds) since 1985, and that address specialized policy concerns, are retained.

Repeal of private activity bond classification for section 501(c)(3) organization bonds

The concept of an "exempt person" that existed under the Code bond provisions before 1986, is reenacted. An exempt person is defined as (i) a State or local governmental unit or (ii) a section 501(c)(3) organization when carrying out its exempt activities under Code section 501(a). Thus, bonds issued by a section 501(c)(3) organization to carry out its exempt activities are no longer classified as private activity bonds. Financing for unrelated business activities of such organizations continue to be treated as a private activity for which tax-exempt financing is not authorized.

As exempt persons, section 501(c)(3) organizations are subject to the same limits as States and local governments on using their bond proceeds to finance private business activities or to make private loans. Thus, no more than 10 percent of the bond proceeds [72] can be used in a business use of a person other than an exempt person if the Code security interest test is satisfied, and no more than five percent ($5 million if less) can be used to make loans to such "nonexempt" persons.

Repeal of most additional restrictions on section 501(c)(3) organization bonds

The bill repeals present Code section 145, which establishes additional restrictions on qualified 501(c)(3) bonds. The bill also repeals the restriction on bond-financed costs of issuance for section 501(c)(3) organization bonds (Code sec. 147(h)). This repeal of Code section 145 eliminates the $150 million per institution limit on non-hospital bonds for section 501(c)(3) organizations.

Retention of certain specialized requirements for section 501(c)(3) organization bonds

As stated above, the bill retains certain specialized restrictions on bonds for section 501(c)(3) organizations. First, the bill retains the requirement that existing residential rental property acquired by a section 501(c)(3) organization in a tax-exempt-bond-financed transaction satisfy the same low-income tenant requirements as similar housing financed for for-profit developers. Second, the bill retains the present-law maturity limitations applicable to bonds for

---

[71] For example, if as part of its regular curriculum a private university offered instruction in aviation, it would be permissible to use the proceeds of tax-exempt bonds to purchase trainer aircraft which present law would not permit under sec. 147(e).

[72] This limit would be reduced to five percent in the case of disproportionate private use as under the present law governmental bond disproportionate private use limit.

501(c)(3) organizations, and the public approval requirements applicable generally to private activity bonds. Third, the bill continues to apply the penalties on changes in use of tax-exempt bond-financed section 501(c)(3) organization property to a use not qualified for such financing.

Effective Date

The bill applies generally to bonds issued after December 31, 1989.

An exception permits bonds for which a transitional exception was provided in the Tax Reform Act of 1986 to be issued under the rules currently applicable to those bonds, unless the issuers elected to be subject to the bill's provisions. Such an election is to be made on an issue-by-issue basis before the bonds are issued, and is irrevocable once made.

2. Refinancings of certain bond issues (sec. 6642 of the bill)

Present Law

A bond (including refunding bonds) is a private activity bond if an amount exceeding the lesser of five percent or $5 million of bond proceeds is to be used (directly or indirectly) to make or finance loans to any person other than a governmental unit.

Reasons for Change

The private loan rules restrict the ability of issuers to utilize tax-exempt bonds to make or finance loans to persons other than a governmental unit. The committee believes that a limited exception from these rules is justified in the refunding case allowed under this provision.

Explanation of Proposal

The provision allows a current refunding on a tax-exempt basis to qualified issuers if the following restrictions are satisfied: (1) the amount of the refunding issue may not exceed the outstanding amount of the refunded bonds; and (2) the final maturity date of the refunding issue may not be later than six months following the scheduled final maturity date of the issue of which the refunded bond is a part. A qualified issuer must have issued the bonds to be refunded to provide financial assistance to a financially troubled issuer that is a separate political subdivision and that issued the bonds in order to alleviate the risk of default on the financial obligations of the financially troubled issuer.

Effective Date

The provision is effective on the date of enactment.

3. Sports facility bonds (sec. 6643 of the bill and sec. 142 of the Code)

Present Law

Interest on State and local government bonds generally is tax-exempt (Code sec. 103). Interest on private activity bonds issued by such governments is taxable unless a specific exemption is provided in the Code. In addition, the availability of certain private activity tax-exempt bond financing is limited by the State annual private activity volume limitation. Specifically, the volume limitation applies to (1) exempt-facility bonds (other than bonds for airports, docks and wharves, and certain governmentally-owned solid waste disposal facilities), (2) qualified mortgage bonds, (3) small-issue bonds, (4) qualified student loan bonds, and (5) qualified redevelopment bonds. Certain other private activity bonds for which tax-exemption specifically is provided in non-Code provisions also are subject to the new private activity bond volume limitations. While sports stadiums and convention facilities could be financed as qualified Industrial Development Bonds (IDBs) under prior law, they no longer fall within any category of exempt-facility bonds eligible for tax-exemption under present law.

Reasons for Change

The committee believes that sports facilities provide public benefits. Consequently, the committee believes it is appropriate to make tax-exempt financing available to such facilities. Because of the benefits which can inure to private persons, the committee believes it is important to subject bonds for such facilities to the State private activity bond limitation and to insure that such facilities are publicly owned.

Explanation of Provision

The bill provides that sports facilities are an exempt facility and can be financed using tax-exempt bonds subject to the State private activity bond limitation.[73] The bill provides that such facilities financed with tax-exempt bonds must be governmentally owned.

Effective Date

The provision is effective for bonds issued after December 31, 1989.

---

[73] The provision does not alter the prohibition against the financing of skyboxes with the proceeds of tax-exempt bonds (sec. 147(e)).

F. Insurance Provisions

1. Study relating to section 833 deduction (sec. 6651 of the bill)

Present Law

The Tax Reform Act of 1986 added a rule that an organization described in sections 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance 501(m)). The 1986 Act provided special rules for certain health insurance providers subject to this provision. In particular, the 1986 Act provided a special deduction for then-existing Blue Cross or Blue Shield organizations and other organizations that meet certain requirements and substantially all of whose activities are providing health insurance.

The special deduction is provided under Code section 833 to such organizations with respect to their health business, and is equal to (1) 25 percent of the claims and expenses incurred during the taxable year, less (2) the adjusted surplus at the beginning of the year. This deduction is calculated by computing surplus, taxable income, claims incurred, expenses incurred, tax-exempt income, net operating loss carryovers, and other items attributable to health business. The deduction may not exceed taxable income attributable to health business for the year (calculated without regard to this deduction).

In addition, the 1986 Act provided special rules for determining the accounting method, unearned premium reserves, and asset basis of such organizations, relating to their former tax exempt status.

Reasons for Change

The committee believes it is appropriate to review the operation of the section 833 deduction and the provisions determining eligibility for the deduction, as well as whether organizations meeting requirements similar to the eligibililty standards for the section 833 deduction should be treated as a category of tax-exempt organizations.

Explanation of Provision

The Secretary of the Treasury or his delegate is required to conduct a study of the standards for eligibility for, and the operation of, the special deduction provided under section 833 to certain existing Blue Cross or Blue Shield organizations and other organizations with respect to their health business. The study is to include an examination of whether organizations in existence on August 16, 1986, which are similar to Blue Cross and Blue Shield organizations should also be eligible for the section 833 deduction. The

22-661 O—89——7

study should also examine whether similar organizations that meet certain requirements such as continuous open enrollment and others indicating public purpose (including requirements similar to those described in section 833(c)(3)) should be eligible for tax-exempt status.

Effective Date

Not later than March 15, 1990, the Secretary of the Treasury is required to submit to the Finance Committee of the Senate and the Committee on Ways and Means of the House of Representatives a report on the study, together with such recommendations as the Secretary may deem advisable.

2. Treatment of certain reserves under minimum premium plans (sec. 6652 of the bill)

Present Law

Under present law, a property and casualty insurance company is subject to tax on its underwriting income and its investment income. Underwriting income is defined for this purpose as the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

In calculating the amount of premiums earned on insurance contracts, 80 percent of the increase in unearned premiums during the year is deducted from gross premiums (less return premiums and premiums paid for reinsurance). The deduction for losses incurred includes losses paid during the year (adjusted for salvage and reinsurance recoverable), and the increase in discounted unpaid losses during the year.

Under present law, it is unclear whether amounts set aside by an insurance company as a reserve pursuant to State law or regulation for future claim payments to be made upon the termination of a minimum premium plan are properly treated for Federal income tax purposes as unearned premiums, as unpaid losses, or as nondeductible amounts.

Reasons for Change

The committee believes that amounts set aside as a reserve pursuant to State law or regulation for future claims payments upon the termination of a minimum premium plan should be treated for Federal income tax purposes as unearned premiums.

Explanation of Provision

The bill provides that, for purposes of section 832(b)(4) of the Code (or any corresponding provision of prior law), the term "unearned premiums" includes amounts set aside as a reserve pursuant to State law (or any rules or regulations thereunder) by an insurance company for future claims payments upon the termination of a minimum premium plan, to the extent a premium or other consideration corresponding to such reserve has been included in the gross income of the company.

Effective Date

The provision applies to taxable years beginning before, on, or after the date of enactment of the bill.

G. Compliance Provisions

1. IRS notice to taxpayers of underreporting of amounts withheld and statute of limitations for certain refund claims (secs. 6661-6662 of the bill and new sec. 7523 of the Code)

Present Law

Under procedures in effect for taxable years beginning before 1987, the Internal Revenue Service did not notify taxpayers or make adjustments on income tax returns when it was determined that the amount reported as withheld on an income tax return was less than the amount reported on an information return. On March 22, 1989, the Internal Revenue Service announced revisions in its procedures for the 1987 taxable year and thereafter. Under these revised procedures, discrepancies involving amounts reported as withheld on information returns will be adjusted in the same manner as discrepancies in amounts reported as withheld on Forms W-2 or W-2P. Such an adjustment may involve a correction of the return where information has been reported on the wrong part of the return. In other cases, the Internal Revenue Service's procedures require that the IRS contact the taxpayer to inform the taxpayer of the discrepancy.

Reasons for Change

The committee believes that the interests of taxpayers would be best protected if the Internal Revenue Service was required to notify taxpayers where it was determined that the amount of tax reported as withheld on an information return was $5 or more in excess of the amount of tax reported as withheld on an income tax return.

In addition, the committee believes that taxpayers should have an additional year within which to file an amended return claiming a refund due to underreporting of withholding.

Explanation of Provisions

Underreporting of amounts withheld

If, in connection with one or more information return matching programs, the Internal Revenue Service determines that the amount of tax shown on information returns as withheld for any taxable year exceeds by $5 or more the amount of tax shown on the income tax return as withheld for that taxable year, then the Internal Revenue Service is required to notify the taxpayer of such excess. In addition, the IRS notice must inform taxpayers of how to file a claim for a refund of these unreported withheld amounts. (This is identical to S. 811, introduced by Senator Bentsen.)

Amended returns for certain refund claims

In addition, the bill provides that a taxpayer may file an amended return until April 15, 1990, for the taxable year ending December 31, 1985, if the amended return relates to an overpayment of tax attributable to the taxpayer's failure to take proper credit for amounts of tax withheld by a payor from any income included in the taxpayer's gross income for that taxable year. (This is identical to S. 753, introduced by Senator Gore, Senator Pryor, and Senator Harkin.)

Effective Date

The provision applies to all information return matching that occurs after the date of enactment.

2. Increase in refund review threshold for reports submitted to the Joint Committee on Taxation (sec. 6663 of the bill and sec. 6405 of the Code)

Present Law

No refund or credit in excess of $200,000 of any income tax, estate or gift tax, or certain other specified taxes, may be made until 30 days after the date a report on the refund is provided to the Joint Committee on Taxation (sec. 6405). A report is also required in the case of certain tentative refunds. Additionally, the staff of the Joint Committee on Taxation conducts post-audit reviews of large deficiency cases and other select issues.

Reasons for Change

The committee believes that it is appropriate to increase the refund review threshold, which has been set at $200,000 since 1976. This increase will accelerate the issuance of refunds between $200,000 and $1,000,000 to the taxpayers involved. In addition, this increase will free up significant resources of both the Internal Revenue Service and the staff of the Joint Committee on Taxation, without materially impairing the ability to monitor problems in the administration of the tax laws.

Explanation of Provision

The threshold above which refunds must be submitted to the Joint Committee for review is increased from $200,000 to $1,000,000.

The committee expects that the staff of the Joint Committee on Taxation will continue to exercise its existing statutory authority to conduct a program of expanded post-audit reviews of large deficiency cases and other select issues. The committee expects that the IRS will fully cooperate in this expanded program.

Effective Date

The provision is effective on the date of enactment, except that the higher threshold will not apply to a refund or credit with respect to which a report was made before the date of enactment.

H. Exempt Organizations

1. Cooperative service organizations for certain foundations (sec. 6671 of the bill and new sec. 501(n) of the Code)

Present Law

Present-law section 501(c)(3) requires that an organization be organized and operated exclusively for an exempt purpose in order to qualify for tax-exempt status under that section.

Section 501(f) provides that an organization shall be treated as organized and operated exclusively for charitable purposes if it is comprised solely of members that are educational institutions and is organized and operated to hold, commingle, and collectively invest (including arranging for investment services by independent contractors) in stocks and securities, the moneys contributed thereto by the members, and to collect income therefrom and turn over the entire amount thereof, less expenses, to such members.

Reasons for Change

The committee believes it is appropriate to extend to private foundations and community foundations present-law rules which permit educational institutions to form tax-exempt cooperative service organizations to provide for collective investment of their assets.

Explanation of Provision

Under the provision, a cooperative service organization comprised exclusively of members which are tax-exempt private foundations or community foundations [74] is treated for purposes of section 501(c)(3) as organized and operated exclusively for charitable purposes if: (1) it has at least 20 members; (2) no one member holds more than 10 percent (by value) of the interests in the organization; (3) no one member, by itself, controls the organization or controls any other member; (4) the members are permitted to dismiss the organization's investment adviser upon a vote of members holding a majority of interest in the organization; and (5) the organization is organized and operated solely to hold, commingle, and collectively invest (including arranging for investment services by independent contractors) in stocks and securities, the moneys contrib-

[74] For purposes of the provision, "community foundations" are a form of charitable trust or fund (which generally are established to attract large contributions of a capital or endowment nature for the benefit of a particular community or area) as to which section 170(b)(1)(A)-(vi) applies (*see* Treas. Reg. sec. 1.170A-9(e)(10)).

uted by the members, and to collect income therefrom and turn over the entire amount thereof, less expenses, to such members.[75]

A cooperative service organization meeting the criteria of the provision is subject to the present-law excise tax provisions applicable to private foundations (e.g., sec. 4941 rules governing self-dealing arrangements), other than sections 4940 and 4942. In addition, the proportionate share (whether or not distributed) of the net income of the cooperative service organization (including capital gains) of each member (other than certain exempt operating foundations) for any taxable year of the cooperative service organization is, for purposes of the excise tax imposed under present-law section 4940, treated as net investment income of the member for the taxable year of such member in which the taxable year of the cooperative service organization ends.

Effective Date

The provision applies to taxable years beginning after December 31, 1989.

2. Certain existing arrangements exempt from excise tax on self-dealing involving private foundations (sec. 6672 of the bill and sec. 4941 of the Code)

Present Law

Section 509(a) defines a private foundation as any tax-exempt organization described in section 501(c)(3) other than certain organizations described in section 170(b)(1)(A) (e.g., churches, educational institutions, and hospitals), organizations which meet the "public support" test of section 509(a)(2) (i.e., organizations normally receiving one-third of their support from gifts, grants, contributions, membership fees, and certain other permissible sources and also not receiving more than one-third of their support from gross investment income and certain other business activities), and certain other organizations.

Section 4941 provides for the imposition of excise taxes when private foundations engage in "self-dealing" transactions with certain disqualified persons. The transactions prohibited as "self-dealing" generally include (1) the sale, exchange, or leasing of property between a private foundation and a disqualified person, (2) the lending of money or other extension of credit between a private foundation and a disqualified person, and (3) payment of compensation by a private foundation to a disqualified person. For purposes of the section 4941 excise taxes, disqualified persons generally include substantial contributors [76] to private foundations, managers of private foundations, certain relatives of substantial contributors and foundation managers, and certain government officials (sec. 4946).

---

[75] A cooperative service organization described in the provision qualifies for tax-exempt status under section 501(c)(3) only if the other relevant requirements of that section (e.g., limitations on political and lobbying activities) are satisfied.

[76] A "substantial contributor" is any person who contributed or bequeathed an aggregate amount of more than $5,000 to the private foundation, if such amount is more than two percent of the total contributions and bequests received by the foundation before the close of the taxable year of the foundation in which the contribution or bequest is received by the foundation from such person (secs. 507(d)(2) and 4946(a)(2)).

Reasons for Change

The committee believes it is appropriate to permit certain tax-exempt organizations that become private foundations after having qualified as public charities to avoid disruptions of their operations by continuing for a limited period certain business arrangements reflecting arm's-length transactions.

Explanation of Provision

The provision permits an organization that becomes a private foundation with respect to a taxable year after having met the public support tests of section 509(a)(2) for a minimum of three prior years to continue (or to renew) certain qualified existing arrangements which are the result of arm's-length transactions. Such arrangements are exempted from the excise taxes imposed upon self-dealing transactions by section 4941 for a period not to exceed the longer of (1) the period provided by an existing binding contract entered into more than two years before the start of the taxable year with respect to which the organization becomes a private foundation, or (2) a five-year period beginning with the taxable year with respect to which the organization becomes a private foundation.

For purposes of the provision, "qualified existing arrangements" include the continuance or renewal of the following arrangements if such arrangements were in effect during the period the organization satisfied the public support test of section 509(a)(2): (1) the leasing by a disqualified person to a private foundation of office space in a building with other tenants who are not disqualified persons if the leasing is pursuant to a binding lease; (2) the furnishing of goods, services (including banking services), or facilities by a disqualified person to a private foundation;[77] (3) the sale of property from a private foundation to a disqualified person pursuant to a binding contract; and (4) to the extent provided by regulation, any other arrangement.

Under the provision, existing arrangements may be continued or renewed only if they are the result of an arm's-length transaction (i.e., the terms of the transaction are not less favorable to the private foundation than if it had contracted with a member of the general public who was not a disqualified person). Any renewal or modification of an existing arrangement may not substantially modify such arrangement.

The provision does not apply to any arrangement between a private foundation and a disqualified person who is a substantial contributor to the foundation within the meaning of section 4946(a)(2). Such transactions between a private foundation and a substantial contributor continue to be governed by the present-law rules prohibiting self-dealing arrangements provided for by section 4941.

---

[77] The furnishing of goods, services, or facilities by a disqualified person to a private foundation on an intermittent basis is permitted by the provision for a five-year period even though there is no binding contract requiring the continuation of the arrangement, provided that the disqualified person previously had furnished substantially similar goods, services, or facilities to the organization when it met the public support test of section 509(2)(2) and after the organization becomes a private foundation the arrangement reflects an arm's-length transaction.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

I. Other Provisions

1. Adoption expense deduction (sec. 6681 of the bill and new sec. 221 of the Code)

Present Law

The Tax Reform Act of 1986 (the "1986 Act") repealed the deduction for adoption expenses associated with special needs children, effective for taxable years beginning on or after January 1, 1987. Under prior law, a deduction of up to $1,500 of expenses associated with the adoption of special needs children was allowed. The 1986 Act provided for a new outlay program under the existing Adoption Assistance Program to reimburse expenses associated with the adoption process of these children. The group of children covered under the outlay program is somewhat broader than the group covered by the prior deduction. Aid to Families with Dependent Children (AFDC) and Title IV-E Foster Care assistance outlay program provides assistance for adoption expenses for these special needs children as well as special needs children in private and State-only programs.

One component of the Adoption Assistance Program requires States to reimburse certain costs incurred for special needs children. The Federal government shares 50 percent of these costs up to a maximum Federal share of $1,000 per child. Reimbursable expenses include those associated directly with the adoption process such as legal costs, social service review, and transportation costs.

Reasons for Change

The committee believes an individual who is willing to adopt a child with special needs will incur greater expenses in the process of the adoption than would an individual who will adopt a child without such special needs. It is appropriate public policy then to offset some of the expenses through available tax provision in order to encourage such individuals.

Explanation of Provision

The proposal will allow a taxpayer to exclude from adjusted gross income (AGI) up to $3,000 of expenses incurred in the course of the adoption of a child with special needs. This exclusion will be allowed as an "above-the-line" deduction. A child with special needs means any child who, as determined by a State, cannot or should not be returned to the home of the birth parents and cannot be placed with adoptive parents without providing adoption assistance.

Eligible adoption expenses will be limited to those: (1) directly associated with the adoption process and (2) that are of a type eligible for reimbursement under the Adoption Assistance Program. These include reasonable and necessary court costs, legal expenses, and other expenses directly related to the legal adoption of a child.

Effective Date

The provision applies to taxable years beginning after December 31, 1989.

2. Tax pre-contribution gain on certain in-kind partnership distributions (sec. 6682 of the bill and sec. 704(c) of the Code)

Present Law

A partnership is not subject to tax at the partnership level, but rather, income and loss of the partnership is subject to tax at the partner level (Code sec. 701). A partner's distributive share of items of partnership income, gain, loss, deduction or credit generally may be determined by the partnership agreement if the allocations under the agreement have substantial economic effect. If partnership allocations do not have substantial economic effect, partners' distributive shares are required to be determined in accordance with the partners' interests in the partnership (determined by taking into account all facts and circumstances) (sec. 704(b)).

Income, gain, loss, and deduction with respect to property contributed to the partnership by a partner is required to be shared among partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution (sec. 704(c)). Thus, for example, if appreciated property that was contributed to the partnership is sold by the partnership, gain recognized on the sale is required to be allocated to the contributing partner to the extent he has not previously taken the pre-contribution gain into account.

A partner generally does not recognize gain on a distribution of partnership property (except on a distribution of money in excess of a partner's basis in his partnership interest) (sec. 731). In addition, a partnership does not recognize gain on a distribution of property to a partner. Thus, if appreciated property that was contributed by a partner is distributed to other partners (rather than sold by the partnership), the contributing partner may avoid recognizing the pre-contribution gain.

Present law provides that a partnership is considered as terminated under certain circumstances, including the sale or exchange of 50 percent or more of the total interest in partnership capital and profits within a 12-month period (sec. 708(b)). Applicable Treasury regulations provide that in such a termination, the partnership property is deemed distributed to the partners and then is deemed recontributed to the partnership. The regulations do not provide specific rules for coordinating the effect of such a partnership termination with the required sharing of partnership items under section 704(c).

Another provision of present law provides, generally, that no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind which is to be held either for productive use in a trade or business or for investment (section 1031). Certain listed property does not qualify for nonrecognition treatment (sections 1031(a)(2) and (e)). In order for the nonrecognition rule to apply, the property received in the exchange must be (1) identified within 45 days after the taxpayer transfers the relinquished property, and (2) received before the earlier of 180 days after the taxpayer transfers the relinquished property, or the due date (with regard to extensions) of the taxpayer's income tax return for the year the property was relinquished.

Reasons for Change

The committee believes that the present-law inconsistency in treatment of partnership sales and partnership distributions of property contributed by partners makes it possible for partners to circumvent the rule requiring pre-contribution gain on contributed property to be allocated to the contributing partner. Therefore, in order to limit the inconsistency and to reduce opportunities for circumventing this rule, the committee believes that the contributing partner should recognize pre-contribution gain when property is distributed by the partnership to a partner other than the contributing partner, if the distribution of the contributed property occurs less than 3 years after the contribution.

The committee also believes that, in limited circumstances, where multiple properties of a like kind are distributed to partners, and the transaction would have been treated as a like-kind exchange had it occurred outside the partnership, the partners should receive treatment similar to like-kind exchange treatment.

Explanation of Provision

The bill provides that, in the case of a distribution of contributed property within three years of its contribution, the contributing partner is treated as recognizing gain or loss. Gain or loss recognition is not required under the bill, however, to the extent partnership property is distributed to the partner who originally contributed the property to the partnership. When gain or loss recognition is required by the provision, the amount the contributing partner is treated as recognizing is equal to the amount he would have had to take into account by reason of the variation between basis and value upon contribution of the property, had the property been sold by the partnership at its fair market value at the time of the distribution.

For example, if a partner contributes property (e.g., a tract of raw land) with a basis of 20 and a value of 100, and the partnership distributes it to other partners within 3 years, at a time when the property's value is 150, the contributing partner is treated as recognizing a gain of 80 under the provision (i.e., the amount of the variation between basis (20) and value (100) of the property at the time of contribution). If the partnership had sold the property at the time of distribution, the partnership's gain would have been at least this amount. Similarly, if the property had a value of 60 at the time of distribution to other partners, the contributing partner would be treated as recognizing a gain of 40 under the provision (i.e., the part of the amount of the variation between basis and value that would have been recognized had the partnership sold the property at its fair market value at the time of distribution). These examples assume no intervening allocations were made or required to be made to the contributing partner under section 704(c).

The character of gain or loss to the contributing partner is the same as the character to the partnership had the partnership sold the property to the distributee at the time of the distribution. As under present-law section 704(c), appropriate adjustments are required to be made to the adjusted basis of the contributing partner's interest in the partnership and to the adjusted basis of the distributed property to reflect any gain or loss recognized under the provision. Thus, the contributing partner's adjusted basis for his partnership interest will be increased or decreased, respectively, to reflect any gain or loss he recognized under the provision upon the distribution of the property to another partner (or partners). Similarly, the partnership's adjusted basis for the distributed property will be increased or decreased, respectively, to reflect any gain or loss the contributor recognized under the provision upon the distribution, and this increase or decrease will be taken into account in determining the distributee's adjusted basis for the distributed property under the rules of section 732.

The bill provides that the term contributing partner includes successor partners. Thus, for example, if the partner who originally contributed property to the partnership sells his interest to a successor partner, the successor is treated as recognizing gain or loss under the provision when the contributed property is distributed to other partners within 3 years of the date the selling partner contributed it. The provision does not affect the ability to adjust basis under present law pursuant to a section 754 election.

Gain or loss is not recognized under the provision to the extent contributed property is distributed by the partnership to the contributing partner. A special rule provides that, under regulations, if property contributed by one partner (the "contributing partner") is distributed to another partner (the "distributee partner"), and other property of a like kind is distributed to the contributing partner within a limited time period, then, to the extent of the value of the property actually distributed to the contributing partner, the contributing partner is treated as receiving a distribution of property that he contributed. The limited time period is the period that is the lesser of (i) 180 days following the date of the distribution to the distributee partner, or (ii) the due date of the partner's tax return (with regard to extensions) for the taxable year of the distribution to the contributing partner. It is intended that the value of property distributed be determined in accordance with all the facts and circumstances (including, e.g., the purchase price of such property, or the value of cash, or other items contributed to the partnership in exchange for interests in the partnership). The special rule does not apply to property described in sections 1031(a)(2) or (e).

It is intended that the rule of section 704(c), as amended by the bill, be coordinated with the rules governing partnership terminations (sec. 708). Coordination of this provision of the bill with present law on partnership terminations is intended to be limited in scope, and to provide the following results. First, pre-contribution gain or loss otherwise required to be recognized under the provision is not triggered by a constructive termination under section 708(b)(1)(B). Second, a constructive termination does not change the application of the sharing requirements of 704(c) (as amended by the bill) to pre-contribution gain or loss with respect to property contributed to the partnership before the termination. The rationale for this latter result is that a termination could otherwise cause a shift of pre-contribution built-in gain or loss away from the contributed property to other property, which is contrary to the purpose of this provision of the bill.

It is intended, however, that the deemed contribution of property that occurs (under regulations) upon a constructive termination of the partnership will require the application of section 704(c) (as amended by the bill) to the partners' shares of any increase or decrease in the value of the partnership's assets occurring after those assets were acquired (whether by purchase or contribution) by the partnership and before the termination. As a result, partners will recognize gain or loss in connection with any subsequent distribution of partnership property within 3 years of the date of the termination, to the extent of their respective shares of the pre-termination appreciation or depreciation in the value of the partnership property that is not already required to be allocated under 704(c) to the original contributor (if any) of the property.

Gain or loss will not be triggered under the provision solely by reason of the election under section 761(a) of all the members of an unincorporated organization to exclude the organization from subchapter K. No inference is intended as to any of the tax consequences under present law of an election out of subchapter K under section 761(a).

The provision applies only to a transfer of contributed property to a partner in a transaction that is properly characterized as a distribution to that partner acting in his capacity as a partner for purposes of section 731. To the extent that a transfer of partnership property to a partner by the partnership in a purported distribution is part of a disguised sale, the tax consequences of that transfer are governed by the rules generally applicable to sales or exchanges of property (see section 707(a) and (b), and Reg. section 1.731-1(c)(3)).

Effective Date

The provision is effective with respect to property contributed to a partnership after October 3, 1989, in partnership taxable years ending after that date.

3. Repeal net income limitation for percentage depletion on marginal oil and gas production (sec. 6683 of the bill and sec. 613A(c)(14) of the Code)

Present Law

Under present law, independent producers and royalty owners are permitted to claim percentage depletion on the production of domestic crude oil and domestic natural gas. Such allowance for depletion, however, is subject to several limitations. First, an independent producer or royalty owner can only claim percentage depletion on its combined average daily production of domestic crude oil and domestic natural gas that does not exceed 1,000 barrels (or an equivalent amount of natural gas). Second, percentage depletion is further limited (on a property by property basis) to an amount not in excess of 50 percent of the taxpayer's net taxable income from the property, computed without a deduction for depletion (the "net income limitation"). Finally, a taxpayer's overall deduction for percentage depletion is limited to an amount that is equal to 65 percent of the taxpayer's pre-depletion taxable income for the taxable year (the "taxable income limitation").

Reasons for Change

The committee understands that in many cases, the gross income generated from certain marginally producing oil and gas property is offset to a significant degree by associated operating costs. By operation of the net income limitation, owners of such property often receive little or no benefit from the percentage depletion deduction under present law. The committee understands that as a result of the minimal net income and lack of percentage depletion deduction which occur with respect to some marginal properties, in certain cases taxpayers have contended that it is not economically feasible to continue the operation of such properties. The committee further understands that once the operation of a marginal property is shut down, it is unlikely that production will be restored in the future.

The committee believes that certain incentives should be provided for marginal oil and gas properties so that the extraction of oil and gas reserves from such properties will continue. In particular, the committee believes that it is appropriate to repeal the net income limitation to permit greater percentage depletion deductions for such taxpayers with respect to the operation of certain marginally producing oil and gas properties.

Explanation of Provision

Under the bill, independent producers and royalty owners are permitted to claim percentage depletion under rules identical to present law, except that with respect to certain marginal production of domestic crude oil and domestic natural gas, the net income limitation will not apply. The present-law net income limitation remains unchanged, under the bill, as it applies to the allowance for percentage depletion on production of oil and gas other than that designated under the bill as marginal.

To illustrate this rule, consider the following example. Assume that a domestic property of an independent producer produces crude oil that generates $200 of gross income during a taxable year and has operating costs (before depletion) of $150. Further assume that the production from the property qualifies as marginal production under the bill. Under the present-law percentage depletion rate of 15 percent, the maximum amount of depletion which could be claimed on such property is $30 ($200 gross income multiplied by 15 percent). However, under present law, the allowable percentage depletion deduction is limited to $25 because of the 50-percent net income limitation ($50 net income multiplied by 50 percent). Under the bill, the net income limitation is repealed for marginal production. Thus under the bill, the taxpayer would be allowed to claim a percentage depletion deduction of $30 (prior to considering other applicable limitations).

Under the bill, the term marginal production includes (1) domestic crude oil and natural gas produced from a stripper well, and (2) domestic crude oil which is heavy oil (oil that has a weighted average gravity of 20 degrees API or less corrected to 60 degrees Fahrenheit). For purposes of this provision of the bill, a stripper well is any oil or gas well which produced an average of 15 or less equivalent barrels of oil and gas per production day during any 6-month period beginning after December 31, 1985.[78] During the 6-month production period, production must occur at the well's maximum feasible rate of production as determined in accordance with recognized conservation practices designed to maximize the ultimate recovery of crude oil or natural gas in order for the property to qualify as a stripper well. In the case of a unitization or pooling of multiple wells, the bill requires that production shall be allocated to all unitized wells on the basis of sound engineering principles.

Under the bill, for purposes only of computing percentage depletion, an oil or gas well which qualifies as a stripper well for any period will continue to be treated as a stripper well even if future production from that well exceeds the 15 equivalent barrels per day limit provided in the stripper well definition. However, the 50-percent net income limitation will apply to production from such property in excess of such limitation.

The bill does not affect the 1,000 barrel average daily production limitation on the allowance or percentage depletion. Thus, if an independent producer or royalty owner has marginal producing properties (or a combination of marginal and non-marginal producing properties) that in total generate average daily production in excess of 1,000 barrels, the taxpayer will continue to be limited, as under present law, to the 1,000 barrel per day average for purposes of claiming percentage depletion.

Effective Date

The provision is effective for taxable years beginning after December 31, 1990.

4. Treatment of tuxedos held for rental (sec. 6684 of the bill and sec. 168 of the Code)

Present Law

Tuxedos held for rental are assigned a class life of 9 years under the accelerated cost recovery system as modified by the Tax Reform Act of 1986. Consequently, the depreciation deduction for rental tuxedos generally is determined by using a 5-year recovery

---

[78] Equivalent barrels is computed as the sum of (1) the number of barrels of crude oil produced, and (2) the number of cubic feet of natural gas produced divided by 6,000. If a well produced 10 barrels of crude oil and 12,000 cubic feet of natural gas, its equivalent barrels produced would equal 12 (i.e., (10 + (12,000 / 6,000))).

period, the applicable convention, and the 200-percent declining balance method switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Reasons for Change

In response to a statutory mandate to monitor and analyze actual experience with respect to all depreciable assets, the Depreciation Analysis Division of the Office of Tax Analysis of the Department of Treasury issued a report during July of 1989 that recommended a class life of 2 years for tuxedos held for rental.

Explanation of Provision

Tuxedos held for rental are assigned a class life of 2 years. Consequently, the depreciation deduction for rental tuxedos is to be determined by using a 3-year recovery period, the applicable convention, and the 200-percent declining balance method switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized. Alternatively, a taxpayer may elect under the alternative depreciation system to determine the depreciation deduction for rental tuxedos by using a 2-year recovery period, the applicable convention, and the straight-line method.

Effective Date

The provision applies to rental tuxedos placed in service after December 31, 1989.

5. Treatment of certain capital expenditures incurred in order to assist the disabled (sec. 6685 of the bill and sec. 190 of the Code)

Present Law

A taxpayer may elect to deduct qualified architectural and transportation barrier removal expenses that are paid or incurred during any taxable year in lieu of capitalizing such expenses and recovering the expenses over the recovery period of the property to which the expenses relate. The deduction allowed under this provision for any taxable year is limited to $35,000. For this purpose, an architectural and transportation barrier removal expense is any expenditure for the purpose of making any facility, or public transportation vehicle, owned or leased by the taxpayer for use in connection with a trade or business of the taxpayer more accessible to, and usable by, handicapped and elderly individuals. A qualified architectural and transportation barrier removal expense generally is any architectural and transportation barrier removal expense that satisfies standards contained in Treasury regulations.

Reason for Change

The committee believes that businesses should be encouraged to invest in structures, facilities, and equipment that assist disabled customers and employees. For this reason, the bill expands the types of expenditures that will qualify for expensing. In order to make the provision revenue neutral, however, the bill reduces the annual amount that is eligible for expensing.

Explanation of Provision

The definition of qualified architectural and transportation barrier removal expense is expanded to include amounts chargeable to capital account that are paid or incurred in connection with a trade or business in order to provide auxiliary aids and services or reasonable accommodations to individuals with disabilities. In addition, the annual limitation on the deduction allowed for qualified architectural and transportation barrier removal expenses is reduced to $25,000.

Effective Date

The provision applies to taxable years beginning after December 31, 1989.

6. Tax exemption for Overseas Private Investment Corporation (sec. 6686 of the bill and sec. 501(l) of the Code)

Present Law

The Foreign Assistance Act of 1961 established the Overseas Private Investment Corporation (OPIC) as an agency of the United States under the foreign policy guidance of the Secretary of State. The purpose of OPIC is to facilitate the participation of United States private capital and skills in the economic development of less developed countries by conducting insurance, reinsurance, guarantee, and financing operations on a self-sustaining basis for OPIC-approved overseas investment projects of U.S. citizens.

The Foreign Assistance Act of 1961, as amended, specifically provides that OPIC is exempt from all Federal, State, and local taxes (22 U.S.C. sec. 2199(J)).

The International Cooperation Act of 1989, H.R. 2655 (reported by the House Committee on Foreign Affairs on June 16, 1989, H. Rep. 101-90, and passed by the House on June 29, 1989), would amend and recodify the Foreign Assistance Act of 1961, including the provisions governing OPIC, but would not specifically provide that OPIC is exempt from Federal income taxes.

The Internal Revenue Code of 1986 provides that a corporation organized under an Act of Congress which is an instrumentality of the United States is exempt from Federal income tax only if the exemption is provided under such Act as amended and supplemented before July 18, 1984, or if the exemption is provided in the Internal Revenue Code or a revenue Act (Internal Revenue Code sec. 501(c)(1)).

Reasons for Change

The committee believes that it is appropriate to codify in the Internal Revenue Code the existing exemption from Federal income taxes provided for OPIC.

Explanation of Provision

The Internal Revenue Code is amended to specifically provide that OPIC is exempt from Federal income taxes.

Effective Date

The provision is effective on the date of enactment.

7. Denial of retroactive certifications for work incentive (WIN) tax credit (sec. 6687 of the bill)

Present Law

Under prior law, the work incentive (WIN) credit provided a tax credit to employers for the employment of certain qualified individuals. Prior to the Economic Recovery Tax Act of 1981 (ERTA), the WIN credit did not specifically require certification of an employee as a qualified individual prior to the date of employment. In 1981, ERTA modified the WIN credit by merging it with the targeted jobs credit. ERTA also required that certification of an individual as a member of a targeted group must be obtained or requested before the date an individual begins work. This change was made generally effective on July 23, 1981, to avoid the potential for substantial revenue losses.

The law is unclear as to whether the requirement that the request for certification be made contemporaneously with employment applies only to the new targeted jobs credit or to the prior separate WIN credit. The Internal Revenue Service took the position that retroactive certifications under the prior-law WIN credit are not valid.[79] The Tax Court recently held that retroactive certifications are valid for purposes of claiming the prior-law WIN credit.[80]

Reasons For Change

The committee believes that the allowance of the WIN credit for retroactive certifications clearly undermines the incentive effect intended under the credit. Past congressional action has been in conformance with this belief but recent judicial action has injected some uncertainty as to the operation of present law. In some instances employers attempt to claim the WIN credit either on audit or through amended tax returns several years after the eligible employee was hired. The committee believes that this provision will eliminate any uncertainty and, by preventing further retroactive certifications, reduce a drain on the Federal Treasury that would result from future reliance on the Tax Court case. This provision was passed by the House in 1987 with an effective date of March 11, 1987.[81] This effective date was retained in order to serve the goals of the provision without creating undue administrative complexity.

---

[79] General Council Memorandum 39604, 2/26/87.
[80] *Lucky Stores Inc.* v. *Commissioner*, No. 35251-86, 92 T.C. No. 75, 5/3/89.
[81] H.R. 3545 (100th Congress).

Explanation of Provision

The provision clarifies that certifications for the WIN credit (sec. 50B(h)(1) of the Code as in effect for taxable years beginning before January 1, 1982) must be made on or before the day the individual begins work.

Effective Date

The provision is effective for WIN credits first claimed after March 11, 1987.

8. Treatment of income from personal injury awards for minor children (sec. 6688 of the bill and sec. 1(i) of the Code).

Present Law

As a result of the Tax Reform Act of 1986, the unearned income of a child under age 14 generally is taxed at the top marginal rate of his or her parents.

Reasons for Change

Unearned income of minor children is taxed at the marginal rate of the parents in order to reduce shifting of income producing assets among family members and in recognition of the fact that a family is, in a sense, a single economic unit. The committee concluded that personal injury awards were not susceptible to income shifting and when such awards could not satisfy an obligation of support, they did not enrich the family.

Explanation of Provision

Income attributable to lump sum damages received by a child on account of personal injuries or sickness would be taxed at the child's rate if such income accrues in a custodial account and is prohibited from being used to satisfy an obligation of support.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

J. Estate and Gift Tax Provisions

1. Estate tax inclusion related to valuation freezes (sec. 6691 of the bill, and secs. 2036(c) and 2207B of the Code)

Present Law

If a person holds a substantial interest in an enterprise and in effect transfers property having a disproportionately large share of the potential appreciation in such person's interest in the income of, or rights in, the enterprise, and retains an interest in the income of, or rights in, the enterprise, then the transferred property is includible in such person's gross estate (sec. 2036(c)). The estate is entitled to recover from the person receiving the property a portion of the estate tax attributable to the inclusion (sec. 2207B).

Reasons for Change

The committee was concerned that the statute's complexity, breadth, and vagueness posed an unreasonable impediment to the transfer of family businesses. The committee was also concerned about the difficulties taxpayers and the Treasury Department encountered in interpreting the statute.[82] Many taxpayers uncertain about the scope of these rules have refrained from legitimate intrafamily transactions.

The current rules are overinclusive because they apply if the transferor retains virtually any retained interest in the income from, or rights in, the enterprise. The Technical and Miscellaneous Revenue Act of 1988 responded to these concerns by enacting a number of safe-harbors and by allowing a correction period for compliance with the statute. The committee believes, however, that this response was not sufficient to deal fully with the statute's over inclusiveness.

The committee is convinced that additional technical and substantive modifications to the current rules would exacerbate rather than solve the current problems with the statute. The committee is concerned, however, about the potential for abuse in this area. As a result, the committee is studying various alternative ways of addressing this problem and believes that an appropriate solution must be targeted narrowly to prevent egregious valuation abuses.

Explanation of Provision

Code sections 2036(c) and 2207B are repealed.

[82] The committee agrees with the Treasury Department and others who contend that many of the statute's operative terms are neither adequately defined in the statute nor susceptible to generally accepted interpretation. Notice 89-99, (August 31, 1989).

Effective Date

The repeal of sections 2036(c) and 2207B is retroactive from their date of enactment.

2. $2 million exclusion from generation-skipping transfer tax to grandchildren (sec. 6692 of the bill and sec. 1433(b)(3) of the Tax Reform Act of 1986)

Present Law

The Tax Reform Act of 1986 imposed a generation-skipping transfer tax (GSTT) on direct transfers to grandchildren. However, a person may make direct skip transfers of up to $2 million to a grandchild prior to January 1, 1990, without incurring this tax (the "$2 million exclusion"). A transfer to a trust qualifies for the $2 million exclusion only if (1) the grandchild is the only beneficiary; (2) the property will be includible in the grandchild's gross estate; and (3) trust income must be distributed annually after the grandchild attain age 21 (the "distribution requirement").

Reasons for Change

The GSTT is designed to tax transfers to grandchildren as if the property passes through the child's estate. As a result, it is imposed at the maximum estate tax rate. The imposition of this tax is warranted where the intervening generation has a significant interest in the property (i.e., a life estate or term of years). The Committee believes that it is appropriate to continue to impose the GSTT on taxable terminations and taxable distributions, while providing different tax treatment for outright transfers to skip persons (or transfers in trust for the skip person's exclusive benefit).

The Committee believes that the primary problem with respect to generation-skipping transfers relates to transfers in trust rather than direct transfers. Prior to 1976, taxpayers could avoid the estate tax by setting up complicated trusts that gave successive life estates to their children, grandchildren, and great-grandchildren. This technique allowed the individuals in the lower generations to enjoy the property but did not require the property to be included in their estates. However, in the case of an outright transfer to a grandchild, the child receives no economic benefit from the transfer. In light of these considerations, the committee believes that the current law treatment of direct transfers must be modified.

Explanation of Provision

The $2 million exclusion for direct transfers is made permanent. In addition, the distribution requirement is eliminated.

Effective Date

The provision is effective for transfers made after October 3, 1989.

3. Joint purchase of term and remainder interest in property (sec. 6693 of the bill and sec. 167 of the Code)

Present Law

The purchaser of a term interest in property is, for income tax purposes, entitled to amortize the cost of the interest over its expected life. The purchaser of a remainder interest in property generally does not include currently in income increases in the value of the interest.

On the other hand, a person who divides an interest in property into two parts cannot create an amortizable asset where none previously existed. Thus, a person who retains a term interest in property while transferring the remainder in that property cannot amortize the cost of the term interest.[83]

Reasons for Change

A common method of deferring income tax is for two related persons to purchase jointly a term and remainder interest in property. Typically, a parent will purchase an income interest in property while, at the same time, a child purchases the remainder interest in that same property. Joint purchases can be made of many types of property.

Under present law, the parent reduces taxable income from the term interest by the amortization deduction of the cost of the term interest. The child has gain on the remainder interest when the property is sold or exchanged.

For example, assume that interest rates are 10 percent and that a parent purchases for $435.53 a 6-year term interest in land that has a fair market value of $1,000 and rental income of $100 per year. At the same time, the parent's child purchases the remainder interest in the land for $564.47. The parent receives the income of $100 per year, but is allowed a deduction of $72.59 ($435.53 divided by 6) per year. If the value of the land does not change, the child will recognize gain of $435.53 ($1,000 minus $564.47) on its sale.

If the parent had purchased the land outright for $1,000 and then given the remainder interest in the land to the child, the parent would have been currently taxed on the $100 of rental income, without any amortization deduction. The child would recognize gain only if the amount realized from the sale of the land exceeded $1,000.

The committee understands that the deferral implicit in a joint purchase results from the fact that the remainderman is not taxed currently on the increase in value of the remainder interest. Present law limits the tax reduction possibilities inherent in such deferral by denying the creator of a term interest an amortization deduction. Denial of the deduction to the creator substitutes for taxing the remainderman. The committee believes that such substitute taxation is appropriate whenever related persons own both the term and remainder interests.

---

[83] *See, e.g.*, Lomas Santa Fe, Inc. v. Commissioner, 74 T.C. 662, 682-83 (1980); United States v. Georgia R.R. & Banking Co., 348 F.2d 278, 288-89 (5th Cir. 1965), *cert. denied*, 382 U.S. 973 (1966).

Explanation of Provision

No depreciation or amortization deduction is allowed for a term interest in property for any period during which the remainder interest in such property is held (directly or indirectly) by a related person. The provision does not otherwise change the depreciation of the underlying property. For example, the provision would not affect the depreciation allowed to an income beneficiary of a gift made in trust. *See* sec. 167(h).

When the term interest terminates, the taxpayer is treated as having a loss from the sale or exchange of such interest no greater than the deductions disallowed by the provision.[84]

A term interest in property is a life interest in property, an interest in property for a term of years, or an income interest in a trust. A related person is any person bearing a relationship to the taxpayer described in section 267(b) or 267(e). In determining whether persons are related, the constructive ownership rules of section 267(c) apply.

The Secretary of the Treasury shall prescribe such regulations as may be necessary to carry out the purposes of the provision, including regulations preventing avoidance of the provision through cross-ownership arrangements or otherwise. Such regulations shall prevent avoidance of the provision by one family owning a term interest in one property and a remainder interest in a second property, while another family owns a remainder interest in the first property, and a term interest in the second property. Such regulations would also prevent avoidance through the joint purchases of interests in substantially similar property. For example, a parent could not avoid the provision by purchasing a life interest in stock of a corporation while a child purchases a remainder interest in other stock of the same corporation.

The committee intends that the Treasury regulations prevent the avoidance of the provision through the use of property or properties in which the term interest terminates over time, such as interest in a shrinking portion of property. In appropriate circumstances, such regulations might defer any loss until the taxpayer's interest in the entire property (or all properties) terminates.

The committee does not intend to affect the taxation of a stripped bond under section 1286 or transactions in which the lessor is imputed income under section 467(f).

Effective Date

The provision applies to life or terminable interests acquired after July 27, 1989, in taxable years ending after such date.

---

[84] The exact amount of the loss is to be determined by Treasury Regulations. The committee expects that in the joint purchase of land described in the above example, the parent would receive a loss equal to $435.53 in year six.

4. Waiver of right of recovery for certain marital deduction property (sec. 6694 of the bill and sec. 2207A 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 includible in the estate of the surviving spouse. The surviving spouse's estate is entitled to recover the portion of the estate tax attributable to the inclusion of such property in the surviving spouse's gross estate from the person receiving the property, unless the spouse directs otherwise by will. Thus, a will requiring that all taxes be paid from probate property may have the effect of waiving the right to recovery.

Reasons for Change

The committee understood that persons utilizing standard testamentary language were often inadvertently waiving the right of recovery. Accordingly, the committee decided that the right of recovery should not be waived absent specific reference to that right.

Explanation of Provision

The right of recovery with respect to qualified terminable interest property applies unless the spouse otherwise directs in a provision of the will specifically referring to this provision, i.e., a specific reference to section 2207A.

Effective Date

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

5. Inclusion in gross estate of gifts made within three years of death (sec. 6695 of the bill and section 2035 of the Code)

Present Law

If property is transferred within three years of the decedent's death from a revocable trust which would be includible in the decedent's estate under section 2038, the value of the gross estate includes the value of the property so transferred (sec. 2035). This rule could be interpreted to include in the transferor's gross estate transfers of less than $10,000 that qualified for the annual exclusion.

Reasons for Change

Many persons use revocable trusts as a substitute for wills. By including transfers from such a trust made three years prior to death in the gross estate, present law penalizes such persons. The committee determined that the transfer tax consequences of making a gift from such a trust should be no different than if such gift was made directly.

Explanation of Provision

Section 2035 would not apply to any transfer from a trust with respect to which the decedent retained the right to revoke unless section 2035 would apply to such transfer if made directly by the decedent. In addition, the provision makes clarifying changes to section 2035.

Effective Date

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

6. Definition of qualified terminable interest property (sec. 6696 of the bill and secs. 2056(b)(7) and 2523(f) of the Code)

Present Law

Since December 31, 1981, a marital deduction has been allowed for qualified terminable interest property (QTIP). In order to qualify as qualified terminable interest property, the surviving spouse must have a qualifying income interest for life, which in turn requires that the spouse be entitled to all of the income from the property, payable annually or at more frequent intervals. Property qualifying under the QTIP rule generally is includible in the gross estate of the surviving spouse for Federal estate tax purposes.

Under proposed regulations, an income interest will not fail to constitute a qualifying income interest for life solely because income between the last distribution date and the date of the surviving spouse's death is not required to be distributed to the surviving spouse or the surviving spouse's estate. *See* Prop. Reg. secs. 20.2056(b)-7(c)(1), 25.2523(f)-1(b). Contrary to the regulations, the United States Tax Court has held that in order to satisfy the QTIP requirements, income accumulated between the date of the last distribution and the date of the spouse's death (the "accumulated income") must be paid to the spouse's 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).

Explanation of Provision

Under the bill, an income interest does not fail to qualify as qualified income interest for life solely because income for the period after the date of the last distribution and before the date of the surviving spouse's death is not required to be distributed to the surviving spouse. Where the marital deduction is allowed, however, the income for such period is includible in the gross estate of the surviving spouse for Federal estate tax purposes.

No inference with respect to present law is to be drawn from the provision.

Effective Date

The provision applies to decedents dying, and gifts made, after October 3, 1989. The proposal would not require the inclusion in the surviving spouse's gross estate of property for which no marital deduction was claimed.

The estate of a surviving spouse dying after October 3, 1989, is required to include property transferred prior to that date for which a marital deduction was in fact allowed even though the accumulated income from the property was not required to be paid to the surviving spouse.

Subtitle G. Revision of Civil Penalties

1. Information reporting penalties (secs. 6711–6715 of the bill and new secs. 6721–6724 of the Code and secs. 6011 and 6038 of the Code)

Present Law

In general

Any person that fails to file an information return with the Internal Revenue Service on or before the prescribed filing date is subject to a $50 penalty for each failure, with a maximum penalty of $100,000 per calendar year. Information returns relating to interest and dividends are subject to this $50 penalty for each failure, but without any cap on the total amount of penalty that may be imposed. In addition, any person that fails to provide a copy of an information return (a "payee statement") to a taxpayer on or before the prescribed due date is subject to a penalty of $50 for each failure, with a maximum penalty of $100,000 per calendar year. If a person fails to include all of the information required to be shown on an information return or a payee statement or includes incorrect information, then a penalty of $5 may be imposed with respect to each such failure, with a maximum penalty of $20,000 per calendar year. Stricter penalty provisions apply in the case of interest and dividend returns and in the case of intentional failures to comply with the information return requirements.

A penalty may also be imposed for each failure to include a correct taxpayer identification number on a return or statement and for each failure to furnish a correct taxpayer identification number to another person. The amount of the penalty that may be imposed is either $5 or $50 for each failure, depending on the nature of the failure.

Foreign provisions

Income of foreign persons subject to withholding

Persons having control, receipt, custody, disposal, or payment of certain types of U.S. income of foreign persons are required to deduct and withhold U.S. tax from such income under chapter 3 of the Code's income tax provisions (secs. 1441–1464). Generally, any person required to serve as a withholding agent under chapter 3 must provide each income recipient an annual withholding statement (Form 1042S) and must file all required Forms 1042S with the IRS accompanied by a return (Form 1042) summarizing the information on the Forms 1042S (Reg. sec. 1.1461-2). As described above, the Code generally provides penalties for each failure to file a required information return with the IRS and each failure to provide a required payee statement. These penalties do not apply, however, to each failure with respect to Forms 1042S.

Information reporting

Generally, every U.S. person is required to report certain information concerning any foreign corporation that such person controls and information relating to transactions between the corporation and certain specified persons. Failure to provide such information subjects the U.S. person to a monetary penalty plus a denial of foreign tax credits (sec. 6038). These information reporting requirements and this penalty do not specifically refer to all types of information needed to determine tax liabilities with respect to controlled foreign corporations.

Reasons for Change

The committee believes that the present-law penalties should be modified to encourage persons to file correct information returns even though such returns are filed after the prescribed filing date. The committee believes that it is important to give taxpayers an incentive to correct their errors as rapidly as possible.

Explanation of Provisions

Overview

The bill modifies the information return penalties provided under present law in order to encourage persons to file correct information returns even though such returns are filed after the prescribed filing date. The committee has established a three-tier penalty structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. The committee believes that this structure will give taxpayers an incentive to correct their errors as rapidly as possible. The committee also provides that taxpayers may correct a *de minimis* number of errors and avoid penalties entirely. The bill makes uniform the reporting requirements applicable to magnetic media and requires a study of service bureaus, which file information documents on behalf of other persons.

Failure to file correct information returns

Under the bill, any person that fails to file a correct information return with the Internal Revenue Service on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is $15 per return, with a maximum penalty of $75,000 per calendar year. If a person files a correct information return after the date that is after 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is $30 per return, with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1 of any year, the amount of the penalty is $50 per return, with a maximum penalty of $250,000 per calendar year.

The committee chose this initial 30-day period for filing correct information returns with a smaller penalty because it believes that it is vital to the integrity of the self-assessment system that taxpayers receive their payee statements on a timely basis (generally, these must be provided by January 31). The preparation of these payee statements given to taxpayers is integrally connected with the preparation of the parallel information returns given to the IRS. The committee believes that this initial 30-day period gives filers of these information returns an appropriate amount of time within which to correct failures with respect to documents prepared for the IRS without jeopardizing the provision of the payee statements directly to taxpayers on a timely basis. Similarly, the committee chose the August 1 date because this is approximately the date on which the IRS begins intensive processing and use of this data. Consequently, submission of the data after this date is effectively equivalent to not providing the data at all. The committee expects that in future years advancements in available technology may permit the IRS to utilize this data earlier in the year. If this proves to be the case, the committee expects the IRS to request that the Congress consider modifying this deadline legislatively.

The bill also provides a special rule for *de minimis* failures to include the required, correct information. This exception applies to incorrect information returns that are corrected on or before August 1. Under the exception, if an information return is originally filed without all of the required information or with incorrect information and the return is corrected on or before August 1, then the original return is treated as having been filed with all of the correct required information. The number of information returns that may qualify for this exception for any calendar year is limited to the greater of (1) 10 returns or (2) one-half of one percent of the total number of information returns that are required to be filed by the person during the calendar year.

The use of 10 returns for this purpose effectively provides a special small-business rule in this penalty. According to IRS statistics, approximately 84 percent of payors who file information returns with the IRS file 10 or fewer forms. Thus, these payors will have until August 1 to correct without penalty errors of omission or commission on information returns that were originally timely-filed with the IRS. If the total number of returns corrected by the taxpayer exceeds the *de minimis* threshold, only the number exceeding the threshold is subject to penalty. This specific *de minimis* rule in no way restricts the ability of the IRS or the courts to grant a waiver based on reasonable cause (discussed below). The reasonable cause waiver is applied before the *de minimis* rule is applied.

In addition, the bill provides special, lower maximum levels for this penalty for small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent 3 taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

The bill also incorporates into this general structure the penalty for failure to provide information reports to the IRS or statements to payees relating to pension payments.

The committee intends that taxpayers who correct errors in payor statements filed with IRS also make any necessary parallel corrections to payee statements provided to taxpayers. In addition, the committee intends that the substance of the current IRS temporary regulations (Treas. Reg. sec. 301.6723-1T(b)), providing an exception from penalty for inconsequential omissions and inaccuracies, be continued and expanded to apply to information returns, payee statements, and failures to comply with other information reporting requirements (new secs. 6721, 6722, and 6723).

In addition, the committee notes that the IRS permits taxpayers to request extensions of time to file information returns (such as by Form 8809). The committee approves of the existence of administrative procedures to consider requests for extension and expects that these types of procedures will continue to be available to payors.

The bill maintains the present-law rules for failures that are due to intentional disregard of the filing requirement. Failure to correct information returns within a reasonable time after being requested to do so by the IRS could be considered to be intentional disregard. In addition, some have expressed to the committee the belief that the overall caps on these penalties are inappropriate, in that payors who are required to file large number of information returns or payee statements may ignore the requirements to do so and pay the maximum penalty as a "cost of doing business" where it is less than the cost of compliance would be. The committee believes that the general caps serve an important function and should be retained. The committee believes that behavior such as ignoring filing requirements in the manner just described is intentional disregard of those requirements, and that payors who engage in such behavior should be subject to the higher penalties (without caps) that apply in cases of intentional disregard.

Failure to furnish correct payee statements

Under the bill, any person that fails to furnish a correct payee statement to a taxpayer on or before the prescribed due date is subject to a penalty (as under present law) of $50 per statement, with a maximum penalty of $100,000 per calendar year. If the failure to furnish a correct payee statement to a taxpayer is due to intentional disregard of the requirement, the bill generally provides a penalty of $100 per statement or, if greater, 10 percent [85] of the amount required to be shown on the statement, with no limitation on the maximum penalty per calendar year. The committee has not altered the present-law deadline by which these payee statements must be furnished, because it believes that it is vital to the integrity of the self-assessment system that taxpayers receive their payee statements on a timely basis. Many taxpayers rely on the timely receipt of these payee statements so that these taxpayers can complete their own tax returns on a timely basis.

[85] Five percent for several types of statements.

Failure to comply with other information reporting requirements

Under the bill, any person that fails to comply with other specified information reporting requirements on or before the prescribed date is subject to a penalty of $50 for each failure, with a maximum penalty of $100,000 per calendar year. The information reporting requirements specified for this purpose include any requirement to include a correct taxpayer identification number on a return or statement and any requirement to furnish a correct taxpayer identification number to another person. The bill coordinates this penalty with the penalty for failure to file correct information returns and the penalty for failure to file correct payee statements by making this penalty inapplicable to failures penalized under those provisions.

Waiver, definitions, and special rules

The bill consolidates the waiver standards relating to information reporting into one provision. The bill provides that any of the information reporting penalties may be waived if it is shown that the failure to comply is due to reasonable cause and not to willful neglect. If a payor correctly reports information that the payor received from a payee, the payor is not subject to penalty for errors that the payee made in reporting the information to the payor (provided that the payor had no reason to believe that the information was incorrect). The committee intends that for this purpose, reasonable cause exists if significant mitigating factors are present, such as the fact that a person has an established history of complying with the information reporting requirements.[86] The separate, higher waiver standard under present law for interest and dividends is repealed. Interest and dividend returns and statements are consequently subject to this general waiver standard. The committee intends that payors of interest and dividends that comply with the present-law due diligence standards be considered (for purposes of this bill) to have established reasonable cause.

Foreign provisions

Penalties for failure to file withholding statements

The bill integrates the penalty for failure to file Form 1042S and failure to provide Form 1042S to the payee into the general penalty structure. Thus, the bill treats each Form 1042S required to be filed with the IRS and provided to a payee as an information return and as a payee statement, respectively, as those terms are defined in section 6724. Accordingly, each failure to file any required Form 1042S will be subject to a separate penalty under section 6721, and each failure to provide a payee any required Form 1042S will be subject to a separate penalty under section 6722.

---

[86] In addition, the committee intends that reasonable cause generally be considered to exist for failures due to (a) catastrophes such as equipment and software failures or fires, storms, or other casualties, or (b) statutory or regulatory changes (i) that have a major, direct impact upon data processing and (ii) that are made so close to the time that the information reporting is required that, for all practical purposes, the changes cannot be complied with.

Penalties for failure to report information with respect to certain foreign corporations

The bill clarifies the reporting requirements and penalties imposed by section 6038 by expressly applying those provisions to failures to provide certain information with respect to related parties, such as controlled foreign corporations of which the person subject to the requirements is a U.S. shareholder.

Uniform requirements for returns on magnetic media

The bill provides that uniform magnetic media requirements apply to all information returns filed during any calendar year. The bill accomplishes this by making statutory the requirement currently contained in IRS regulations that persons filing more than 250 information returns file those returns on magnetic media. The bill makes this requirement applicable to all types of information returns. Thus, the bill repeals the provision of present law that requires persons filing more than 50 information returns relating to payments of interest, dividends, and patronage dividends to file all such returns on magnetic media. The committee also intends that the IRS permit payors to file in as many formats as is feasible, and that IRS requirements keep pace with technological advances. The bill provides that the penalty for failing to file information returns on magnetic media when required to do so applies only to the number required to be so filed that exceeds 250. The penalties for failure to file on a timely basis correct information returns would apply to the first 250 returns.

The bill provides that the IRS is to take into account (among other factors) the ability of the taxpayer to comply at a reasonable cost with the magnetic-media filing requirements. The committee intends that the IRS take into consideration other instances of undue hardship, such as temporary equipment breakdowns or destruction of magnetic media equipment, in granting one-year or multi-year exemptions from this requirement.

Study of procedures to prevent mismatching

The bill requires the General Accounting Office, in consultation with the Treasury Department, to conduct a study on whether, if the name and taxpayer identification number of any person that is set forth on an information return do not correspond to the name and taxpayer identification number of such person contained on the records of the IRS, the IRS should be permitted to disclose to the person that has filed such information return such information as may be necessary to determine the correct name and taxpayer identification number. The study should also consider (1) alternative means of correcting the mismatch between names and taxpayer identification numbers that involve the least amount of disclosure of confidential taxpayer identity information, (2) what exact information it is that IRS has in its records that would help resolve mismatches, (3) how the IRS can better process in a timely manner name change information (for example due to marriage or divorce) received initially by the SSA, which IRS uses to revise its records, and (4) how taxpayers can best inform the IRS of a name or address change, prior to waiting until the next tax return filing date.

22-661 O—89——8

A report on the study, together with any recommendations, is to be submitted to the tax-writing committees of the Congress by June 1, 1990. In the interim, the IRS should establish a procedure and contact point within the IRS where taxpayers themselves (or information return filers who obtain an exception from the taxpayer) can obtain a listing of the names that the IRS recognizes as valid when matching information returns with a particular taxpayer identification number.

Study of service bureaus

The bill requires the General Accounting Office, in consultation with the Treasury Department, to conduct a study of whether service bureaus engaged in the business of transmitting information returns or other documents to the IRS on behalf of other persons should be subject to registration or other regulation. A report on the study, together with any recommendations, is to be submitted to the tax-writing committees of the Congress not later than July 1, 1990.

The committee is concerned that some service bureaus may not be effectively communicating with their customers as to difficulties the IRS has encountered with the data the service bureau has transmitted on behalf of payors. This failure of communication may increase the difficulty that both the actual payor and the IRS have in resolving problems with the transmitted data. In addition, it may be difficult for payors to assess the relative competence of individual service bureaus, in that the IRS cannot legally state whether or not it has encountered problems with a particular service bureau. The GAO study should consider problems such as these.

Effective Dates

The information reporting provisions of the bill generally apply to information returns and payee statements the due date for which (determined without regard to extensions) is after December 31, 1989.

2. Accuracy penalties (sec. 6721 of the bill and new secs. 6662–6665 of the Code and secs. 6621(c), 6653, 6659, 6659A, 6660, and 6661 of the Code)

Present Law

Negligence penalty

If any part of an underpayment of tax required to be shown on a return is due to negligence or disregard of rules or regulations, a penalty may be imposed equal to 5 percent of the total amount of the underpayment. An underpayment of tax that is attributable to a failure to include on an income tax return an amount shown on an information return is treated as subject to the negligence penalty absent clear and convincing evidence to the contrary.

Fraud penalty

If any part of an underpayment of tax required to be shown on a return is due to fraud, a penalty may be imposed equal to 75 percent of the portion of the underpayment that is attributable to fraud.

Substantial understatement penalty

If the correct income tax liability of a taxpayer for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 25 percent of the underpayment of tax attributable to the understatement. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return. Special rules apply to tax shelters.

Valuation penalties

If an individual, personal service corporation, or closely held corporation underpays income tax for any taxable year by $1,000 or more as a result of a valuation overstatement, then a penalty may be imposed with respect to the amount of the underpayment that is attributable to the valuation overstatement. A valuation overstatement exists if the valuation or adjusted basis of any property claimed on a return is 150 percent or more of the correct value or adjusted basis. The amount of the penalty that may be imposed increases from 10 to 20 to 30 percent of the underpayment attributable to the valuation overstatement as the percentage by which the valuation claimed exceeds the correct valuation increases. Similar penalties may be imposed with respect to (1) an underpayment of income tax that is attributable to an overstatement of pension liabilities and (2) an underpayment of estate or gift tax that is attributable to a valuation understatement.

Reasons for Change

The committee believes that the number of different penalties that relate to accuracy of a tax return, as well as the potential for overlapping among many of these penalties, causes confusion among taxpayers and leads to difficulties in administering these penalties by the IRS. Consequently, the committee has revised these penalties and consolidated them. The committee believes that its changes will significantly improve the fairness, comprehensibility, and administrability of these penalties.

Explanation of Provisions

Overview

The bill consolidates into one part of the Internal Revenue Code all of the generally applicable penalties relating to the accuracy of tax returns. The penalties that are consolidated are the negligence penalty, the substantial understatement penalty, and the valuation penalties. These consolidated penalties are also coordinated with the fraud penalty. The bill repeals the present-law versions of these penalties. The bill reorganizes the accuracy penalties into a new structure that operates to eliminate any stacking of the penalties. The bill is effective for returns the due date for which is after December 31, 1989.

Accuracy-related penalty

The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation overstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement.

(1) Negligence

If an underpayment of tax is attributable to negligence, the negligence penalty is to apply only to the portion of the underpayment that is attributable to negligence rather than, as under present law, to the entire underpayment of tax. This is a significant change from present law. Under present law, if any portion of an underpayment is attributable to negligence, the negligence penalty applies to the entire underpayment (both the portion attributable to negligence and the portion not attributable to negligence). Thus, under present law, a taxpayer who has an underpayment, only a small portion of which was attributable to negligence, is subject to the same penalty as a taxpayer with the same underpayment, all of which is attributable to negligence, even though the behavior of the first taxpayer is arguably less culpable than the behavior of the second taxpayer. The bill rectifies this inequity by applying the negligence penalty only to the portion of the underpayment attributable to negligence.

Negligence includes any careless, reckless, or intentional disregard of rules or regulations, as well as any failure to make a reasonable attempt to comply with the provisions of the Code. In addition, the bill repeals the present-law presumption under which an underpayment is treated as attributable to negligence if the underpayment is due to a failure to include on an income tax return an amount shown on an information return. As a practical matter, even in the absence of a statutory presumption, evidence of such a failure is still strong evidence of negligence.

(2) Substantial understatement of income tax

The accuracy-related penalty that applies to the portion of an underpayment that is attributable to a substantial understatement of income tax is the same as the substantial understatement penalty provided under present law with three principal modifications. First, the rate is lowered to 20 percent. Second, the committee expands the list of authorities upon which taxpayers may rely (currently contained in Treasury regulations) to include proposed regulations, private letter rulings, technical advice memoranda, actions on decisions, general counsel memoranda, information or press releases, notices, and any other similar documents published by the

IRS in the *Internal Revenue Bulletin.*[87] In addition, the list of authorities is to include General Explanations of tax legislation prepared by the Joint Committee on Taxation (the "Blue Book"). Third, the bill requires the IRS to publish not less frequently than annually a list of positions for which the IRS believes there is no substantial authority and which affect a significant number of taxpayers. The purpose of this list is to assist taxpayers in determining whether a position should be disclosed in order to avoid the substantial understatement penalty. Thus, if a taxpayer takes a position that is enumerated on this list, the taxpayer could choose to disclose that position to avoid imposition of the substantial understatement component of the accuracy-related penalty. However, inclusion of a position on this list is not conclusive as to whether or not substantial authority exists with respect to that position and no inference is to be drawn that there is (or could be) substantial authority for a position that is not on the list. If, however, there is litigation as to whether there is substantial authority, and the court concludes that the IRS is correct in the belief that there is not substantial authority for the position, then this penalty would apply. The committee believes that this list will be useful to taxpayers, in that it will assist taxpayers in determining whether substantial authority exists with respect to a particular issue on the list. Although the list is not exclusive, the committee intends that the IRS make the list as comprehensive as practical, which will make it more useful to taxpayers and their advisors. The committee intends that there should be no inference that substantial authority exists with respect to positions that are not included on this list. Disclosure of a position for purposes of this penalty does not necessarily prevent imposition of the negligence penalty. Thus, for example, if a taxpayer discloses a frivolous position, the imposition of the negligence penalty could be appropriate.

(3) Substantial valuation overstatement

The penalty that is to apply to the portion of an underpayment that is attributable to a substantial valuation overstatement is generally the same as the valuation overstatement penalty provided under present law with five principal modifications. First, the bill extends the penalty to all taxpayers. The committee believes that this modification increases the fairness of this component of the accuracy-related penalty, in that the penalty is imposed upon proscribed behavior, regardless of who engages in it. Second, a substantial valuation overstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the correct value or adjusted basis. Third, the penalty is to apply only if the amount of the underpayment attributable to a valuation overstatement exceeds $5,000 ($10,000 in the case of most corpora-

[87] The committee's intent is to broaden the list of authorities upon which taxpayers may rely. The committee would, however, permit the Treasury to issue regulations providing that specific items on the committee's list of additional authorities (except for proposed regulations not yet superceded or "Blue Books") that were issued prior to the date of enactment of this bill may not be considered to be substantial authority. For example, Treasury regulations could provide that private letter rulings issued prior to the date they began to be publicly disseminated are not substantial authority. Any such limitation should, however, be as narrow as practicable, in order to further the committee's general intent that the list of authorities on which taxpayers may rely should be broadened.

tions). This increases five-fold the threshold below which the penalty does not apply to individuals. Fourth, the amount of the penalty for a substantial valuation overstatement is 20 percent of the amount of the underpayment if the value or adjusted basis claimed is 200 percent or more but less than 400 percent of the correct value or adjusted basis. Fifth, as explained below, the bill provides that the rate of this penalty is doubled if the value or adjusted basis claimed is 400 percent or more of the correct value or adjusted basis. The bill retains the special rules in present law that apply to charitable deduction property. The committee believes that raising both the threshold and the minimum percentage will eliminate from the penalty's scope a number of instances of good-faith valuation disputes that may be subject to penalty under present law. As under present law, valuation misstatements that do not fall within the scope of this or the following elements of the accuracy-related penalty may still be subject to penalty if they are attributable to negligence or fraud or give rise to a substantial understatement of income tax.

(4) Substantial overstatement of pension liabilities

The accuracy-related penalty also applies to substantial overstatements of pension liabilities. This penalty is derived from the present-law penalty in section 6659A. The committee has, however, modified the present-law penalty by providing that the taxpayer is subject to this component of the accuracy-related penalty only if the actuarial determination of pension liabilities (taken into account for purposes of computing the deduction under paragraph (1) or (2) of section 404(a)) is 200 percent or more of the amount determined to be correct (under present law, the penalty applies to claims 150 percent or more in excess of the amount determined to be correct). As under present law, this penalty applies only if the underpayment attributable to the valuation overstatement exceeds $1,000.

(5) Substantial estate or gift tax valuation understatement

The accuracy-related penalty also applies to substantial estate or gift tax valuation understatements. This penalty is derived from the present-law penalty in section 6660. The committee has, however, modified the present-law penalty by providing that the taxpayer is subject to this penalty only if the value of any property claimed on an estate or gift tax return is 50 percent or less of the amount determined to be correct. (Under present law, the penalty applies to claims that are 66 2/3 percent or less of the amount determined to be correct.) In addition, the committee has modified the present-law penalty by increasing five-fold the threshold below which the penalty does not apply, from $1,000 to $5,000. The committee believes that raising both the threshold and the minimum percentage will eliminate from the penalty's scope a number of instances of good-faith valuation disputes that may be subject to penalty under present law.

(6) Gross valuation misstatements

The bill provides that the rate of the general accuracy penalty is to be doubled (to 40 percent) in the case of gross valuation misstatements. There are three types of gross valuation misstatements. The first is the same as the substantial valuation overstatement component of the accuracy-related penalty, except that the doubling is to apply only to valuation overstatements claimed on a return that are 400 percent or more of the amount determined to be the correct amount. The second is the same as the substantial overstatement of pension liabilities component of the accuracy-related penalty, except that the doubling is to apply only to overstatements of pension liabilities that are 400 percent or more of the amount determined to be the correct amount. The third is the same as the substantial estate or gift tax valuation understatement component of the accuracy-related penalty, except that the doubling is to apply only to valuations claimed on the estate or gift tax return that are 25 percent or less of the amount determined to be the correct amount.

Fraud penalty

The fraud penalty, which is imposed at a rate of 75 percent, applies to the portion of any underpayment that is attributable to fraud.

The committee has retained the special rule in present law that determines the portion of the understatement that is attributable to fraud. The bill provides that, if the IRS establishes that any portion of an underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud, except with respect to any item that the taxpayer establishes is not attributable to fraud. The committee has clarified the taxpayer's burden of proof in establishing the items not attributable to fraud (present law is unclear on this issue). The committee has provided that the taxpayer must establish the items not attributable to fraud by a preponderance of the evidence. The committee has not altered the present-law burden of proof imposed on the IRS in establishing fraud initially; the IRS must continue to meet its burden of proof by clear and convincing evidence. The committee believes that it is appropriate that the burden imposed on the IRS be higher than the burden imposed on a taxpayer in these circumstances.

Under the bill, the accuracy-related penalty is not to apply to any portion of an underpayment on which the fraud penalty is imposed. (Under present law, the fraud penalty is coordinated in this manner with the negligence penalty, but not with the other components of the accuracy-related penalty.) However, the accuracy-related penalty may be applied to any portion of the underpayment that is not attributable to fraud.

Definitions and special rules

The bill provides special rules that apply to each of the penalties imposed under the new structure. First, the bill provides standardized exception criteria for all of these accuracy-related penalties. The bill provides that no penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayer acted in good faith. The enactment of this standardized exception criterion is designed to permit the courts to review the assertion of penalties under the same standards that apply in reviewing additional tax that the Internal Revenue Service asserts is due.

By applying this unified exception criterion to all the accuracy-related penalties, the committee believes that taxpayers will more easily understand the standard of behavior that is required. The committee also believes that this unified exception criterion will simplify the administration of these penalties by the IRS.

The committee is concerned that the present-law accuracy-related penalties (particularly the penalty for substantial understatements of tax liability) have been determined too routinely and automatically by the IRS. The committee expects that enactment of standardized exception criterion will lead the IRS to consider fully whether imposition of these penalties is appropriate before determining these penalties.

In addition, the committee has designed this standardized exception criterion to provide greater scope for judicial review of IRS determinations of these penalties. Under the waiver provision contained in present law, the Tax Court has held that it can overturn an IRS determination of the substantial understatement penalty on reasonable cause and good faith grounds only if the Tax Court finds that the IRS abused its discretion in asserting the penalty. The committee believes that it is appropriate for the courts to review the determination of the accuracy-related penalties by the same general standard applicable to their review of the additional taxes that the IRS determines are owed. The committee believes that providing greater scope for judicial review of IRS determinations of these penalties will lead to greater fairness of the penalty structure and minimize inappropriate determinations of these penalties.

The committee believes that the application of standardized exception criteria to the negligence component of the accuracy-related penalty will result in several consequences that are beneficial to taxpayers. First, the complete, item-specific disclosure of a non-frivolous position on a tax return may generally be considered to permit an exception from the negligence penalty insofar as such disclosure would tend to demonstrate that there was no intentional disregard of rules or regulations. Disclosure must be full and substantive, parallel to the disclosure required under the substantial understatement component of the accuracy-related penalty; completing and filling in a tax form is by itself insufficient disclosure for this purpose. In addition, the disclosure must be clearly identified as being made to avoid the imposition of the accuracy-related penalty. Imposition of the negligence component of the accuracy-related penalty would not be eligible for exception due to disclosure where the taxpayer fails to keep proper books and records or to substantiate items properly. Second, the application of standardized exception criteria to the negligence component of the accuracy-related penalty may also permit a taxpayer to avoid imposition of that penalty where the taxpayer makes a good-faith challenge to the validity of an IRS regulation, if the taxpayer discloses (in the manner just described) that the taxpayer is taking the position and makes specific reference to the regulation being challenged. As under present law, frivolous challenges to IRS regulations would be subject to penalty. The committee intends that the terms "reasonable cause" and "good faith" be interpreted under the bill as those terms are interpreted under present law.

Second, the bill provides that an accuracy-related or fraud penalty is to be imposed only if a return has been filed. This is intended to improve the coordination between the accuracy-related penalties and the failure to file penalties. Under present law, the courts have dealt with a number of difficult interpretative issues on the relationship between the penalty for failure to file a tax return and the accuracy-related penalties. The committee determined that it would clarify the law if the penalty for failure to file were entirely separate and distinct from the accuracy-related penalties. (The bill also provides for an increase in the failure to file penalty where that failure is due to fraudulent failure to file.)

Third, the bill provides a standard definition of underpayment for all of the accuracy-related penalties. This standard definition is intended to simplify and coordinate the definitions in present law; it is not intended to be substantively different from present law.

The bill retains the general rule of present law that interest on these penalties commences with the date the return was required to be filed. The committee believes this rule is appropriate because the behavior being penalized is reflected on the tax return, so that imposition of interest from this date will reduce the incentives of taxpayers and their advisors to "play the audit lottery."

Repeal of present-law penalties

The bill repeals the present-law penalties for negligence and fraud,[88] substantial understatements of liability,[89] valuation overstatements,[90] and valuation understatements for purposes of estate or gift taxes.[91] The bill also repeals the special negligence rules applicable to straddles [92] and to amounts shown on information returns.[93] The committee believes that, by repealing the special rule applicable to information returns, the burdens on taxpayers will be reduced. Finally, the bill repeals the higher interest rate that applies to substantial underpayments that are attributable to tax-motivated transactions.[94]

Effective Date

The accuracy provisions of the bill generally apply to returns the due date for which (determined without regard to extensions) is after December 31, 1989.

[88] Present-law section 6653. The portion of 6653 applicable to stamp taxes is retained.
[89] Present-law sec. 6661.
[90] Present-law secs. 6659 and 6659A.
[91] Present-law sec. 6660.
[92] Present-law sec. 6653(f).
[93] Present-law sec. 6653(g).
[94] Present-law sec. 6621(c).

3. Preparer, promoter, and protester penalties (secs. 6731–6738 of the bill and new sec. 6673 of the Code and secs. 6672, 6694, 6695, 6700, 6701, 6702, 7216, and 7407 of the Code)

Present Law

Return preparer penalties

An income tax return preparer is also subject to a penalty of $25 for each failure to (1) furnish a copy of a return or claim for refund to the taxpayer; (2) sign the return or claim for refund; or (3) furnish his or her identifying number.

Penalty for promoting abusive tax shelters

Any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, is subject to a penalty if in connection with such activity the person makes or furnishes a false or fraudulent statement or a gross valuation overstatement. The amount of the penalty equals the greater of $1,000 or 20 percent of the gross income derived or to be derived by the person from the activity. It is unclear under present law whether the term "activity" refers to each sale of an interest in a tax shelter or whether it refers to the overall activity of promoting an abusive tax shelter.

Penalty for aiding and abetting the understatement of tax liability

Any person who aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return or other document under the tax laws which (1) the person knows will be used in connection with any material matter arising under the tax laws, and (2) the person knows will (if so used) result in an understatement of the tax liability of another person is subject to a penalty equal to $1,000 for each return or other document ($10,000 in the case of returns and documents relating to the tax of a corporation).

Frivolous income tax return penalty

Any individual who files a frivolous income tax return is subject to a penalty of $500.

Sanctions and costs awarded by courts

If it appears to the Tax Court that (1) proceedings before it have been instituted or maintained primarily for delay, (2) the taxpayer's position is frivolous, or (3) the taxpayer has unreasonably failed to pursue administrative remedies, the Court may award damages not to exceed $5,000 to the United States.

Authority to counterclaim for balance of penalty in partial refund suits

Taxpayers may pay a portion of the penalties for failure to collect and pay over tax, for understatement of a taxpayer's liability by an income tax return preparer, for promoting abusive tax shelters, and for aiding and abetting the understatement of tax liability. By doing so, they may obtain judicial review of the imposition of these penalties. Present law may prohibit the Federal Government from counterclaiming for the balance of the penalty in the same lawsuit.

Bonding requirement

Return preparers may post a bond, thereby preventing any proceeding by the Federal Government under section 7407 seeking to enjoin a return preparer from engaging in prohibited conduct.

Disclosure of certain information by return preparers

In general, return preparers are subject to penalty for disclosing tax return information that is furnished to the return preparer in connection with the preparation of tax returns. The IRS may by regulation provide exceptions to this general prohibition.

Reasons for Change

The committee believes that it is appropriate to reconsider, in the context of the entire penalty structure, these specific penalties. These penalties have been enacted and modified on a piecemeal basis, and have not been subject to comprehensive review.

Explanation of Provisions

Return preparer penalties

The return preparer penalties that apply to each failure to (1) furnish a copy of a return or claim for refund to the taxpayer, (2) sign the return or claim for refund, (3) furnish his or her identifying number, and (4) file a correct information return, are made uniform. The penalty is $50 for each failure and the total penalties imposed for any single type of failure for any calendar year are limited to $25,000.

The committee intends that imposition of the present-law preparer penalty (contained in section 6694) not lead automatically to any disciplinary action, or any initiation of contact with a practitioner, by the Internal Revenue Service Director of Practice. In addition, when the Director of Practice initiates contact with a practitioner but does not yet have sufficient information to determine whether a basis for discipline exists, the committee believes it is important that the Director of Practice inform the practitioner that the contact does not imply any finding of wrongdoing.

Penalty for promoting abusive tax shelters

Under the bill, the amount of the penalty imposed for promoting abusive tax shelters equals $1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). In calculating the amount of the penalty, the organizing of an entity, plan or arrangement and the sale of each interest in an entity, plan, or arrangement constitute separate activities. The committee has made these modifications because the courts have differed in their interpretations of the provisions of present law. The committee believes that its modifications will eliminate confusion for cases arising in the future. The bill also clarifies that the penalty applies to direct or indirect actions. The bill provides a six-year statute of limitations for this penalty.

The committee is concerned about the large number of old tax shelter cases that await resolution. The committee recognizes that the Tax Court has, in the last several years, made significant progress in reducing its inventory of old tax shelter cases. The committee expects the Tax Court as well as the IRS to redouble their efforts to resolve or encourage settlement of old tax shelter cases. The committee realizes that delay is often caused by the litigants themselves. The committee encourages the Tax Court to use every means within its disposal, including the sanctions on litigants and attorneys imposed under this bill, to encourage litigants to resolve their disputes as expeditiously as possible. Similarly, the committee encourages the IRS to make every effort to resolve old tax shelter cases, through means such as additional settlement initiatives, better caseload management, and better utilization of the appeals process.

The committee wishes to clarify that, under present law, "investment plan or arrangement" and "other plan or arrangement," as those terms are used in section 6700 of the Code, include obligations issued by or on behalf of State or local governments which are represented to be described in section 103(a) of the Code ("bonds").[95] Therefore, the penalty imposed by section 6700 may apply to bond counsel, investment bankers and their counsel, issuers (and beneficiaries of "conduit" bonds) and their counsel, financial advisors, feasibility consultants and engineers, and other persons, who (1) are involved in the organization or sale of such State or local government bonds and (2) know or have reason to know that their opinions, offering documents, reports, or other statements (or material on which they relied in making such statements) are false or fraudulent as to any matter material to the tax exemption of the interest on the bonds. A person who makes a statement facilitating the issuance or sale of State or local government bonds (including a sale occurring subsequent to the issuance of the bonds) is involved in the organization or sale of such bonds.

Whether a person who makes or furnishes or causes another person to make or furnish a statement in connection with the organization or sale of bonds (including a statement that interest on the bonds is exempt from taxation), knows or has reason to know that such person's statement is false or fraudulent as to any material matter depends upon that person's role in the organization or sale. For example, bond counsel, issuer's counsel, and underwriters' counsel would be entitled to rêply upon a feasibility study conducted by an engineering firm reputed to be expert in the subject matter and area of the study, unless such counsel independently knew or had reason to know information bringing into question the results of that study. Absent that, counsel would not be required to question the assumptions underlying, or results reached by, the study. Similarly, bond counsel would be able to rely, as to matters

---

[95] For purposes of determining whether an obligation is represented as so described, qualifications or conditions with respect to the opinion of the bond counsel for the issue which are commonly accepted in the marketplace are not to be considered. For example, an obligation could still be represented to be described in section 103(a), even though bond counsel's opinion assumed continuing compliance with certain requirements of the Code (*e.g.*, arbitrage rebate).

of fact or expectation relevant to his or her opinion, on information provided by other parties (including the issuer) absent actual knowledge or a reason to know of its inaccuracy or the use of statements not credible or reasonable on their face. On the other hand, bond counsel must draw their own legal conclusions from that information. For example, bond counsel may rely on an engineer's description of a facility as to its physical characteristics, operations, functions, and performance, but would not be able to rely on such certification for counsel's legal conclusion that the facility qualified under section 142 of the Code. Similarly, an investment banking firm organizing or assisting in the organization of the bonds holding itself out as expert in the particular subject area of the financing would have reason to question the conclusion of a feasibility consultant if that consultant's report omitted consideration of a principal factor typically discussed in feasibility reports used in such financings (*e.g.*, competition for a project's source of supply of materials).

In addition, section 6700 applies even if the Service has insulated bondholders from the effect of a declaration of taxability of a bond sold as tax-exempt by entering into a closing agreement with the issuer of the bonds.[96] Furthermore, so long as there has been a determination that a false or fraudulent statement (which may include a conclusion of law based on a false or fraudulent statement) has been utilized, action under section 6700 is not precluded by failure of the Service to enter into a closing agreement, to declare taxability, or otherwise to penalize the issuer or owners of the bonds in question. In addition, action may be taken under section 6700 prior to delivery of bonds if a false or fraudulent statement is being used in their offering.

Penalty for aiding and abetting the understatement of tax liability

The bill amends the penalty for aiding and abetting the understatement of tax liability by imposing the penalty in cases where the person aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return or other document if (1) the person knows or has reason to believe that the return or other document will be used in connection with any material matter arising under the tax laws, and (2) the person knows that if the portion of the return or other document were so used, an understatement of the tax liability of another person would result.

In addition, the bill provides that a penalty for promoting abusive tax shelters is not to be imposed on any person with respect to any document if an aiding and abetting penalty is imposed on such person with respect to the same document. Both penalties may however be imposed with respect to separate documents, such as, for example, when a promoter furnishes promotional material at the time of sale and subsequently provides partnership schedules (Forms K-1) to the investors. The committee believes that this pen-

[96] Such closing agreements generally provide that the Service will not tax the interest earned by the bondholders in exchange for certain actions by the issuer, including in some cases payment designed to compensate the Federal Government for all or an appropriate percentage of lost tax revenues.

alty should not be used as a means of avoiding the procedural requirements of a John Doe summons under section 7609(f).

The bill also provides a six-year statute of limitations for this penalty.

Frivolous income tax return penalty

The bill deletes the special provision in present law permitting taxpayers who contest the imposition of this penalty to pay 15 percent of the penalty, which halts further collection proceedings until final judicial resolution of the dispute. Thus, taxpayers who wish to contest imposition of this penalty must pay the full penalty before seeking judicial review of imposition of the penalty. The committee believes that repealing this special 15-percent rule places taxpayers who contest this penalty by way of a refund action in the same position as taxpayers who contest the assertion that they owe additional tax to the IRS. By repealing this special rule, the bill makes suits for refund of this penalty permissible only under the generally applicable rules on suits for refunds. Suits contesting the imposition of this penalty may be brought only in the district courts and the Claims Court.

Sanctions and costs awarded by courts

The bill authorizes the Tax Court to impose a penalty not to exceed $25,000 if a taxpayer (1) institutes or maintains a proceeding primarily for delay, (2) takes a position that is frivolous, or (3) unreasonably fails to pursue available administrative remedies. The committee intends that the increased penalty (above $5,000) apply primarily (but not exclusively) to tax shelter cases, where the $5,000 maximum provided under present law appears to be ineffective in deterring taxpayers from taking frivolous positions.

The committee has explicitly chosen to call these awards "penalties", rather than "damages" (as under present law), so that it is clear that specific damages incurred by the United States need not be proved before the court may impose this penalty. The committee believes that dealing with these frivolous lawsuits wastes scarce judicial resources and delays the resolution of legitimate disputes. The committee expects that its modifications to this provision will further decrease frivolous lawsuits. The committee also intends to monitor the use of this penalty to ensure that it continues to be used, as it has in the past, only in situations in which its use is appropriate. The committee has also called these awards "penalties" rather than "damages" in the parallel provisions applicable to other courts. The committee has provided that any monetary sanctions, penalties, or costs awarded in a tax case by one of these other courts may be assessed and collected in the same manner as a tax. This permits these sanctions, penalties, and costs, when awarded by one of these other courts, to be collected in the same manner as if they were awarded by the Tax Court.

The committee has eliminated the last sentence from present law section 6673(a) (relating to assessment and payment) because, in light of the use of the term "penalty", the purpose of that last sentence is accomplished by section 6671(a). The committee intends that no substantive modification be made to the assessment and payment procedures because of the deletion of this last sentence of section 6673(a).

The bill also authorizes the Tax Court to require any attorney or other person permitted to practice before the Court to pay excess costs, expenses, and attorney's fees that are incurred because the attorney or other person unreasonably and vexatiously multiplied any proceeding before the Court. If the attorney is appearing on behalf of the Commissioner of Internal Revenue, the United States is to pay these costs in the same manner as an award of these costs by a district court. This provision is comparable to the authority already provided to district courts under 28 U.S.C. section 1927.

Authority to counterclaim for balance of penalty in partial refund suits

The bill clarifies that, where taxpayers utilize the provisions of present law (other than with respect to frivolous income tax returns) that permit partial (rather than full) payment of certain penalties to obtain judicial review of the imposition of these penalties, the United States may counterclaim as part of the same lawsuit for the remainder of the penalty. Present law may prohibit a counterclaim of this nature; thus, an additional lawsuit must be brought even if the taxpayer loses the case brought after partial payment of the tax. The committee believes that multiple court cases with respect to the same issue wastes scarce judicial resources. Consequently, the committee permits all issues relating to these penalties to be considered in one lawsuit.

Repeal of bonding requirement

The bill repeals the provision permitting return preparers to post a bond and thereby prevent any proceeding by the Federal Government under section 7407 seeking to enjoin a return preparer from engaging in prohibited conduct. The committee believes that return preparers should not be able to prevent judicial resolution of the issue of whether the return preparer has engaged in prohibited conduct.

Disclosure of certain information by return preparers

The bill provides that the IRS regulations relating to the use of tax information by return preparers are to provide that a return preparer may disclose tax information to another return preparer solely for purposes of quality or peer reviews. The purpose of this provision is to enable a return preparer to obtain the benefits of having another return preparer review the first preparer's work. The bill does not permit disclosure of this information by the IRS for these purposes.

Effective Dates

The modifications to the return preparer penalties apply to documents prepared after December 31, 1989. The modifications to the penalty for promoting abusive tax shelters and the aiding and abetting penalty apply to activities after December 31, 1989. The modification to the frivolous income tax return penalty applies to returns filed after December 31, 1989. The modifications to the court-awarded sanctions apply to proceedings pending on, or commenced after, December 31, 1989. The provision relating to counterclaims is effective on the date of enactment. The provision repealing the bonding requirement for return preparers is effective for actions or proceedings commenced after December 31, 1989. The provision relating to disclosures by return preparers is effective on the date of enactment.

4. Delinquency penalties (secs. 6741-6743 of the bill and new sec. 6656 of the Code and secs. 1463 and 6651 of the Code)

Present Law

Failure to file

A taxpayer who fails to file a tax return on a timely basis is subject to a penalty equal to 5 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of 5 months or 25 percent. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.

Failure to make timely deposits of tax

If any person who is required to deposit taxes imposed by the Internal Revenue Code with a government depositary fails to deposit such taxes on or before the prescribed date, a penalty may be imposed equal to 10 percent of the amount of the underpayment, unless it is shown that such failure is due to reasonable cause and not willful neglect. The amount of the underpayment for this purpose is the excess of the amount of the tax required to be deposited over the amount of the tax, if any, deposited on or before the prescribed date.

Failure to withhold on income of foreign persons

As described above, persons having control, receipt, custody, disposal, or payment of certain types of U.S. income of foreign persons are required to deduct and withhold U.S. tax from such income under chapter 3 of the Code's income tax provisions (secs. 1441-1464). The amount withheld is credited against the U.S. tax liability of the foreign income recipient.

Where a tax on the U.S. income of a foreign recipient was required to be withheld but the withholding agent failed to do so, and instead the tax is paid by the income recipient, a penalty may be imposed on the recipient or the withholding agent for failure to pay the tax only if the failure was fraudulent and for the purpose of evading payment (sec. 1463). By contrast, where a U.S. employer fails to withhold income tax from an employee's wages but the employee pays the tax due, the employer remains liable for any penalties and additions to tax otherwise applicable (sec. 3402(d)).

Reasons for Change

The committee believes that the flat 10-percent penalty for failure to deposit taxes is very unfair, in that the same penalty applies whether the taxpayer is one day or one year late in making a deposit. The committee believes that it is important to give taxpayers an incentive to correct as rapidly as possible any failure to deposit.

Explanation of Provisions

Failure to file

The bill modifies present law by providing that the fraud and negligence penalties are not to apply in the case of a negligent or fraudulent failure to file a return. Instead, the bill provides that in the case of a fraudulent failure to file a return, the failure to file penalty is to be increased to 15 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of 5 months or 75 percent. The burden of proof on the fraud element of this increased portion of the penalty is on the IRS (sec. 7454(a)). If the IRS does not sustain its burden, and if the IRS determined in the alternative in the notice of deficiency that the taxpayer is liable for the basic failure to file penalty under section 6651(a)(1), then the Court could consider the basic penalty and the burden of proof in respect thereof would be on the taxpayer. On the other hand, if the IRS does not sustain its burden on the fraud element and failed to make an alternative determination on the notice but did in its answer or other pleading assert that the taxpayer is liable for the basic penalty, then the Court could also consider that penalty but the burden of proof in respect thereof would be on the IRS. Finally, if the IRS does not sustain its burden on the fraud element and failed to either make an alternative determination in the notice or assert the basic penalty in its answer, the Court could not consider that penalty and the taxpayer would not be liable for any failure to file penalty.

The committee has made this modification to improve the coordination of the failure to file penalty with the accuracy-related penalties. The committee intends that the courts and the IRS should consider the same elements when considering the imposition of this new aspect of the penalty as is done under present law when considering imposition of the 6653 penalty where there has been a failure to file a return. Thus, the actions or behavior that trigger the penalty under the bill are to be the same as those under present law.

Failure to make timely deposits of tax

The bill also modifies the penalty for the failure to make timely deposits of tax in order to encourage depositors to correct their failures. The committee has established a four-tiered penalty structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. Under the bill, a depositor is subject to a penalty equal to 2 percent of the amount of the underpayment if the failure is corrected on or before the date that is 5 days after the prescribed due date. A depositor is subject to a penalty equal to 5 percent of the amount of the underpayment if the failure is corrected after the date that is 5 days after the prescribed due date but on or before the date that is 15 days after the prescribed due date. A depositor is subject to a penalty equal to 10 percent of the amount of the underpayment if the failure is corrected after the date that is 15 days after the due date but on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). Finally, a depositor is subject to a penalty equal to 15 percent of the amount of the underpayment if the failure is not corrected on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). This will mean that, on average, a taxpayer will generally have approximately 40 days from the due date of the quarterly return that reconciles liability with amounts deposited to make up any shortfall in deposits before the rate of the penalty increases from 10 to 15 percent. This time period could be significantly shorter in cases of jeopardy. In cases of jeopardy, the 15-percent rate applies if the taxes are not deposited on or before the date on which notice and demand for immediate payment is given under section 6861, section 6862, or the last sentence of section 6331(a). For purposes of this penalty, "deposit" means that payment must be made in accordance with the instructions of the IRS.

This penalty structure gives the taxpayer an incentive to correct any underpayments before the IRS discovers the underpayment and demands payment. The committee recognizes the importance of a penalty for failure to deposit taxes, since many of the taxes subject to this penalty are trust fund taxes (i.e., amount withheld from employee wages), held in trust by the depositor on behalf of the employee and the Federal Government. The committee believes that the present-law 10-percent penalty applicable to all failures to deposit tax is too harsh in some circumstances and that depositors complying with the law on or before 15 days after the prescribed due date should pay a penalty significantly less than 10 percent (i.e., 2 percent or 5 percent). In contrast, the committee believes that those depositors who have not made required deposits on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer should pay a more substantial penalty (i.e., 15 percent). As under present law, no penalty is to be imposed if the failure to make a timely deposit is due to reasonable cause and not willful neglect. The committee intends that this penalty not apply in circumstances in which the estimated tax penalties (secs. 6654 and 6655) apply. The bill also repeals the present-law 25 percent penalty on overstated deposit claims.

Failure to withhold on income of foreign persons

The bill provides that in cases where a tax on the U.S. income of a foreign person was required to be withheld under chapter 3 but was not in fact withheld, and the person who would have been entitled to a credit for any withholding tax paid instead satisfies its own proper tax liability, the withholding agent remains liable for any penalties and additions to tax otherwise applicable for failure to withhold. Thus, under the bill these withholding agents are subject to the same general approach applicable to U.S. employers who withhold income taxes from employees' wages.

Effective Dates

The modification to the failure to file penalty applies to returns the due date for which (determined without regard to extensions) is after December 31, 1989. The modification to the penalty for the failure to make timely deposits of tax applies to deposits that are required to be made after December 31, 1989. The modification to the rules on liabilities of withholding agents applies to failures to deduct and withhold taxes after December 31, 1989.

Subtitle H. Technical Corrections Provisions

Amendments to the Technical and Miscellaneous Revenue Act of 1988

1. Corporate provisions

a. Method of computing net unrealized built-in gain or loss (sec. 6811(b)(4) of the bill, secs. 1006(d)(22) and 1006(f)(5)(A) of the 1988 Act and secs. 382(h)(6) and 1374(d)(5) of the Code)

Present Law

Under present law, for purposes of sections 382, 384, and 1374, the computation of net unrealized built-in gain and net unrealized built-in loss does not include certain items of income or loss unless such items are recognized within the recognition period.

Explanation of Provision

Items of income or loss that would be treated as built-in gain or built-in loss if recognized within the recognition period are included in the computation of net unrealized built-in gain or net unrealized built-in loss, without regard to when or whether such items are actually recognized within the recognition period. The provision also clarifies that a net operating loss or capital loss carryforward is not treated as a separate item of built-in deduction but simply offsets recognized built-in gain to the extent otherwise permitted under the applicable section.

b. Modification of conforming amendment relating to S corporations engaged in banking operations (sec. 6811(b)(6) of the bill, sec. 1006(f) of the 1988 Act and sec. 1361(b)(2)(B) of the Code)

Present Law

Under present law, a corporation cannot be an S corporation if the corporation is a bank or a thrift institution, regardless of whether or not that corporation can claim any deduction for bad debts under the reserve method.

Explanation of Provision

Prior to the Tax Reform Act of 1986 (the "1986 Act"), a corporation could not be an S corporation if the corporation's deductions for bad debts could be taken under the reserve method as a bank (under Code sec. 585) or as a thrift institution (under sec. 593). The 1986 Act disallowed the use of the reserve method for bad debts for large banks (sec. 901(a)(1) of the 1986 Act). As a conforming amendment, the 1986 Act provided that a corporation could not be an S corporation if the corporation was a bank or a thrift institution, regardless of whether or not that corporation could claim any deduction for bad debts under the reserve method (sec. 901(d)(4)(G) of the 1986 Act).

The provision modifies the conforming amendment in the 1986 Act such that a corporation is not eligible to be an S corporation if the corporation could claim a deduction for bad debts under the reserve method as a bank if it were a small bank.

c. Reduction in S corporation income taxed to shareholders by the amount of built-in gains tax paid (sec. 6811(b)(7) of the bill, sec. 1006(f) of the 1988 Act and sec. 1366(f) of the Code)

Present Law

The amount of net recognized built-in gain of an S corporation subject to tax for any taxable year is limited by the taxable income of such corporation. Net recognized built-in gain in excess of such corporation's taxable income is treated as net recognized built-in gain in succeeding years and is subject to tax in such succeeding years. Under present law, the amount of S corporation income taxed to shareholders for any taxable year is reduced by the amount of built-in gains tax imposed on the S corporation.

Explanation of Provision

The provision clarifies that the amount of any built-in gains tax paid by an S corporation reduces the amount of S corporation income that is taxed to the S corporation shareholders.

d. Reduction in built-in gains tax by minimum tax credit carryovers (sec. 6811(b)(8) of the bill, sec. 1006(f) of the 1988 Act and sec. 1374(b) of the Code)

Present Law

Under present law, it is unclear whether minimum tax credit carryovers of an S corporation, arising in a taxable year for which the corporation was a C corporation, may offset the built-in gains tax of such S corporation.

Explanation of Provision

The provision provides that any minimum tax credit carryover of an S corporation arising from a year the corporation was a C corporation may reduce the built-in gains tax of the S corporation.

e. Determination of tax basis of property transferred to Alaska Native Corporations (sec. 6815(b) of the bill and sec. 5021(e) of the 1988 Act)

Present Law

No provision in any law may affect the date on which a transfer to an Alaska Native Corporation is made for purposes of determining basis for Federal tax purposes.

Explanation of Provision

The 1988 Act states that no provision in any law (whether enacted before, on, or after the date of enactment of the 1988 Act) shall affect the date on which a transfer to an Alaska Native Corporation is made for purposes of determining basis for Federal tax purposes. The amendment removes any retroactive effect of this provision in the 1988 Act and permits Alaska Native Corporations to rely on provisions of law that were in effect prior to the 1988 Act with respect to determining the tax basis of their property. No inference is intended regarding the interpretation of such prior law.

2. Minimum tax provisions (sec. 6811(c) of the bill and secs. 53-59 of the Code)

a. Tax benefit rule

Present Law

The Tax Reform Act of 1986 provided that the Treasury Department may prescribe regulations providing proper adjustments where the taxpayer will not receive a tax benefit from an item for any taxable year.

Explanation of Provision

The provision clarifies that this rule applies whether the tax benefit will result in the current year or in another year.

The bill also clarifies that the repeal of section 58(h) of prior law by the Tax Reform Act of 1986 did not affect the authority of the Secretary of the Treasury or his delegate to take into account preferences arising in taxable years beginning before January 1, 1987, in determining tax liabilities for taxable years beginning after December 31, 1986.

b. Minimum tax credit

Present Law

Present law allows a minimum tax credit for the minimum tax paid in prior years by reason of deferral preferences.

Explanation of Provision

The provision clarifies that the minimum tax credit includes any minimum tax imposed in prior years by reason of the 90-percent limitation on the use of the alternative minimum tax foreign tax credit. This position is consistent with the position taken by the Internal Revenue Service in its forms and accompanying instructions. (Under present law, the minimum tax credit includes any minimum tax previously paid because of the 90-percent limitation on the use of net operating loss deductions.)

c. Incentive stock options

Present Law

Under present law, for purposes of the individual minimum tax, stock acquired pursuant to the exercise of an incentive stock option is treated without regard to the rules of section 421. Instead, the rules of section 83 apply.

Explanation of Provision

The bill clarifies that the minimum tax rules applicable to a disqualifying disposition of stock acquired pursuant to the exercise of an incentive stock option where the amount realized is less that the value at the time of exercise follows the regular tax rules of section 422A(c)(2) where the stock is disposed of in the same taxable year the income is taken into account for minimum tax purposes. Thus the amount included in alternative minimum taxable income will not exceed the amount realized on the sale or exchange of the stock over the adjusted basis of the stock.

d. Treatment of acquisition expenses of life insurance companies

Present Law

In determining adjusted current earnings, acquisition expenses of life insurance companies are required to be capitalized and amortized in accordance with the treatment required under generally accepted accounting principles, as if such treatment were required for all prior taxable years.

Explanation of Provision

The committee wishes to clarify that to the extent that life insurance reserves are relevant in determining the amortization schedule under generally accepted accounting principles, tax reserves (instead of reserves determined under generally accepted accounting principles) are to be used. This clarification is considered necessary in order to treat acquisition expenses consistently under the book income preference and the ACE provision, and should not be considered as establishing a connection between the tax reserve method for a life insurance contract and the income tax treatment of acquisition costs relating to such contract.

3. Accounting provisions

a. Treatment of long-term contracts (secs. 6811(d) and 6815(e) of the bill, secs. 1008 and 5041 of the 1988 Act, and sec. 460 of the Code)

Present Law

Taxpayers engaged in the production of property under a long-term contract must compute income from the contract under either the percentage of completion method or the percentage of completion-capitalized cost method. Exceptions to these required accounting methods are provided for certain construction contracts of small businesses (generally, those taxpayers with no more than $10 million in average annual gross receipts for the three taxable years preceding the taxable year in which the contract is entered into) and certain home construction contracts.[97]

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 (1) the gross contract price and (2) the percentage of the contract completed as of the end of the taxable year. The percentage of the contract completed as of the end of a taxable year is determined by comparing costs incurred with respect to the contract as of the end of the year with the estimated total contract costs.

At the time that a contract reported under the percentage of completion method is completed (or, in the case of amounts that are received or accrued after the completion of the contract, at the time that the amounts are received or accrued), a determination is made whether the taxes paid with respect to the contract for each year of the contract were greater than or less than the amount that would have been paid if gross income had been computed by using the actual gross contract price and actual total contract costs, rather than the anticipated contract price and costs. Interest must be paid by the taxpayer if, after applying this "look-back" method, there is an underpayment of tax by the taxpayer with respect to the taxable year. Similarly, interest must be paid to the taxpayer by the Internal Revenue Service if there is an overpayment of tax with respect to the taxable year.

In applying the look-back method, amounts that are received or accrued after the completion of the contract are to be taken into account by discounting such amounts to their present value as of the completion of the contract. A taxpayer may elect with respect to any contract not to discount amounts received or accrued after the completion of the contract.

Under the percentage of completion-capitalized cost method, a taxpayer must take into account 90 percent of the items under the contract under the percentage of completion method. The remaining 10 percent of the items under the contract must be taken into account under the taxpayer's normal method of accounting (*e.g.*,

---

[97] A contract is treated as a home construction contract only if 80 percent or more of the estimated total contract costs (as of the close of the taxable year in which the contract is entered into) are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of certain dwelling units or certain improvements to real property directly related to such dwelling units.

the completed contract method of accounting). Exceptions to the 90/10 requirement are provided for certain ship construction contracts (40 percent under the percentage of completion method and 60 percent under the taxpayer's normal method of accounting) and certain residential construction contracts (70 percent under the percentage of completion method and 30 percent under the taxpayer's normal method of accounting).

Explanation of Provisions

The bill contains several modifications and clarifications with respect to the present-law treatment of long-term contracts.

First, the bill provides that, except for purposes of applying the look-back method, all of the income under a long-term contract must be taken into account no later than the taxable year that follows the taxable year in which the contract is completed. This rule is to apply even though all of the estimated total contract costs have not been incurred as of the end of that taxable year. Because this provision does not apply for purposes of the look-back method, a taxpayer may be entitled to receive interest under the look-back method if costs properly allocable to the contract are actually incurred after the end of that taxable year.

In addition, the bill clarifies the exception to the long-term contract rules for certain construction contracts of taxpayers whose average annual gross receipts for the prior three taxable years do not exceed $10 million. Under the bill, the gross receipts of any predecessor of the taxpayer (and certain related persons) are to be taken into account in determining whether this exception applies.

The bill also clarifies that the cost of installing any integral component to real property (*e.g.*, a heating or air conditioning system) is to be considered a qualifying cost for purposes of the definition of home construction contract and residential construction contract.

The bill contains two clarifications with respect to the look-back method. First, the bill provides that interest payable by a taxpayer under the look-back method is to be treated as an increase in tax for purposes of subtitle F of the Code (other than the estimated tax provisions). Consequently, in the case of a failure to timely pay the interest due under the look-back method, interest and any applicable penalties would apply. Second, the bill provides for a reapplication of the look-back method if costs are properly taken into account after the completion of the contract or if an adjustment is made to the estimated total contract costs after the completion of the contract. In applying the look-back method, costs under a contract that are taken into account after the completion of a contract are to be treated for purposes of discounting in the same manner as items of income.

Finally, the bill clarifies that the regulatory authority granted to the Secretary of the Treasury to prevent the avoidance of the long-term contract rules applies to qualified ship contracts.

b. Treatment of certain installment sales by nondealers (sec. 6815(g) of the bill, sec. 5076 of the 1988 Act, and sec. 453A of the Code)

Present Law

Under present law, special installment sale rules apply to nondealer sales of property with a sales price in excess of $150,000, other than property used or produced in the trade or business of farming, and timeshares and residential lots with respect to which interest is paid. First, an interest charge is imposed on the tax that is deferred under the installment method to the extent attributable to the amount by which the deferred payments arising from all dispositions of such property during any year exceed $5 million. Second, if any indebtedness is secured directly by an installment obligation that arises out of the disposition of such property, the net proceeds of the secured indebtedness are treated as a payment on such installment obligation.

Explanation of Provision

The bill provides that the sale of personal use property by an individual is not subject to the special installment sale rules that generally apply to a nondealer sale of property with a sales price in excess of $150,000. For this purpose, personal use property is defined as any property substantially all the use of which by the taxpayer is not in connection with a trade or business of the taxpayer or an investment activity.

c. Exceptions to the uniform cost capitalization rules (sec. 6816(b) of the bill, sec. 6026 of the 1988 Act, and sec. 263A of the Code)

Present Law

The Technical and Miscellaneous Revenue Act of 1988 contains two exceptions to the uniform cost capitalization rules. First, the Act provides an exception to the uniform cost capitalization rules for any otherwise deductible expense that is paid or incurred by an individual that is engaged in the business of being a writer, photographer, or artist.

Second, the Act provides an exception to the uniform cost capitalization rules for any otherwise deductible expense that is incurred by a taxpayer in connection with the production of animals in any farming business other than a farming business of a corporation, partnership or tax shelter that is required to use an accrual method of accounting. Prior to the Act, the uniform cost capitalization rules applied to the cost of producing an animal with a preproductive period of more than two years, unless an election was made to use the alternative depreciation system with respect to property used in the farming business. A taxpayer that made such an election for a taxable year beginning before January 1, 1989, is allowed to revoke the election for the first taxable year beginning after December 31, 1988, without the consent of the Treasury Secretary.

Explanation of Provisions

Exception for free-lance authors, photographers, and artists.—The bill clarifies that the exception to the uniform cost capitalization rules for certain free-lance authors, photographers, and artists also applies to certain expenses incurred by certain corporations owned by such persons.

Exception for certain producers of animals.—In addition, the bill clarifies that only taxpayers engaged in a farming business that involves the production of animals having a preproductive period of more than two years may revoke prior elections to use the alternative depreciation system with respect to property used in the farming business.

d. Treatment of interest expense under the uniform cost capitalization rules (sec. 6831(c) of the bill, sec. 803 of the 1986 Act, and sec. 263A of the Code)

Present Law

Under the uniform cost capitalization rules, certain interest costs and taxes incurred in connection with the production of property are required to be capitalized and, generally, are recovered over the applicable recovery period of the property to which the costs relate. In general, interest costs are required to be capitalized if the indebtedness to which the interest relates is directly attributable to production expenditures incurred in producing certain long-lived property or property with an extended production period. Additional interest costs are required to be capitalized if the interest costs could have been avoided if the production expenditures had not been incurred. For this purpose, production expenditures are defined as all costs required to be capitalized or included in inventory under the uniform cost capitalization rules, including interest that was capitalized in a prior taxable year.

The law in effect before the enactment of the uniform capitalization rules (sec. 189) required the capitalization of certain construction period interest and taxes. These capitalized costs were generally amortized over a 10-year period.

The uniform cost capitalization rules and the repeal of prior law are effective for costs incurred after December 31, 1986, in taxable years ending after such date. Property produced by a taxpayer for use by the taxpayer, however, is not subject to the uniform cost capitalization rules if substantial construction occurred before March 1, 1986. Instead, such property remains subject to the rules of prior law. In addition, certain transition property is excluded from the interest capitalization provisions of present law.

Explanation of Provision

The bill clarifies that interest incurred after December 31, 1986, is subject to capitalization under present law even though attributable to costs incurred prior to January 1, 1987. The costs incurred before January 1, 1987, that are taken into account in determining the amount of interest to be capitalized, however, are limited to those costs that (1) were required to be capitalized under prior law and (2) would have been taken into account in determining the amount of interest to be capitalized under prior law. This clarification does not alter the treatment of certain property that was provided transition relief under the 1986 Act or the treatment of property produced by a taxpayer for use by the taxpayer if substantial construction occurred before March 1, 1986. In addition, this clarification does not alter the amortization of interest and taxes that were capitalized under the law in effect before the 1986 Act.

In addition, the bill clarifies that certain property that was provided transition relief under the 1986 Act is subject to the capitalization rules of prior law with respect to interest and subject to the uniform cost capitalization rules of present law with respect to other costs, including taxes.

4. Foreign tax provisions

a. Special rules for transportation income (sec. 6811(h)(8)-(10) of the bill, sec. 1012(e) of the 1988 Act, and secs. 872, 883, and 887 of the Code)

Present Law

Gross basis tax

The 1986 Act generally imposed a four percent tax on the U.S. source gross transportation income of foreign persons. As amended by the 1988 Act, U.S. source gross transportation income means gross income, not effectively connected with the conduct of a trade or business in the United States, but attributable to transportation which either begins or ends (but that does not both begin *and* end) in the United States. The gross basis tax was not intended to override U.S. income tax treaties with foreign countries. Therefore, a foreign person entitled to a treaty exemption is not subject to the tax.

For a foreign person's transportation income (other than leasing income) to be effectively connected with the conduct of a trade or business in the United States, the 1986 Act provided that (1) the foreign person must provide regularly scheduled transportation into, out of, or within the United States; (2) substantially all of the person's U.S. source gross transportation income must be attributable to the regularly scheduled transportation; and (3) the foreign person must maintain a fixed place of business in the United States through which the foreign person conducts its U.S. transportation business. Thus, for example, an occasional flight or voyage to the United States will not allow foreign persons to treat themselves as being engaged in a U.S. trade or business and thereby avoid the gross basis tax. For a foreign person engaged in the leasing of ships or aircraft to derive effectively connected transportation income, the foreign person must maintain a fixed place of business in the United States and substantially all of the person's U.S. source gross transportation income must be attributable to the fixed place of business.

Reciprocal exemption

As amended by the Tax Reform Act of 1986, the Code provides an exemption from U.S. tax on certain types of transportation income earned by a corporation that is organized in, or a nonresident alien that is resident in, a foreign country that grants an equivalent exemption to corporations that are organized in the United States or individual residents of the United States. The classifications of income that qualify for the reciprocal exemption are (1) income from the international operation of a ship or ships, (2) income from the international operation of aircraft, and (3) certain earnings from payments for temporary use of railroad rolling stock.

Countries treating foreign-organized corporations as domestic

Certain countries, for purposes of their internal tax laws, generally treat as domestic a corporation organized in a foreign country (such as the United States) if the corporation's primary location for tax jurisdiction purposes (e.g., its place of management and control) is in fact in that country, rather than its place of organization. Treasury has exchanged notes on exemption from tax on transportation income with numerous countries. Generally, in establishing the criteria for the reciprocal tax exemption on transportation income in the 1986 Act, Congress did not intend to condition the exemption of corporations organized in any particular country on that country's grant of an equivalent exemption covering corporations which are properly treated as residents of that foreign country under its tax laws. Thus, a foreign country could be viewed as generally providing U.S. corporations a tax exemption even if it does not exempt from tax corporations organized the United States, but treated as residents of that country under its laws, assuming those laws would treat a U.S. corporation as a local resident only on the basis that such corporation's center of management or control, or comparable attribute, was in that foreign country.

Possessions of the United States

When Congress enacted the four percent tax on U.S. source gross transportation income, Congress anticipated that this tax, by increasing U.S. taxation of persons from foreign countries that have not provided reciprocal exemptions to U.S. persons, would encourage those foreign countries to amend their tax laws to provide such reciprocal exemptions.

The income tax laws of the United States are currently in effect, completely or partially, in Guam, the Commonwealth of the Northern Mariana Islands ("CNMI"), the U.S. Virgin Islands, and American Samoa as their own income tax systems. These jurisdictions are termed "possessions" of the United States for tax purposes. To transform the Code into a local tax code, each possession, in effect, substitutes its name for the name "United States" where appropriate in the Code. The possessions generally are treated as foreign countries for U.S. tax purposes. Similarly, the United States generally is treated as a foreign country for purposes of possessions taxation. This word-substitution system is known as the "mirror system." As a result of changes brought about by the 1986 Act, individual possessions are able to take steps that would permit them to amend their tax laws internally. As of this time, certain possessions have taken the necessary steps to permit such internal amendment, but others have not.[98]

Thus, for example, a U.S. corporation operating a transportation business traversing a route between a possession on the mirror system and the United States would generally be subject in the possession to the four percent tax on the *possession* source gross transportation income, unless United States law provides an exemption from the equivalent tax for corporations organized in the possession. Similarly, a corporation organized in that possession operating on the same route would generally be subject in the United States to the four percent tax on the U.S. source gross transportation income, unless the possession's internal law provides an exemption from the equivalent tax to U.S. corporations.

Assuming that the internal laws of both the United States and any possession on the mirror system *did* impose the four percent tax on mirror possession persons and on U.S. persons, respectively, then a mirror possession currently without authority to amend its internal tax laws would be deprived of the power to eliminate that tax on a reciprocal basis. On the other hand, if the internal laws of the United States *do not* impose the four percent tax on corporations organized in a mirror possession, or individual citizens and residents of a mirror possession, the exemption is necessarily reciprocal by virtue of the mirror system, thus accomplishing the intended result of the 1986 Act.

Explanation of Provision

Gross basis tax

The bill clarifies the 1986 Act's special rules for determining whether transportation income is treated as effectively connected with the conduct of a trade or business in the United States, by providing that those rules only apply to U.S. source gross transportation income, and not transportation income generally. Thus, under the bill, failure to have substantially all of a taxpayer's U.S. source transportation income attributable to regularly scheduled transportation (or, in the case of income from the leasing of a vessel or aircraft, attributable to a fixed place of business in the United States) would not automatically prevent transportation income *other than* U.S. source gross transportation income from being treated as effectively connected with the conduct of a trade or business in the United States if the general rules would treat such other transportation income as so effectively connected.

Reciprocal exemption

Countries treating foreign-organized corporations as domestic

The bill clarifies that in general a foreign country may be treated as providing a reciprocal exemption for transportation income to corporations organized in the United States even if the laws of

---

[98] Under the 1986 Act, Guam, CNMI, and American Samoa are eligible to amend their internal income tax laws independently of the Code as mirrored, upon the effective date of an "implementing agreement" between the possession and the United States. To date, American Samoa has an implementing agreement in effect, and Guam has entered into such an agreement effective 1991.

such foreign country would not provide an exemption to a corporation which, although organized in the United States, would be subject to tax on a residence basis by the foreign country. The committee intends that a foreign country not be treated as providing an exemption triggering the Code's reciprocal exemption provisions, however, if the laws of the foreign country would tax U.S. corporations on a residence basis even though the corporation is not primarily based in that foreign country. Nor does the committee intend that an exemption apply to corporations organized in a foreign country that imposes residence-based taxation in a manner that would, in practice, deprive a U.S. corporation of a type of tax benefit that a comparably situated corporation organized in the foreign country would enjoy under U.S. law, assuming that the reciprocal exemption provisions of the Code applied to such corporation. The Treasury is authorized to prescribe those characteristics of residence-based taxation systems which will qualify the exemptions provided by such systems to U.S. corporations as "equivalent exemptions" adequate to trigger the Code's reciprocal exemption provisions.

Possessions of the United States

The bill clarifies that the term "U.S. source gross transportation income" does not include any income taxable in a possession of the United States under the provisions of the Code as made applicable in that possession. By operation of the mirror system, the bill clarifies the existence of an equivalent exemption of U.S. persons from taxation by a possession on the mirror system of their possession source gross transportation income. Thus the bill clarifies that a corporation organized in a possession on the mirror system, operating a transportation business traversing a route between the possession and the United States, is not subject in the United States to the four percent tax on the gross U.S. source transportation income. Under the internal law of that possession, by the same token, a U.S. corporation operating a transportation business traversing the same route is not subject in the possession to the four percent tax on the possession source gross transportation income of foreign persons.

For purposes of providing reciprocal exemptions from U.S. tax on the transportation income of foreign persons, the bill authorizes the Treasury to treat U.S. possessions as foreign countries. Thus the bill clarifies that Treasury may initiate agreements pursuant to which, in cases where a possession is not strictly on the mirror system, corporations organized in that possession, and individual residents of that possession, may be entitled on the same basis as residents of foreign countries to U.S. tax exemption on their transportation income.

b. Exception for same-country interest, dividends, rents and royalties (sec. 6811(h)(3) of the bill, sec. 1221(a)(1) of the 1986 Act, and sec. 954(c)(3) of the Code)

Present Law

When a controlled foreign corporation earns subpart F income, including foreign personal holding company income or any other tax haven income, the corporation's U.S. shareholders are generally subject to current U.S. taxation on their pro rata shares of the subpart F income. The term foreign personal holding company income is defined generally to include dividends and interest income as well as rents and royalties (sec. 954(c)(1)(A)). The term excludes, however, certain dividends and interest received from a related person that (1) is created or organized under the laws of the same foreign country as the recipient controlled foreign corporation, and (2) has a substantial part of its assets used in its trade or business located in such same foreign country (sec. 954(c)(3)(A)(i)). The term also excludes certain rents and royalties received from a related person for the use of, or for the privilege of using, property within the country under the laws of which the controlled foreign corporation is created or organized (sec. 954(c)(3)(A)(ii)).

The 1986 Act provided a rule to prevent deductible intercompany payments that benefit from the same-country exception from reducing the total tax haven income of a group of related companies. Under the rule enacted in 1986, interest payments do not qualify for the exception to the extent that such payments reduce the subpart F income of the payor (sec. 954(c)(3)(B)).

Under the literal terms of subpart F, the term "related person" includes pass-through entities such as partnerships and trusts (sec. 954(d)(3)). In the 1986 Act, Congress expanded the definition of the term "related person" in order to end an abuse by which income that would be subpart F income if received from a subsidiary was routed through an entity, e.g. a partnership, that was not included in the definition of a related person. H.R. Rep. 99-426, 99th Cong., 1st Sess. 403 (1985). Congress did not intend by that amendment to permit intercompany payments to reduce the tax haven income of a related group, for example, by the payment of interest by a related pass-through entity which was created or organized in the same country as the interest recipient, or by the payment of rents or royalties by a pass-through entity for the use of property in such country, where the pass-through entity is not the type of person that is subject to subpart F taxation. Nor did Congress intend that pass-through entities be used as devices for transferring the benefit of the same-country exception to payments effectively made by persons from which direct payments would not satisfy the requirements of the same-country exception.

Explanation of Provision

The bill provides that the exception from treatment as foreign personal holding company income for dividends or interest received from a related person that is created or organized under the laws of the same country as the recipient only applies to payments received from a related person that is a corporation. Thus, the bill clarifies that if, for example, two related corporations organize a partnership in a country in which neither partner was created or organized, and if the partnership borrows from a related same-country controlled foreign corporation, the same-country exception will not apply to the interest income received by the controlled foreign corporation from the partnership.

The bill also provides that the exception from treatment as foreign personal holding company income for rents or royalties received from a related person for the use of, or for the privilege of using, property within the country under the laws of which the recipient is created or organized only applies to payments received from a related person that is a corporation. Thus, the bill clarifies that if, for example, two related corporations organize a partnership, and the partnership leases or licenses property from a related controlled foreign corporation, the same-country exception will not apply to the rent or royalty income received by the controlled foreign corporation from the partnership.

c. Dual consolidated losses of insurance companies that are controlled foreign corporations (sec. 6816(k) of the bill, sec. 6135(a) of the 1988 Act, and sec. 953(d) of the Code)

Present Law

A foreign corporation that would qualify to be taxed as an insurance company if it were a domestic corporation may, under certain circumstances, elect to be treated as a domestic corporation (sec. 953(d)).

Under the 1986 Act, a dual consolidated loss is not allowed to reduce the taxable income of any other member of an affiliated group. Generally, the term "dual consolidated loss" is defined as any net operating loss of a domestic corporation which is subject to an income tax of a foreign country without regard to whether such corporation's income is from sources inside or outside of such foreign country, or is subject to tax on a residence basis (sec. 1503(d)). The Treasury has authority to provide by regulations that the term "dual consolidated loss" does not include any loss which, under the foreign income tax law, does not offset the income of any foreign corporation (sec. 1503(d)(2)(B)).

Typically, a foreign corporation that makes the section 953(d) election is a resident of a foreign country, and if it is subject to income tax in that country on a world-wide or residence basis, its losses are dual consolidated losses unless excepted from that definition by regulations. However, the 1988 Act specifically provided that if such an electing corporation is treated as a member of an affiliated group for purposes of filing a consolidated return, any loss of such an electing corporation is treated as a dual consolidated loss as defined in the dual consolidated loss provisions of the 1986 Act (sec. 953(d)(3)). The Treasury generally does not have authority to promulgate regulations making the loss of an electing corporation *not* a dual consolidated loss.

Explanation of Provision

The bill clarifies that any loss of a foreign corporation electing to be treated as a domestic insurance company will be treated as a dual consolidated loss and will therefore not be allowed to reduce the taxable income of any other member of the affiliated group for the taxable year or any other taxable year. Thus, the bill clarifies that the treatment of electing corporation losses as dual consolidated losses under section 953(d) precludes any contrary treatment under regulations that may provide exceptions from the definition of dual consolidated losses.

d. Withholding tax paid by partnerships with respect to foreign partners (sec. 6811(h)(6) of the bill, sec. 1012(s)(1)(A) of the 1988 Act, and secs. 1446 and 1463 of the Code)

Present Law

Partnerships that conduct a trade or business in the United States are required to pay a withholding tax with respect to a foreign partner's distributive share of the partnership's effectively connected taxable income. The 1988 Act requires partnerships to pay this tax in the manner and at the time prescribed by regulations. The amount of the tax is the applicable percentage (which is dependent on corporate or noncorporate status of the foreign partners) of the effectively connected taxable income of the partnership that is allocable under section 704 to foreign partners. The applicable percentage is the highest rate of tax to which each foreign partner is subject.

A foreign partner is allowed a credit against its tax liability for its share of the withholding tax paid by the partnership. An amount of cash equal to this credit is treated as having been distributed to the foreign partner by the partnership on the last day of the partnership's taxable year for which the tax was paid, thus reducing the partner's basis in the partnership. The Treasury has provided by Revenue Procedure that if the foreign partner disposes of its interest in the partnership prior to the last day of the partnership's taxable year, the partner will be treated as having received this cash distribution on the date of disposition of its partnership interest (Rev. Proc. 89-31, sec. 9.01, 1989-20 I.R.B. 136, 143).

The Treasury has provided that the withholding tax generally must be paid in four installments during the taxable year of the partnership in which the effectively connected taxable income is derived (Rev. Proc. 89-31, sec. 7.014). A partnership that is required to pay this tax, but fails to do so, may be liable for the payment of the tax and any applicable penalties or additions including interest. Generally, taxpayers liable for tax under chapters 1 and 2 (secs. 1-1403) must make estimated tax payments for the current year at least quarterly, and penalties are imposed for underpayment of estimated tax (secs. 6654 and 6655). The withholding tax paid by a partnership with respect to a foreign partner's share of effectively connected income is a chapter 3 (secs. 1441-1464) tax, and thus failure to pay this tax does not trigger underpayment of estimated tax penalties.

Explanation of Provision

Rate of tax

The bill clarifies that with respect to foreign corporate partners, the applicable percentage for computing the amount of withholding tax is the highest rate of tax to which corporations generally are subject, currently 34 percent.

Deemed distributions

The bill provides that, except as provided in regulations, a foreign partner's share of withholding tax paid by a partnership is treated as distributed to the partner on the date which is the earlier of (1) the date that the tax is actually paid by the partnership to the Internal Revenue Service, or (2) the last day of the partnership's taxable year for which the tax is paid. Assume, for example, that a U.S. partnership has as its taxable year a calendar year and has one foreign partner. The foreign partner also is a calendar year taxpayer. On June 15, 1990, the partnership pays withholding tax of $100 on behalf of the foreign partner related to effectively connected taxable income of the partnership earned during 1990. Under the bill, the foreign partner is treated as having received a distribution of $100 from the partnership on June 15, 1990, thereby causing a $100 reduction in the basis of its interest in the partnership. Further assume that on April 15, 1991, the partnership pays an additional withholding tax of $200 on behalf of the foreign partner related to the partnership's 1990 effectively connected taxable income. As a result of this additional payment of withholding tax, the foreign partner is treated under the bill as having received a $200 distribution from the partnership on December 31, 1990 (the last day of the partnership's taxable year for which the tax is paid).

The committee contemplates that this rule may be appropriately altered by regulations to provide for earlier deemed distributions and reductions of basis in circumstances such as those involving mid-year dispositions of partnership interests. Assume that in the foregoing example the foreign partner disposed of its interest in the partnership on December 15, 1990. The committee anticipates that the Treasury may treat such a partner as having received a distribution of $200 (corresponding to the April 15, 1991 tax payment) on December 15, 1990, thus reducing the partner's basis in its partnership interest for purposes of determining its gain or loss resulting from the disposition.

Penalties, interest, and other additions

Under the bill, the Treasury is authorized to impose penalties for failure to satisfy withholding tax liabilities, which penalties would be similar to those imposed on corporations for failure to pay estimated tax under section 6655. For purposes of imposing such penalties, the bill provides the Treasury authority to treat the withholding tax as a tax imposed by section 11 and to treat any partnership required to pay such tax as a corporation. In addition, the Treasury may provide appropriate adjustments in applying the rules of section 6655 to any underpayments of the withholding tax by a partnership. For example, section 6665 contains an exception which limits a corporation's required annual payment of estimated tax to the lesser of 90 percent of its current year's tax or 100 percent of its preceding year's tax. The committee does not intend that a partnership which fails to satisfy its obligation under section 1446, but that owed no prior year withholding tax, would be excused from the penalty. However, the committee contemplates that a rule similar to the section 6655 rule allowing a corporation to determine its required installment of estimated tax on the basis of annualized income could also be made available to partnerships by the Treasury.

Generally, penalties, interest, and other additions to tax paid by a partnership as a result of failure to pay withholding tax on behalf of a foreign partner will not be creditable by such partner against its substantive tax liability. However, in order to avoid the assessment of underpayment of estimated tax penalties against both the partnership and the foreign partner with respect to the same item of income (i.e., the foreign partner's distributive share of the partnership's effectively connected taxable income), the committee anticipates that the Internal Revenue Service may allow the foreign partner a reduction of its estimated tax underpayment penalty attributable to partnership income, in the amount of any estimated tax underpayment penalty paid by the partnership with respect to failure to pay withholding tax on income that is allocable to that partner.

e. Excise tax on insurance premiums paid to foreign insurers and reinsurers (sec. 6811(h)(11) of the bill, sec. 1012(q)(13) of the 1988 Act, and sec. 4371 of the Code)

Present Law

In certain cases, an excise tax is imposed (sec. 4371) on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer to or for or in the name of a domestic corporation or partnership, or a U.S. resident individual, with respect to risks wholly or partly within the United States, or to or for or in the name of any foreign person engaged in business within the United States with respect to risks within the United States. The excise tax is imposed at the rate of (1) 4 cents on each dollar (or fraction thereof) of the premium paid on a policy of casualty insurance or indemnity bond; (2) 1 cent on each dollar (or fraction thereof) of the premium paid on a policy of life, sickness, or accident insurance, or annuity contract on the life or hazards to the person of a U.S. citizen or resident, *unless the insurer is subject to tax under section 842(b) (relating to the taxation of foreign insurance companies)*; and (3) 1 cent on each dollar (or fraction thereof) of the premium paid on a policy of reinsurance covering any of the contracts taxable under (1) or (2). Present law exempts any amount which is effectively connected with the conduct of a trade or business within the United States from the excise tax on insurance and reinsurance premiums, unless that amount is exempt from net-basis taxation pursuant to a treaty obligation of the United States.

If a foreign company would, were it domestic, be subject to the Code's insurance company tax provisions, and that company carries on an insurance business within the United States, then its income effectively connected with the conduct of a trade or business in the United States is subject to U.S. income tax rules applicable to the income of domestic insurance companies (sec. 842(a)). Thus, the excise tax by its terms applies only to premiums the income from which is not subject to the income tax. No less than a certain required amount of the foreign insurance company's net investment income must be treated as income effectively connected with the conduct of a trade or business in the United States (sec. 842(b)). Life, sickness, accident, and annuity premiums paid to a foreign insurance company are not subject to the excise tax if the company is subject to taxation under this rule for measuring U.S. effectively connected net investment income. However, if a foreign insurance company carries on an insurance business within the United States and collects *casualty* insurance premiums both effectively connected and not effectively connected with the conduct of that business, then the effectively connected premiums are exempt from the excise tax, but the non-effectively connected premiums on policies covering U.S. risks are subject to the excise tax.

Prior to the 1988 Act, the excise tax did not have a general exemption for U.S. effectively connected amounts. Instead, the Code provided a general exemption from the excise tax in the case of policies signed or countersigned by an officer or agent of the insurer in a state or the District of Columbia, within which such insurer is authorized to do business.[99] During the pre-1988 Act period, the special excise tax exemption for life, sickness, accident, and annuity premiums could in some cases exempt from the excise tax premiums effectively connected with a U.S. insurance business, which premiums otherwise would arguably *not* have been exempted by the general exemption for policies signed or countersigned in places where the company was authorized to do business. *See Neptune Mutual Association, Ltd., of Bermuda* v. *United States,* 862 F.2d 1546 (Fed. Cir. 1988). Moreover, during that period any foreign life insurance company (as contrasted with a non-life company) carrying on a life insurance business within the United States was subject to special U.S. taxing rules.[100] Since the 1988 Act, however, the special excise tax exemption for life, sickness, accident, and annuity premiums paid to foreign insurance companies subject to the rules for imposing income tax on net investment income can only

[99] Prior to the Foreign Investors Tax Act of 1966, the Code did not generally impose income tax on foreign insurers and reinsurers carrying on an insurance business in the United States by reference to whether or not the income of such companies was effectively connected with the conduct of a trade or business in the United States. Rather, such companies (other than life insurance companies) were generally subject to U.S. tax only on their income from sources within the United States.

[100] Prior to the 1966 Act any foreign *life* insurance company carrying on a *life* insurance business within the United States was generally subject to a special rule taxing its U.S. insurance income in the same manner as a domestic life insurance company. Beginning with the Life Insurance Company Income Tax Act of 1959, certain adjustments not applicable to U.S. life insurance companies were made applicable to the income of foreign life insurance companies subject to such U.S. income taxation. Corresponding to the special rules for the imposition of U.S. income tax on foreign life insurance companies carrying on a life insurance business in the United States, the Code prior to the 1966 Act had a special exemption from the excise tax for life, sickness, accident, and annuity policy premiums paid to any foreign life insurance company subject to the special income tax rule.

Since the 1966 Act the Code has contained rules (amended from time to time, most notably recently by the enactment of section 842(b) in the Omnibus Budget Reconciliation Act of 1987) designed to ensure that no less than a certain required amount of a foreign life insurance company's worldwide investment income is deemed effectively connected with the company's U.S. insurance business and thus is taxed by the United States. In the 1987 Act these rules were strengthened and made applicable to all foreign insurance companies carrying on an insurance business within the United States. Since the 1966 Act the excise tax has been inapplicable to life, sickness, and accident insurance policy premiums, and annuity contract premiums, with respect to the lives or hazards to the person of citizens or residents of the United States, paid to foreign companies subject to these special rules for computing U.S. effectively connected income. (By contrast, when in 1987 the special rules for computing U.S. effectively connected income were extended to foreign non-life insurance companies, Congress did not enact a corresponding exemption from the excise tax for premiums on casualty insurance policies covering U.S. risks paid to foreign companies engaged in a U.S. insurance business.)

exempt from excise tax premiums paid to a company all or part of the premium income of which is also exempt from the excise tax pursuant to the general exemption for non-treaty-protected amounts effectively connected with the conduct of a trade or business within the United States.

Explanation of Provision

The bill repeals the special exemption from excise tax for life, sickness, accident, and annuity premiums paid to foreign companies subject to tax under the special income tax rules setting the required minimum amount of net investment income treated as effectively connected with the conduct of a trade or business in the United States. Under the bill, any premium received by such a company which is effectively connected with its conduct of a trade or business in the United States would continue to be exempt from excise tax under the general exemption as amended by the 1988 Act. On the other hand, if a company carries on an insurance business in the United States and also collects premiums *not* effectively connected with its U.S. business on policies of life, sickness, or accident insurance, or annuity contracts, with respect to the lives or hazards to the person of citizens or residents of the United States, then under the bill these premiums *are* subject to the excise tax. In this respect, therefore, the bill conforms the treatment of life, sickness, accident, and annuity premiums with the treatment of casualty premiums.

f. Foreign currency gains and losses (sec. 6811(h)(7) of the bill, secs. 1012(v) and 6130 of the 1988 Act, and sec. 988 of the Code)

Present Law

In order to resolve uncertainties and to reduce discontinuities arising under the prior law that applied to exchange gains and losses, Congress in the Tax Reform Act of 1986 provided uniform source and character rules for certain gains and losses from foreign currency-related "section 988 transactions." Certain gains and losses from such transactions are referred to under the Act as "foreign currency gains and losses." The general rule under the Act is that the character of foreign currency gain or loss is ordinary.

The Act allows flexibility to alter the character of exchange gain or loss in appropriate circumstances. For example, as amended by the 1988 Act, the term "section 988 transaction" generally includes certain foreign currency-related transactions such as, among other things, entering into or acquiring any forward contract, futures contract, option, or similar financial instrument. However, the term generally *excludes* regulated futures contracts and nonequity options which would be marked to market under section 1256 if held on the last day of the taxable year, unless the taxpayer elects not to have this exclusion apply (sec. 988(c)(1)(B)(iii) and 988(c)(1)(D)(i) and (ii)). In a case where the election is made, gain or loss from a foreign currency-related section 1256 contract [101] may therefore be foreign currency gain or loss, and treated as ordinary income or loss (sec. 988(a)(1)(A)). Previously, in the Tax Reform Act of 1984 Congress enacted a provision stating that, for purposes of the Code, gain or loss from trading of section 1256 contracts shall generally be treated as gain or loss from the sale or exchange of a capital asset (sec. 1256(f)(3)(A)). In extending section 988 ordinary income and loss characterization to gains and losses from section 1256 contracts in certain cases in the 1986 and 1988 Acts, Congress did not intend that such characterization be defeated by reference to the language of the 1984 Act regarding gains and losses from trading section 1256 contracts.

Explanation of Provision

The bill clarifies that the income and loss characterization rules in section 988 apply without regard to other income tax provisions in the Code. Thus, where ordinary income and loss characterization applies, pursuant to the terms of section 988, to gains and losses from trading section 1256 contracts, the bill clarifies that such gains and losses are not to be considered gain or loss from the sale or exchange of a capital asset pursuant to section 1256(f)(3).

g. Tax-exempt shareholders of DISCs (sec. 6811(h)(12) of the bill, sec. 1012(bb)(6) of the 1988 Act, and sec. 995 of the Code)

Present Law

In the 1988 Act, Congress provided that when a tax-exempt entity that is a shareholder of a Domestic International Sales Corporation (DISC) is deemed to receive a distribution from a DISC, actually receives a distribution from a DISC of previously untaxed income, or realizes gain from disposition of DISC shares which is treated as a dividend, then that income is treated as derived from the conduct of an unrelated trade or business (sec. 995(g)). This treatment was intended to prevent taxable entities from seeking to exempt active business income from tax by assigning DISC stock to controlled tax-exempt entities such as their pension or profit-sharing plans.

The provision applies to organizations described in the principal Code provisions that impose tax on unrelated business income (secs. 511(a)(2) and (b)(2)). Generally, sections 511(a)(2) and (b)(2) describe certain organizations exempt from tax (other than tax on income from an unrelated trade or business) by reason of section 501(a) (e.g., qualified pension plans described in section 401(a) and public charities described in section 501(c)(3)), state colleges and universities and related organizations, and certain exempt trusts. Congress did not intend that taxable entities be enabled to exempt active business income from tax by assigning DISC stock to other generally tax-exempt entities which are subject to taxation on their

[101] The term "section 1256 contract" is defined in section 1256(b) and includes "regulated futures contracts" and "nonequity contracts" as those terms are defined in section 1256(g) (1) and (3).

unrelated business income but may not be described in sections 511(a)(2) and (b)(2).

Explanation of Provision

The bill clarifies that if a tax-exempt entity is either described in sections 511(a)(2) or (b)(2), or is otherwise subject to tax under section 511, then income of that entity in the form of deemed DISC distributions, actual DISC distributions of previously untaxed income, and gain from the disposition of DISC shares which is treated as a dividend, is treated as derived from the conduct of an unrelated trade or business. Thus, the bill clarifies that if for example an individual retirement account were to own stock in a DISC, such an account being subject to the unrelated business income tax pursuant to section 408(e)(1), then that account would be subject to tax on income from the DISC in the same manner as if the account were instead a pension plan trust described in section 401(a). Similarly, under the bill any other person of any description that owns DISC stock and is subject to the tax on unrelated business income must treat any DISC-related income as income from the conduct of an unrelated trade or business in the same manner as would a pension plan, charity, or other organization exempt from taxation by reason of section 501(a).

5. Estate and gift tax provisions

a. Treatment of survivor annuities under QTIP rules (sec. 6816(l) of the bill, sec. 6152 of the 1988 Act, and sec. 2056(b)(7)(C) of the Code)

Present Law

A marital deduction is allowed for Federal estate tax purposes for an interest in property passing to a spouse if that interest is not terminable (i.e., the property does not pass to a person other than the spouse on termination of the interest). A special rule, applicable to qualified terminable interest property (QTIP), allows a marital deduction where the surviving spouse has only an income interest in the property if an election is made which results in the inclusion of the property in his or her estate. Under the 1988 Act, unless otherwise elected, the transfer to a surviving spouse of an interest in a survivor annuity in which only the spouse has the right to receive any payment during that spouse's life qualifies for the marital deduction for Federal estate tax purposes under the QTIP rule.

Explanation of Provision

A joint and survivor annuity would be treated as qualifying under the QTIP rule under the 1988 Act only if the annuity is includible in the decedent's estate as an annuity. Thus, an annuity created by the decedent's will does not qualify under the amendment made in the 1988 Act.

b. Rates and unified credit (sec. 6815(c) of the bill, sec. 5032 of the 1988 Act, and sec. 2101(b) of the Code)

Present Law

The Federal estate and gift taxes are unified, so that a single progressive rate schedule is applied to an individual's cumulative gifts and bequests. For decedents dying prior to 1993, the gift and estate tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach 55 percent on taxable transfers over $3 million.

U.S. citizens and resident noncitizens are allowed a unified credit of $192,800 in determining the net tax payable. Nonresident noncitizens are allowed by statute a unified credit of $13,000. However, some treaties allow the estate of a nonresident noncitizen the same unified credit allowed a U.S. citizen multiplied by the proportion of the gross estate situated in the United States.

The estate and gift tax rate for transfers in excess of $10 million is increased by five percent until the benefit of the unified credit and graduated brackets is recaptured. The additional five percent rate for decedents dying and gifts made before 1993 is imposed upon cumulative taxable transfers between $10,000,000 and $21,040,000. This additional five percent rate has the effect of phasing out the graduated brackets and unified credit of $192,800. An estate of a nonresident noncitizen is subject to this five percent addition even if it did not receive a unified credit of $192,800.

Explanation of Provision

Appropriate adjustments are made in the additional five percent rate imposed to reflect the actual credit allowed the nonresident noncitizen. Under the provision, the additional five percent rate applies to the taxable transfers of a nonresident noncitizen in excess of $10 million only to the extent necessary to phase out the benefit of the graduated rates and unified credit actually allowed, either by statute or by treaty.

c. Joint tenancies (sec. 6815(d)(16) of the bill, sec. 5033 of the 1988 Act, and sec. 2040 of the Code)

Present Law

The creation of a joint tenancy in property is generally treated as a completed gift. Prior to the 1988 Act, such gift between spouses qualified for the marital deduction from the estate and gift tax. Only one-half of the jointly held property was included in the estate.

Effective July 14, 1988, the 1988 Act repealed the marital deduction for gifts made to a noncitizen spouse. That Act also provided that jointly held property was includible in the estate, reduced by the portion of the property for which consideration was received.

In determining estate tax, the value of gifts includible in the gross estate effectively is reduced by the value of the taxable gift when made. Thus, for a joint tenancy created after the 1988 Act, the amount included in the estate effectively is reduced by the amount transferred when the tenancy was created. For a joint tenancy created prior to the 1988 Act, there is no such reduction because the gift was not taxable, (i.e., it qualified for the marital deduction).

Explanation of Provision

A gift made by creating a joint tenancy in property prior to July 14, 1988, is treated as consideration belonging to the surviving spouse for purposes of determining the value of the tenancy includible in the decedent spouse's estate. Accordingly, the amount of joint tenancy property included in the spouse's estate is reduced proportionately by the amount of the gift.

d. Marital deduction for property passing to noncitizen spouses (sec. 6815(d) of the bill, sec. 5033 of the 1988 Act, and secs. 2056(d), 2056A and 2523(i) of the Code)

Present Law

In general

A deduction generally is allowed for Federal estate and gift tax purposes for the value of property passing to a spouse. Except in specified situations, no deduction is allowed if the interest passing to the spouse is terminable (i.e., will terminate upon a lapse of time, the occurrence of a contingency, or on the failure of an event or contingency to occur)(secs. 2056(b), 2523(b)).

Annual exclusion and marital deduction for property passing to noncitizen spouse

The marital deduction is generally disallowed for the value of property passing to noncitizen spouse. The first $100,000 per year of gifts from a U.S. citizen or resident to a noncitizen spouse, however, is not subject to gift tax. In addition, property passing at death to a noncitizen spouse may qualify for the marital deduction so long as it satisfies the requirements of section 2056(b) and passes in a qualified domestic trust (QDT). Property passing to the spouse outside the probate estate is treated as passing in a QDT if it is transferred to such trust before the estate tax return is filed.

Definition of qualified domestic trust (QDT)

To be a QDT, a trust must meet four conditions. First, the trust instrument must require that all trustees be U.S. citizens or domestic corporations. Second, the surviving spouse must be entitled to all the income from the property in the trust, payable annually or at more frequent intervals. Third, the trust must meet the requirements of Treasury regulations prescribed to ensure collection of the estate tax imposed upon the trust. Finally, the executor must elect to treat the trust as a QDT.

Estate tax on QDT

An estate tax is imposed upon distributions from a QDT made prior to the surviving spouse's death and upon the value of property remaining in a QDT upon that spouse's death. The tax, however, is not imposed on distributions of income, as defined under local law. The tax is also imposed upon the trust property if a person other than a U.S. citizen or domestic corporation becomes a trustee of the trust or if the trust ceases to meet the requirements of Treasury regulations prescribed to ensure collection of the estate tax.

The amount of the estate tax is the additional estate tax which would have been imposed had the property subject to the tax been included in the decedent spouse's estate. If the estate tax for the decedent spouse's estate has not been finally determined, a tentative tax is imposed using the highest estate tax rate in effect as of the date of the decedent's death. When the decedent spouse's estate tax liability is finally determined, the excess of the tentative tax over the additional estate tax that would have been imposed had the property been included in the decedent's taxable estate is allowed as a credit or refund.

Credit for tax previously paid

If the marital deduction is denied solely because the spouse is a noncitizen at the time of the decedent's death, the estate of the surviving spouse who is a U.S. citizen or resident at death generally is entitled to a credit with respect to estate tax paid on property passing from the decedent. This credit is applied against property treated as passing from the decendent's estate determined without regard to when the decedent spouse died. The credit is also allowed for the estate tax imposed against the QDT. For purposes of determining the amount of the credit, the net value of property treated as passing from the decedent's estate to the surviving spouse is reduced by the amount for which a marital deduction was allowed.

Explanation of Provisions

Gift tax on amounts passing to noncitizen spouse

The bill clarifies that the $100,000 annual exclusion for transfers by gift to a noncitizen spouse is allowed only for transfers that would qualify for the marital deduction if the donee were a U.S. citizen.[102] For example, a gift in trust does not qualify for the $100,000 annual exclusion unless it is within one of the exceptions to the terminable interest rule.

The bill also provides that a nonresident noncitizen is entitled to a marital deduction or annual exclusion for gift tax purposes in the same circumstances as a U.S. citizen or resident. Thus, gifts from a nonresident noncitizen to a U.S. citizen spouse qualify for the marital deduction. In addition, each year the first $100,000 in gifts from a nonresident noncitizen to a noncitizen spouse is not taxed, so long as the gifts would qualify for the marital deduction if the donee were a U.S. citizen. The deduction and annual exclusion apply only if the property passing to the spouse is subject to U.S. gift tax.

Marital deduction for bequests to noncitizen spouse

Under the bill, the estate tax marital deduction is allowed for property passing to a noncitizen spouse if the spouse becomes a U.S. citizen before the estate tax return is filed, so long as the spouse was a U.S. resident at the date of the decedent's death and

[102] This change is made effective for gifts after June 29, 1989.

at all times before becoming a U.S. citizen. In addition, all property, probate and nonprobate, passing to a noncitizen spouse qualifies for the marital deduction if the property is transferred or irrevocably assigned [103] to a QDT before the estate tax return is filed.[104] Property passing from decedents dying before enactment of the bill is treated as qualifying for the marital deduction if transferred or assigned to a QDT within one year of enactment. The bill also confirms that property passing from a nonresident noncitizen to a noncitizen spouse qualifies for the estate tax marital deduction if it passes in a qualified domestic trust.

Definition of QDT

The bill retains the present-law requirement that property passing to a noncitizen spouse satisfy requirements generally applicable to the marital deduction such as section 2056(b) in order to qualify for the marital deduction. The bill modifies the independent requirements a trust must meet in order to qualify as a QDT. Under the bill, only one trustee is required to be a U.S. citizen or domestic corporation, so long as no distribution may be made from the trust without the approval of that trustee. In addition, the bill eliminates the independent requirement that the surviving spouse have an income interest in a QDT.[105] This change allows a trust that meets the terminable interest rule but in which the spouse is not entitled to all the income to qualify as a QDT.

The bill also contains provisions allowing reformation of a trust to meet the independent QDT requirements. The determination of whether a trust is a QDT is made either (1) when the estate tax return is filed, or (2) if a reformation suit to conform to the QDT requirements is commenced before the return is filed, when changes pursuant to the suit are made. If a reformation suit is initiated before the return is filed, the statute of limitations with respect to the decedent's estate does not lapse until one year after the Secretary of the Treasury is notified of the resolution of the suit.

Estate tax on QDT

When imposed

Under the bill, lifetime distributions from a QDT and the property remaining in the trust on the surviving spouse's death remain subject to an estate tax based on the decedent's rates and unified credit. The tax is imposed if the trust fails to meet the requirements regarding citizenship of trustees or the regulatory requirements designed to ensure collection. The tax ceases to be imposed if the surviving spouse subsequently becomes a U.S. citizen so long as either (1) the spouse was a U.S. resident at the date of the dece-

[103] The Committee understands that, pursuant to the regulatory authority described below, the Secretary of the Treasury will provide rules regarding the treatment of property that is assigned to a QDT but not transferred to the QDT within a fixed period of time. Such regulations might treat the failure to transfer the property as a distribution from the trust subject to the estate tax or as giving rise to disallowance of the marital deduction.

[104] In addition, as under present law, there is no requirement that the QDT be created by the decedent. Thus, the QDT may be created by the executor or the surviving spouse.

[105] To qualify under the terminable interest rule, however, the spouse might be required to have an income interest. *See* I.R.C. sec. 2056(b)(5), (7).

dent's death and at all times thereafter, or (2) the spouse elects to treat any distribution upon which tax was imposed as a taxable gift made by (and any unified credit allowed against such a distribution as unified credit allowed to) such spouse for purposes of determining future estate and gift tax liability with respect to the spouse.

Amount subject to tax

Under the bill, income distributions to the surviving spouse continue to be exempt from the estate tax on distributions. The Secretary of the Treasury is granted regulatory authority to modify the definition of income for purposes of determining the amount subject to the tax. The committee intends that such regulations define income so as to prevent avoidance of the estate tax.

The committee understands that authority distinguishing income and corpus under section 643(b) would not necessarily be determinative for purposes of the estate tax. The committee also understands that these regulations may clarify the characterization of items that are presently unclear. The committee expects, for example, that the Secretary of the Treasury will provide rules for determining when payments under an annuity would be treated as income for purposes of the estate tax on distributions. The committee expects that payments under an annuity would be treated as corpus to the extent of the value of the annuity when acquired by the QDT.

The bill exempts from the distribution tax amounts paid to the surviving spouse on account of hardship. The bill also provides that payment of the estate tax on distributions is itself a distribution subject to the tax.

Availability of estate tax benefits

The bill allows charitable and marital deductions against the deathtime tax on QDTs so long as that property is includible in the surviving spouse's gross estate (or would have been includible had the surviving spouse been a U.S. citizen) and the requirements of those deductions are otherwise met. The bill also allows the benefits of alternate valuation, special use valuation, capital gains treatment of redemptions of stock to pay estate tax, and extension of time to pay estate tax with respect to the deathtime tax on QDTs if such benefits would be allowed to the surviving spouse's estate.

Treatment of multiple QDTs; tentative tax

The bill provides that the refund of tentative tax imposed pending final resolution of estate tax liability bears interest. The bill also provides rules for the taxation of multiple QDTs. If there is more than one QDT, the tax rate on each QDT is the highest estate tax rate in effect when the decedent died, unless, pursuant to a designation made by the decedent's executor, a U.S. citizen or domestic corporation is responsible for filing all estate tax returns with respect to the QDTs and meets such requirements as the Secretary may prescribe. The Committee intends that these requirements ensure the collection of the estate tax.

Recipient's basis in distributed property

Property distributed during the surviving spouse's life from a QDT receives a carryover basis. The basis of property is increased (but not above fair market value) by the amount of the estate tax allocable to the appreciation in the value of the property occurring after the decedent's death.

Due date of returns

The return for the estate tax imposed on QDT property on the death of the surviving spouse is due nine months after date of death. The return for the estate tax imposed on distributions from a QDT during the calendar year in which the spouse dies is due no later than that date.

Credit for previous estate tax

The credit for estate tax previously paid by the decedent spouse is allowed to a surviving spouse who is a nonresident noncitizen at the time of death. In determining the amount of the credit for estate tax imposed against a QDT, the value of property treated as having passed to the surviving spouse is not reduced by the amount that qualified for the marital deduction.

Regulatory authority

The Secretary of the Treasury is directed to prescribe regulations necessary or appropriate to carry out the purposes of the provisions, including regulations treating an annuity includible in decedent's gross estate as a QDT. Such regulations might treat distributions from a qualified plan as qualifying for the marital deduction even if not assigned to a QDT if the payor of the annuity withholds an amount equal to the distribution tax and meets other conditions designed to ensure collection of the tax.

e. Effect of repeal of marital deduction for noncitizen spouses on treaties (sec. 6815(d)(14) of the bill, sec. 5033 of the 1988 Act, and sec. 2056(d) of the Code)

Present Law

The 1988 Act

Prior to the 1988 Act, the Code allowed a marital deduction for property passing from a U.S. citizen or resident ("U.S. person") to a surviving spouse but not for property passing from a nonresident noncitizen to a surviving spouse. In 1988, Congress amended the Code to deny the marital deduction for property passing from a U.S. person to a noncitizen spouse (unless the property passes in a qualified domestic trust) and to allow a marital deduction for property passing from a noncitizen to a U.S. citizen spouse.

Existing treaties

The United States has bilateral treaties in effect with over 15 countries for the avoidance of double taxation and fiscal evasion with respect to one or more of the taxes on estates, inheritances, gifts, and generation-skipping transfers. Generally these treaties provide that property passing from residents of one contracting state will not be subject to transfer taxes in the other state except in specified circumstances, such as the transfer of real property located in the contracting state other than the residence country of the donor or decedent.

Imposition of U.S. estate, gift, and other taxes on nationals of countries with which the U.S. has entered into a tax treaty (either an income tax treaty or an estate and gift tax treaty) is generally limited by so-called nondiscrimination clauses which typically provide that the United States will not impose on treaty-country citizens any taxes (or any requirements connected therewith) different from, or more burdensome than, those to which similarly situated U.S. citizens are subject. For example, article 8 of the estate and gift tax treaty between the United States and the United Kingdom provides that property passing from a U.K. domiciliary or national which may be taxed in the United States qualifies for a U.S. marital deduction to the extent that a marital deduction would have been allowable if the decedent or transferor had been domiciled in the United States.

Prior to the 1988 Act, the United States entered into at least two bilateral treaties providing a marital deduction to domiciliaries of the treaty countries. Article 11 of the treaty currently in force between the United States and France with respect to taxes on estates, inheritances, and gifts provides that, under certain circumstances, French domiciliaries may, in computing their U.S. estate and gift tax, take the marital deduction that would be allowed to a U.S. domiciliary on November 24, 1978, the date the treaty was signed. When this treaty was negotiated, ratified, and signed, a U.S. citizen or resident was generally entitled to a marital deduction computed by reference to 50 percent of the adjusted gross estate or 50 percent of the amount of gifts made to the spouse.[106]

Article 10 of the treaty between the United States and the Federal Republic of Germany with respect to taxes on estates, inheritances, and gifts, similarly to the French treaty, generally provides that property which passes to the spouse of a domiciliary of one of the countries and which is subject to situs country taxation is subject to tax in the situs country only to the extent that the value of the property passing to the spouse exceeds 50 percent of the total value of the property subject to tax in that country.

Relationship of 1988 Act to treaties

If an actual conflict exists between an earlier treaty and a later statute, as properly construed, the statute prevails (Sen. Rep. No. 100–445, 100th Cong., 2d Sess. 316–28 (1988)). This is true even without an explicit statement of congressional intent to override the treaty (*id.* at 325). The legislative history of the 1988 Act indicates that Congress did not believe that the 1988 Act marital deduction provisions violated nondiscrimination provisions of existing tax treaties (H.R. Rep. No. 100–795, 100th Cong., 2d Sess. 593 (1988)). In addition, the marital deduction provision contained in

[106] Article 11 also provides that if the benefit of the marital deduction under U.S. law is substantially reduced, the tax authorities of the two countries will consult on whether this provision should be modified or terminated.

the 1988 Act also prevails over conflicting marital deduction provisions contained in prior treaties.

Explanation of Provision

The French and German treaty provisions granting a marital deduction for property passing from nonresident noncitizens were negotiated and ratified on the assumption that such property did not qualify for the marital deduction. The 1988 Act did not alter this assumption with respect to property passing to a noncitizen spouse. In consideration of this fact and the policies underlying those provisions, the committee believes that the limitations of the 1988 Act should not apply to such property.[107]

Accordingly, the bill provides that for property passing from a nonresident noncitizen domiciled in a country with which the U.S. has an estate or gift tax treaty, the amendments made by the 1988 Act do not apply to the extent inconsistent with a marital deduction provided by the treaty. Thus, property passing from a nonresident noncitizen domiciled in France or the Federal Republic of Germany is allowed the marital deduction provided under those treaties.[108]

The bill allows no additional benefits under the U.K. treaty, however, since that treaty merely puts U.S. and U.S. persons on an equal footing.

6. Generation-skipping transfer tax

a. Disallowance of double deductions of expenses (sec. 6811(i)(3) of the bill, sec. 1014 of the 1988 Act, and sec. 642(g) of the Code)

Present Law

In determining the Federal estate tax, a deduction generally is allowed for administration expenses, indebtedness and taxes. Similar deductions are allowed in determining the generation-skipping transfer tax on taxable distributions and taxable terminations.

Generally, administration expenses, indebtedness and taxes that are deducted in determining the estate tax are not also deductible in determining the income tax of the estate. The estate may, however, elect to deduct such amounts in determining its income tax if such amounts are not also deducted in determining the estate tax.

Explanation of Provision

Rules similar to those governing the deduction of administration expenses, indebtedness and taxes for income and estate tax purposes are adopted with respect to items deductible in determining the taxable amount for taxable distributions and taxable termina-

[107] In contrast, by denying the marital deduction to property passing from a U.S. person to a noncitizen, the 1988 Act altered the assumption underlying treaties entered into prior to 1988 with respect to U.S. persons domiciled abroad. The committee does not believe that this change in U.S. internal law should be frustrated by treaty provisions that when adopted provided a marital deduction no better than that available under U.S. internal law.

[108] Moreover, when treaty benefits are not claimed, property passing from such persons to U.S. citizens will be eligible for the statutory marital deduction to the extent provided in the 1988 Act.

tions. Thus, those amounts generally are not deductible in determining taxable income, unless an election is made not to deduct those amounts in determining the taxable amount subject to generation-skipping tax.

b. Basis adjustments (sec. 6811(i)(2) of the bill, sec. 1014 of the 1988 Act, and sec. 2654(a) of the Code)

Present Law

The basis of property acquired by gift is its basis in the hands of the donor. This basis is increased, but not above the fair market value of the property, by the amount of gift tax paid allocable to appreciation in the value of the gift while held by the donor. The basis of property transferred in a generation-skipping transfer is generally increased (but not above the fair market value of the property) by an amount equal to the portion of generation-skipping transfer tax attributable to the excess of the fair market value of the property over its adjusted basis before the transfer.

Explanation of Provision

The basis adjustment for generation-skipping transfer tax is applied after the basis adjustment for gift tax paid. Thus, the bill confirms that the two adjustments combined cannot increase the basis in the property above its fair market value.

c. Valuation date for transfer for which gift tax return not required (sec. 6811(i)(4) of the bill, sec. 1014 of the 1988 Act, and sec. 2642(b) of the Code)

Present Law

If an allocation of GST exemption is made on a timely filed gift tax return required under the Federal gift tax, the value of property for generation-skipping transfer tax purposes is the same as its value for gift tax purposes, and the allocation is effective on and after the date of transfer. No gift tax return is required to be filed for gift tax purposes for a transfer of less than $10,000.

Explanation of Provision

The requirement that GST exemption be allocated on a gift tax return required for gift tax purposes is eliminated. The gift tax return must nonetheless be timely. Thus, under the bill, if an allocation to a transfer in trust of less than $10,000 is made on a gift tax return that would be timely filed were a return required, the value of property for generation-skipping transfer tax purposes is the same as its value for gift tax purposes and the allocation is effective on and after the date of transfer.

7. Estimated taxes of trusts and estates (sec. 6811(i)(5), (6) of the bill, sec. 1014 of the 1988 Act, and sec. 6654(l) of the Code)

Present Law

Trusts and estates generally are required to pay estimated taxes in the same manner as individuals. Estates, however, do not pay estimated taxes for taxable years ending within two years of the decedent's death. Likewise, a grantor trust that receives the residue of the probate estate under the grantor's will is exempted from payment of estimated taxes with respect to such taxable years. No exemption is available if no will is admitted to probate.

Explanation of Provision

If no will is admitted to probate, a grantor trust that is primarily responsible for paying taxes, debts and expenses of administration is not required to pay estimated taxes for taxable years ending within two years of the decedent's death.

8. Insurance provisions

a. Treatment of modified endowment contracts (sec. 6815(a) of the bill, sec. 5012 of the 1988 Act, and secs. 72 and 7702A of the Code)

Present Law

Under present law, amounts received under modified endowment contracts are treated first as income and then as recovered basis. In addition, loans under modified endowment contracts and loans secured by modified endowment contracts are treated as amounts received under the contract. Finally, an additional 10-percent income tax is imposed on certain amounts received under modified endowment contracts to the extent that the amounts received are includible in gross income.

A modified endowment contract is defined as any contract that satisfies the definition of a life insurance contract but fails to satisfy a 7-pay test. A contract fails to satisfy the 7-pay test if the cumulative amount paid under the contract at any time during the first 7 contract years exceeds the sum of the net level premiums that would have been paid on or before such time had the contract provided for paid-up benefits after the payment of 7 level annual premiums.

Explanation of Provision

Distribution rules

In determining whether an amount not received as an annuity under a modified endowment contract is includible in gross income, all modified endowment contracts issued by the same insurer (or affiliates) to the same policyholder during any 12-month period are aggregated. A similar aggregation rule applies to an amount not received as an annuity under an annuity contract. The bill provides that contracts under qualified pension plans are not subject to the aggregation rules that generally apply to modified endowment contracts and annuity contracts. In addition, the bill provides that the aggregation rules are to apply only to those modified endowment contracts (or annuity contracts) that are issued by the same insurer (or affiliates) to the same policyholder during any calendar year.

The aggregation rules are not to apply to an immediate annuity contract. In addition, the committee did not intend to address the treatment of "combination" or "split" annuities in providing the Treasury Department with the authority to provide regulations that are necessary or appropriate to prevent avoidance of the distribution rules contained in section 72(e). No inference is intended with respect to whether the Treasury Department may treat combination or split annuities as a single contract under its general authority to prescribe such rules and regulations as may be necessary to enforce the income tax laws.

Material change rules

If there is a material change in the benefits or other terms of a contract that was not reflected in any previous determination under the 7-pay test, the contract is considered a new contract that is subject to the 7-pay test as of the date that the material change takes effect and adjustments are made in the application of the 7-pay test to take into account the cash surrender value of the contract as of the date of the material change.

The bill clarifies that an increase in the charge for a qualified additional benefit is not a material change in the benefits under a contract, and, consequently, the 7-pay test is not to be reapplied at such time. An addition of, or an increase in, a qualified additional benefit, however, is a material change in the benefits under the contract and requires a reapplication of the 7-pay test, unless the addition of, or increase in, the qualified additional benefit is not considered a material change under the one of the exceptions to the material change rules.

Under one exception, a material change does not include an increase in the death benefit or a qualified additional benefit provided under a contract if the increase is attributable to (1) the payment of premiums necessary to fund the lowest level of the death benefit and qualified additional benefits payable in the first 7 contract years (and certain prescribed death benefit increases), or (2) the crediting of interest or other earnings (including policyholder dividends) with respect to such premiums. For this purpose, a death benefit increase may be considered as attributable to the payment of premiums necessary to fund the lowest death benefit payable in the first 7 contract years or the crediting of interest or other earnings with respect to such premiums if each premium paid prior to the death benefit increase is necessary to fund the lowest death benefit payable in the first 7 contract years. Any death benefit increase that is not considered a material change under the preceding sentence, however, is to be considered a material change as of the date that a premium is paid that is not necessary to fund the lowest death benefit payable in the first 7 contract years.

The bill also clarifies that, to the extent provided in regulations, a material change does not include a death benefit increase attributable to a cost-of-living adjustment that is based on an established broad-based index specified in the contract if the increase is funded ratably over the remaining period during which premiums are required to be paid under the contract (rather than over the remaining life of the contract).

Finally, it is intended that a contract which is materially changed is not to be considered a modified endowment contract if the calculation of the 7-pay premium after the material change results in a negative amount provided that no additional premiums are paid during the first 7 years after the material change.

Effective date

The modified endowment contract provisions generally apply to contracts entered into on or after June 21, 1988. In determining whether a contract is entered into on or after June 21, 1988, for purposes of this effective date, if the death benefit under a contract increases by more than $150,000 over the death benefit under the contract as of October 20, 1988, the material change rules apply as of the date that the death benefit exceeds the threshold. In determining whether the death benefit increase constitutes a material change, the death benefit payable under the contract as of October 20, 1988, increased by $150,000 is to be taken into account rather than the lowest death benefit payable during the first 7 contract years.

A contract is not to be considered entered into on or after June 21, 1988, under this $150,000 increase provision, if, as of June 21, 1988, the terms of the contract required at least 7 level annual premium payments and under which the policyholder makes at least 7 level annual premium payments. If a policyholder fails to make at least 7 level annual premium payments as required under the terms of the contract, the material change rules are to apply to the contract as of the later of (1) the last day of the contract year in which the policyholder failed to make a required level premium payment or (2) the date that the death benefit exceeds the threshold. In determining whether the death benefit increase constitutes a material change, the death benefit payable under the contract as of October 20, 1988, increased by $150,000 is to be taken into account rather than the lowest death benefit payable during the first 7 contract years.

Finally, the 7-pay premium for an insurance contract that is entered into before June 21, 1988, and that is exchanged on or after such date for another contract or that is otherwise treated under the effective date provisions as entered into on or after such date is to be reduced by the cash surrender value of the contract in the same manner as a contract that is materially changed.

b. Treatment of certain workers' compensation funds (sec. 6816(h) of the bill and sec. 6076 of the 1988 Act)

Present Law

Under the Technical and Miscellaneous Revenue Act of 1988, a qualified group self-insurers' fund is not to be assessed a deficiency (and, if assessed, the collection of the deficiency is not to occur) for taxable years beginning before January 1, 1987, to the extent that the deficiency is attributable to the timing of the deduction for policyholder dividends. For taxable years beginning on or after January 1, 1987, a fund's deduction for policyholder dividends is allowed no earlier than the date that the State regulatory authority determines the amount of the policyholder dividend that may be paid by the fund.

Explanation of Provision

The bill provides that if, for the first taxable year beginning on or after January 1, 1987, a qualified group self-insurers' fund changes its treatment of policyholder dividends to take into account such dividends no earlier than the date that the State regulatory authority determines the amount of the policyholder dividend that may be paid, then such change is to be treated as a change in method of accounting and no section 481(a) adjustment is to be made with respect to such change in method of accounting (i.e., a fresh start is provided with respect to the deduction of policyholder dividends of a qualified group self-insurers' fund if the change in method of accounting is made for the first taxable year of the fund beginning on or after January 1, 1987). It is anticipated that a qualified group self-insurers' fund will be allowed to adopt such a method of accounting for its first taxable year beginning on or after January 1, 1987, by filing an amended return for such year on or before the date that is six months after the date of enactment of the bill.

c. Special estimated tax payments (sec. 6816(i) of the bill, sec. 6077 of the 1988 Act, and sec. 847 of the Code)

Present Law

Any insurance company that is required to discount unpaid losses for Federal income tax purposes is allowed an additional income tax deduction in an amount that is not to exceed the amount of unreversed discount (i.e., the excess of (1) the amount of undiscounted, unpaid losses attributable to losses incurred after December 31, 1986, over (2) the amount of related discounted, unpaid losses). This deduction is allowed only to the extent that the amount of the unreversed discount was not taken into account in determining the amount of the deduction for an earlier taxable year. In addition, this deduction is allowed only if timely special estimated tax payments are made equal to the tax benefit of the deduction.

An insurance company that is allowed a deduction under this provision also must establish a special loss discount account which is to be increased by the amount of the deduction. The special loss discount account is to be reduced as the discount with respect to which a deduction was allowed reverses and the amount of such reduction is to be included in the gross income of the insurance company. Special estimated tax payments are to be applied against the amount of tax, if any, that is required to be paid as the result of the inclusion of an amount in gross income due to a reduction to the special loss discount account. To the extent that special estimated tax payments are not used to offset additional tax due for any of the first fifteen years beginning after the year for which the special estimated tax payments were made, such special estimated tax payments are treated as section 6655 estimated tax payments for the sixteenth year after the year for which the payments were made.

Explanation of Provision

The bill contains several modifications and clarifications with respect to the special estimated tax payment provision of present law.

First, the bill provides that the amount of the deduction for unreversed discount is to be determined by considering losses incurred in taxable years beginning after December 31, 1986, rather than losses incurred after December 31, 1986.[109]

In addition, the bill clarifies that a deduction is allowed for unreversed discount only to the extent that the deduction results in a tax benefit for the taxable year of the deduction or a prior carryback year. This clarification ensures that special estimated tax payments equal to the tax benefit of the deduction are made for the taxable year that the deduction is allowed.

The bill also provides that special estimated tax payments are to be made on or before the due date (determined without regard to extensions) for filing the return for the taxable year for which the deduction is allowed. This provision is necessary in order to clarify the due date of such payments for any taxable year for which a deduction for unreversed discount is allowed due solely to the carryback of a net operating loss. This provision is not intended to affect the revenue neutral nature of the provision, including the amount of interest payable to or by the Federal government where special estimated tax payments are timely made.[110]

The bill clarifies that any amount added to the special loss discount account must be subtracted from such account and included in gross income no later than the 15th year after the year for which the amount was added to the account. As under present law, special estimated tax payments are to be applied against the amount of tax, if any, that is required to be paid as a result of this inclusion.

The bill also clarifies that the authority of the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the special estimated tax provision includes the authority to prescribe rules that apply in cases where the deduction allowed for any year is less than the unreversed discount as of the close of such year. In addition, it is anticipated that these regulations will provide guidance on the operation of the special estimated tax payment provision in the case of net operating loss carryovers and credit carryforwards.

The bill provides that the earnings and profits of an insurance company is not to be reduced by the additional deduction for unreversed discount or increased by inclusions required due to reduc-

---

[109] In this regard, it is intended that any reasonable addition to a reserve that occurs in taxable years beginning after December 31, 1986, is to be taken into account in determining the amount of unreversed discount to the extent that the addition is subject to the discounting requirements of section 846.

[110] For example, in the case where a deduction for unreversed discount results in a refund of taxes paid in an earlier taxable year, if the insurance company makes the required special estimated tax payments on or before the date that the refund is paid and the Internal Revenue Service is not required to pay interest with respect to the refund, no interest or penalty is to be imposed on the insurance company. To the extent that the special estimated tax payment is made after the payment of the refund, interest and penalties will apply only from the date that the refund is paid (or, if applicable, the first date with respect to which the Internal Revenue Service was required to pay interest).

tions to the special loss discount account. For purposes of the alternative minimum tax, however, the adjusted current earnings of a corporation is to be reduced by the additional deduction for unreversed discount and increased by the inclusions required due to reductions to the special loss discount account.

Finally, the bill provides that the deduction for unreversed discount is not subject to the section 1503(c) limitations on the use of losses in consolidation.

9. Pension Provisions

a. Treatment of churches under certain deferred compensation programs (sec. 6816(f) of the bill, sec. 6064 of the 1988 Act, and sec. 457 of the Code)

Present Law

Under present law, unfunded deferred compensation plans maintained by an eligible employer are subject to certain special rules (sec. 457). Eligible employers include State or local governments and nongovernmental tax-exempt organizations. The 1988 Act contained a provision that was intended to exempt church plans from the application of section 457.

Explanation of Provision

As originally enacted, the 1988 Act provision did not accomplish the intent of exempting church plans from section 457. The provision clarifies the exemption from the application of section 457 for such plans. Under the provision, churches are exempt from the definition of eligible employer.

b. One-time election with respect to elective deferrals (sec. 6811(f) of the bill, sec. 1011 of the 1988 Act, and sec. 402(g) of the Code)

Present Law

Under present law, elective deferrals are subject to certain restrictions. An elective deferral is generally defined as (1) any employer contribution under a qualified cash or deferred arrangement (sec. 401(k)) to the extent not includible in gross income under section 402(a)(8), (2) an employer contribution not includible in income under section 402(h)(1)(B), and (3) employer contributions to a tax-sheltered annuity (sec. 403(b)) under a salary reduction agreement. An employer contribution is not treated as an elective deferral to a tax-sheltered annuity if it is made pursuant to a one-time irrevocable election made by the employee at the time of initial eligibility to participate in the agreement or is made pursuant to a similar arrangement specified in regulations.

Explanation of Provision

The provision clarifies the regulatory authority in the exception to the definition of elective deferrals (sec. 402(g)(3)) to provide that a contribution is not treated as an elective deferral if, under the salary reduction agreement, the contribution is made pursuant to

(1) a one-time irrevocable election made by the employer at the time of initial eligibility to participate in the agreement or (2) a similar arrangement involving a one-time irrevocable election specified in regulations. As under present law, the regulatory authority does not apply to arrangements other than tax-sheltered annuities.

c. Effective date with respect to deductibility of certain contributions by self-employed individuals (sec. 6812 of the bill and sec. 4972 of the Code)

Present Law

A nondeductible 10-percent excise tax applies to nondeductible contributions to a qualified employer plan (sec. 4972). This provision was as added by the 1986 Act. The 1988 Act provided that contributions required to meet the minimum funding rules are not subject to the excise tax, even if the contributions exceed the earned income of the self-employed individual. The 1988 Act provision was effective as if included in the Pension Protection Act of 1987.

Explanation of Provision

The provision clarifies that the 1988 Act rule relating to the deduction rules for self-employed individuals is effective as if included in the 1986 Act, rather than as if included in the Pension Protection Act of 1987.

d. Deduction for payments relating to standard terminations (sec. 6841(b) of the bill and sec. 404(g) of the Code)

Present Law

Present law provides special rules for the deduction of employer liability payments (sec. 404(g)).

Explanation of Provision

The deduction rule relating to employer liability payments treated as contributions to qualified plans is amended to clarify that the rule applies in the case of standard terminations, effective for payments made after January 1, 1986, in taxable years ending after that date.

e. Tax treatment of transfers of interests in individual retirement accounts and qualified governmental and church plans (sec. 6841(a) of the bill and secs. 408 and 414(p) of the Code)

Present Law

Present law permits a transfer of an interest in an individual retirement account (IRA) to be treated as a nontaxable transfer if the transfer is to a former spouse pursuant to a divorce decree.

Special tax rules apply under present law to the transfer of an interest in a qualified plan pursuant to a qualified domestic relations order (QDRO). These tax rules do not apply to the transfer of interest in governmental or church plans because the QDRO rules do not apply to such plans.

Explanation of Provision

The rule relating to transfers of interests in an IRA incident to a divorce is amended to conform to the treatment generally of such transfers under qualified plans pursuant to the Retirement Equity Act of 1984. The provision permits a transfer of an interest in an IRA to be treated as a nontaxable transfer if the transfer is to a spouse or former spouse under a divorce or separation decree.

The tax rules relating to transfers of interests in a governmental or church plan are also amended to conform generally to the tax rules applicable to other qualified plans pursuant to the Retirement Equity Act. Under the provision, the same tax rules applicable to transfers pursuant to a QDRO apply to transfers of interests in a governmental or church plan pursuant to a domestic relations order as defined in section 414(p)(1) (without regard to section 414(p)(1)(A)).

The provisions are effective for transfers after the date of enactment in taxable years ending after the date of enactment. No inference is intended with respect to whether a transfer of an interest in a governmental or church plan could meet the QDRO requirements under present law.

f. Definition of compensation for purposes of IRA deduction limit (sec. 6841(c) of the bill and sec. 219 of the Code)

Present Law

Under present law, the maximum deduction limit for contributions to an individual retirement account (IRA) is the lesser of $2,000 or 100 percent of compensation.

Explanation of Provision

The provision provides that compensation for purposes of the maximum deduction limit includes the earned income and wages of individuals who are not subject to FICA or SECA taxes because of their religious beliefs. The provision is effective for contributions after the date of enactment.

10. Excise tax provision: Undenatured distilled spirits (sec. 6816(j) of the bill and sec. 5276 of the Code)

Present Law

Educational institutions are exempt from the occupational excise tax on distilled spirits to the extent they procure 25 gallons or less annually of specially denatured distilled spirits. Such acquisitions are for laboratory research purposes.

Explanation of Provision

The provision corrects an omission in the exemption for educational institutions from the distilled spirits occupational tax to apply to procuring less than 25 gallons of distilled spirits free of tax, as well as specially denatured distilled spirits. Usually, alcohol used for laboratory research purposes must be free of denaturants and impurities.

Effective Date

This provision is effective on the date of enactment.

11. Tax-exempt bond provisions

a. Disregard of certain financings in determination of qualification for small-issuer exception (sec. 6816(n) of the bill, sec. 6183 of the 1988 Act, and sec. 148(f)(4)(C)(ii)(II) of the Code)

Present Law

Under the Tax Reform Act of 1986, an exception is provided from the arbitrage rebate requirement for small governmental units. The exception is available only if the governmental unit and all subordinate entities reasonably expect to issue no more than $5 million of tax exempt bonds (other than private activity bonds) during the calendar year.

The 1988 Act clarified the treatment of subordinate entities: (1) An issuer, and all entities which issue bonds on behalf of that issuer, are to be treated as one issuer. The 1988 Act also made other clarifications regarding the small issuer exception.

Explanation of Provision

The provision amends Code section 148(f)(4)(C)(ii)(II) as enacted by section 6183 of the 1988 Act to clarify that bonds issued by a governmental unit "to make loans to," rather than "on behalf of," other qualifying governmental units do not count in the determination of whether the issuing governmental unit has exceeded $5 million in total annual bond issuance.

b. Application of future legislation to transitioned bonds (sec. 6831(d) of the bill, sec. 1318 of the 1986 Act, and secs. 103 and 103A of the Code)

Present law

The statutory basis for the tax exemption of interest on qualified bonds was primarily contained in sections 103 and 103A of the 1954 Code prior to the Tax Reform Act of 1986. Section 1301 of the 1986 Act contained the reformation of the law involving tax-exempt bonds including the enactment of significant new provisions. The 1986 Act also contained transition relief where appropriate.

Explanation of Provision

The provision clarifies that generally in the case of any bond to which the amendments made by section 1301 of the Tax Reform Act of 1986 do not apply by reason of any provision of the Tax Reform Act of 1986, any amendment of the 1986 Code (and any other provision applicable to such Code) included in any law enacted after the date of enactment of the Tax Reform Act of 1986 shall be treated as included in section 103 and section 103A (as appropriate) of the 1954 Code with respect to such bond. Exceptions are provided (1) if such law expressly provides that such amendment (or other provision) shall not apply to such bond, or (2) if such amendment (or other provision) applies to a provision of the 1986 Code for which there is no corresponding provision in section 103 and 103A (as appropriate) of the 1954 Code and which is not otherwise treated as included in such sections 103 and 103A with respect to such bond.

The provision is effective as if included in the Tax Reform Act of 1986.

c. Treatment of certain property subject to use restrictions due to financing with qualified 501(c)(3) bonds (sec. 6815(f) of the bill, sec. 5053 of the 1988 Act, and sec. 145(d) of the Code)

Present Law

If the proceeds of bonds issued after October 21, 1988, by a 501(c)(3) organization are used to acquire existing residential rental property for family units, then, to be qualified 501(c)(3) bonds, the property must satisfy the low-income tenant occupancy requirement of section 142(d)(1). This requirement does not apply to bonds used to finance construction or substantial rehabilitation of residential rental property, the original use of which commences with the beneficiary of the bonds. In addition, this requirement does not apply to any bond issued to refund a bond issued prior to July 15, 1988, if the average maturity date of the refunding issue is not later than the average maturity date of the refunded bonds, if the amount of the refunding bonds does not exceed the outstanding amount of the refunded bond, and if the proceeds of the refunding bond are used to redeem the refunded bond within 90 days of issuance of the refunding bonds.

Explanation of Provision

The provision clarifies two circumstances in which property acquired with the proceeds of qualified 501(c)(3) bonds will be treated as new property for purposes of section 145(d)(2)(A) and, thereby, not subject to the income targeting requirements of section 142(d).

First, if the housing is financed by sources other than tax-exempt debt and is later refinanced with tax-exempt debt, the facility is not considered "existing" housing for purposes of section 145(d) if there was a reasonable expectation that the facility would be so refinanced and the facility was in fact so refinanced within a reasonable period.

Second, if, for the purpose of a tax-exempt financing to replace a taxable financing, the initial use of the property was pursuant to taxable financing and, at the time of the taxable financing, State law prohibited tax-exempt financing for the property so financed, then the property will be treated as new property.

12. Research tax credit provision: election of reduced credit (sec. 6814(d) of the bill, sec. 4008 of the 1988 Act and secs. 41 and 280C of the Code)

Present Law

Present law, as amended by the 1988 Act, provides that the amount of any deduction allowable to a taxpayer under section 174 or any other provision for qualified research expenditures is reduced by an amount equal to 50 percent of the taxpayer's research credit determined for that year (sec. 280C(c)). However, a taxpayer is permitted to avoid a reduction of the section 174 deduction for a taxable year by electing to forgo entirely its section 41 research credit for the year (sec. 41(h)).

Explanation of Provision

The provision permits a taxpayer to avoid a reduction of the section 174 deduction by electing to reduce its section 41 research credit by the amount of tax saved (assuming the taxpayer is in the highest corporate tax bracket) by not making a reduction of its section 174 deduction. An election by a taxpayer to have this provision apply to a taxable year shall be irrevocable and may be made not later than the time for filing the taxpayer's return for such year (including extensions), except that if the taxpayer's return for a taxable year must be filed before 75 days after the date of enactment of this provision, then the election under this provision may be made at any time before 75 days after such enactment.

13. Low-income housing tax credit (sec. 6831(b) of the bill, sec. 252 of the 1986 Act, and sec. 42 of the Code)

Present Law

A tax credit is provided to owners of certain low-income rental housing. Property eligible for the credit need not be owned directly by the taxpayer but may be held indirectly through a pass-through entity like a partnership. However, to be eligible for the credit, such housing must be available to the general public and not used for special populations (*e.g.* employee housing, dormitories or hospitals).

The credit is available for 10 years after the building is placed in service in proportion to the amount of low-income housing provided. No credit is available for buildings unless an allocation of State credit authority is made for that building.

Explanation of Provisions

(1) The operation of the credit in the case of trusts and estates is clarified. Specifically, the amount of credit and any penalty with respect to the credit is apportioned between beneficiaries and a trust or estate on the basis of income allocable to each.

(2) The provision clarifies that students in governmentally supported job training programs, defined as the Job Partnership Training Act and similar Federal, State or local programs, are

deemed to be eligible tenants for purposes of the credit, subject to other income targeting rules.

(3) The provision clarifies that, in the case of a disposition of an ownership interest during the course of a calendar year, the credit is to be allocated pro rata between the seller and purchaser according to the number of days of ownership.

(4) In order to carry out legislative intent, the provision authorizes the Treasury Department to issue regulations permitting housing credit agencies to correct administrative errors and omissions with respect to allocations.

(5) The provision clarifies that a person purchasing an interest in a building (including an interest in a partnership owning credit property) steps into the shoes of the previous owner of such interest for purposes of the credit. This provision does not alter the application of the recapture and bond posting requirements as in effect under present law.

Amendments to the Revenue Act of 1987

1. Accounting provisions

a. Installment sales (sec. 6821(a) of the bill, sec. 10202 of the 1987 Act, and secs. 26, 453 and 453A of the Code)

Present Law

Under present law, a taxpayer may elect to use the installment method with respect to certain sales of residential lots and timeshares if interest is paid on the amount of tax that is deferred under the installment method. In addition, for certain sales of property with a sales price in excess of $150,000, interest is required to be paid on the tax that is deferred under the installment method to the extent attributable to the amount by which the deferred payments arising from all dispositions of such property during any year exceed $5 million.

A taxpayer is subject to the alternative minimum tax for a taxable year to the extent that the tentative minimum tax for such taxable year exceeds the regular tax for such taxable year. The regular tax is defined as the tax imposed by chapter 1 of the Internal Revenue Code with exceptions for certain taxes and with reductions for certain credits. There is no exception under present law for the interest that is imposed with respect to certain installment sales.

Explanation of Provision

In order to ensure that a taxpayer who is otherwise subject to the alternative minimum tax does not avoid the payment of interest that is imposed with respect to certain installment sales, the bill provides that the term "regular tax" does not include such interest.

b. Required payments of certain entities (sec. 6821(b) of the bill, sec. 10206 of the 1987 Act, and sec. 7519 of the Code)

Present Law

Partnerships and S corporations generally are required to conform their taxable years to that of their owners, effective for taxable years beginning after December 31, 1986. Partnerships and S corporations may elect a taxable year other than a required taxable year if certain required payments are made to the Internal Revenue Service. The amount of the required payments for an election year is phased in over a four-year period beginning with election years that begin in 1987 as a means of approximating the four-year spread of income that was provided to certain partners and S corporation shareholders that owned an interest in a partnership or S corporation that was required by the 1986 Act to change to a new taxable year.

Explanation of Provision

The bill provides that the phase-in rule is not to apply for taxable years beginning after 1988 unless more than 50 percent of the net income of the partnership or S corporation for the short taxable year that otherwise would have resulted had the election not been made is allocable to partners or shareholders who would have been eligible to include such income over a four-year period.

2. Corporate provision: Adjustments to earnings and profits and to basis of stock of a subsidiary (sec. 6821(c) of the bill, sec. 10222(a) of the 1987 Act and sec. 1503(e)(2)(A)(ii) of the Code)

Present Law

The rules requiring certain adjustments to earnings and profits and to the basis of stock of a subsidiary, for purposes of determining gain or loss on disposition of such stock, may not apply where the corporation disposing of the stock of a former member of an affiliated group is itself a former member of the group.

Explanation of Provision

The provision clarifies that the rules requiring certain adjustments to earnings and profits and to the basis of stock of a subsidiary, for purposes of determining gain or loss on disposition of such stock, apply where the corporation disposing of the stock of a former member of an affiliated group is itself a former member of the group. The provision is not intended to apply to the extent such adjustments have already been made with respect to a prior disposition.

3. Required meals for crews of certain vessels (sec. 6841(d)(18) of the bill and sec. 274 of the Code)

Present Law

Under present law, the amount allowable as a deduction for certain expenses for food, beverages, and entertainment is limited to 80 percent of the expense. This 80-percent limitation does not apply to expenses for food or beverages required by Federal law to be provided to crew members of a commercial vessel.

Explanation of Provision

The provision clarifies that the exception to the 80-percent limitation applies to food or beverages required by any Federal law (including but not limited to 46 U.S.C. sec. 10303).

Other Pension-Related Technical Corrections

1. Amendments Related to the Tax Reform Act of 1986 (sec. 6861 of the bill)

a. Vesting standards (sec. 1113 of the Reform Act, sec. 411 of the Code, and sec. 203 of ERISA)

Present Law

Under present law, a plan (other than a multiemployer plan) is not qualified unless a participant's employer-provided benefit vests at least as rapidly as under 1 of 2 alternative schedules. A plan satisfies the first schedule if a participant has a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon completion of 5 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent at the end of 4 years of service, 60 percent at the end of 5 years of service, 80 percent at the end of 6 years of service, and 100 percent at the end of 7 years of service.

In the case of a multiemployer plan, a participant's accrued benefit derived from employer contributions is required to be 100-percent vested no later than upon the participant's completion of 10 years of service. This exception applies only to employees covered by the plan pursuant to a collective bargaining agreement.

Prior to the Act, special vesting rules applied to class-year plans. A class-year plan was a profit-sharing, money purchase, or stock bonus plan that provided for the separate vesting of employee rights to employer contributions on a year-by-year basis. The minimum vesting requirements were satisfied under prior law if the plan provided that a participant's rights to amounts derived from employer contributions with respect to any plan year were nonforfeitable not later than the close of the fifth plan year following the plan year for which the contribution was made.

The imposition of the new vesting rules described above, including the repeal of class-year vesting, generally apply to plan years beginning after December 31, 1988, with respect to participants who have at least 1 hour of service after the effective date.

Explanation of Provision

The repeal of class-year vesting was not intended to adversely affect the vesting status of any participant. To fulfill this intent, the bill provides a special rule applicable to plans that after October 22, 1986, used class-year vesting. Whether a plan falls within this category is to be determined without regard to any amendment adopted after October 22, 1986, eliminating class-year vesting.

Plans that fall within the above category are to apply a special rule to any employee who (1) has an hour of service before the adoption of any amendment eliminating class-year vesting; (2) has an hour of service on or after the first day of the first plan year for which the repeal of class-year vesting is applicable to such employee with respect to the plan; and (3) has not incurred a 5-year break in service immediately before performing the hour of service described in (2). Under this special rule, for the year described in (2) above and any subsequent year, the employee's nonforfeitable right to the employee's accrued benefit derived from employer contributions is to be determined under the class-year vesting schedule that was eliminated if such schedule would yield a larger nonforfeitable right than the new vesting schedule. Compliance with this rule will not cause the plan to fail the minimum participation rule (sec. 401(a)(26).

In addition, the bill clarifies that a matching contribution is not treated a forfeitable merely because the contribution is forfeitable if the contribution it matches is an excess contribution (sec. 401(k)(8)(B)), an excess deferral (sec. 402(g)(2)(A)), or an excess aggregate contribution (sec. 401(m)(6)(B)).

b. Coordination of present and prior law

Present Law

The Act contained several provisions to facilitate compliance with the provisions of the Act. Under one such provision, the Act generally allowed plans that operated in compliance with the new requirements of Title XI of the Reform Act to delay the corresponding plan amendments to a specified time.

Under present and prior law, benefits and contributions under a qualified plan may not discriminate in favor of highly compensated employees. Under prior law, a plan was not considered discriminatory merely because an employee's benefits under the plan were reduced in accordance with certain requirements to take into account the employee's social security benefits (sec. 401(l)).

The Act modified the integration rules to limit the permitted disparity between benefits for highly and nonhighly compensated employees. The Act's rules are generally effective for plan years beginning after December 31, 1988. The Act contemplated that the Secretary would prescribe rules coordinating the benefits provided under the rules of prior law and the Act. In the case of a final pay defined benefit pension plan that is frozen as of January 1, 1989, and that was integrated in accordance with prior law, proposed Treasury regulations generally have the effect of precluding benefits from being calculated based on the final average pay of the participant when the participant retires (rather than the date the plan was frozen).

Explanation of Provision

The bill delays the time by which required amendments are to be made for an additional year, so that plan amendments are generally not required until before the first plan year beginning on or after January 1, 1990. The same conditions that originally applied to the delayed amendment rules continue to apply. Thus, for example, the plan must be operated in accordance with applicable requirements.

The bill also provides the same delayed amendment rules (other than those relating to a model amendment to be prescribed by the Internal Revenue Service) with respect to the plan amendments required by Title XVIII of the Act (the technical corrections title) or by the bill itself or by the technical corrections to the Act. These changes further the intent of Congress to ease the administrative burdens on employers that maintain plans by delaying the date required for certain amendments so that, in general, all required amendments can be made in a single year.

In addition, the bill provides that a collective bargaining agreement is not to be treated as terminated merely because a plan is amended pursuant to the agreement to meet the requirement of Title XI or Title XVIII of the Act. The bill does not intend to create an inference that such an amendment otherwise would be considered a termination of a collective bargaining agreement, or that an amendment made solely to conform a plan to a requirement added by another Act, is considered a termination.

The committee intends that the Secretary further facilitate the coordination between prior and present law by prescribing rules that permit a defined benefit pension plan that has frozen accruals to calculate benefits based on final average pay in accordance with a benefit formula in existence on the effective date of the Act's integration rules (and at all times during the existence of the plan or, if a shorter period of time, since 1986) if appropriate conditions, as prescribed by the Secretary, are satisfied. It is intended that among the conditions to be imposed, the Secretary will include a requirement that the employer maintain a nonintegrated plan in years after 1988 that provides a minimum benefit level (i.e., 1 percent of compensation), the employer does not maintain any top-heavy plans, and the benefit formula in effect prior to 1988 would satisfy the 50-percent offset requirement in present law.

c. Health care continuation rules (sec. 1895 of the Reform Act, sec. 4980B of the Code, and secs. 602 and 607 of ERISA)

(1) Covered employees

Present Law

The health care continuation rules generally require that employers provide qualified beneficiaries with the opportunity to continue to participate for a specified period in the employer's health plan despite the occurrence of a qualifying event that otherwise would have terminated such participation. In general, qualified beneficiaries are defined to include certain "covered employees" and certain family members of covered employees.

Explanation of Provision

Under the bill, the definition of covered employee includes any individual who is (or was) provided coverage under a group health plan by virtue of the performance of services by the individual for

1 or more persons maintaining the plan. Thus, the term "covered employee" can include an individual by virtue of the individual's performance of services as, for example, an independent contractor for a third party or as a partner for his or her partnership.

Pursuant to this provision, for purposes of the health care continuation rules, references to employer or employee in the statute are considered to include persons receiving or performing services other than in an employer-employee relationship. In addition, persons receiving services are subject to the employer aggregation rules of section 414(t) and the employee leasing rules of section 414(n) to the same extent as if such persons were employers with respect to the service performer.

The changes made by this provision are mandated by national health policy and concerns, are limited solely to the health care continuation rules, and are not intended to alter or change in any manner the current statutory and common law relationship between an individual and the person for whom the individual performs services.

This provision applies to plan years beginning after December 31, 1989.

(2) New coverage

Present Law

Under the health care continuation rules, continuation coverage may be terminated upon the occurrence of certain events. One such event is the coverage of the qualified beneficiary under the group health plan of an employer other than the employer providing the continuation coverage.

Explanation of Provision

The bill deletes the provision allowing continuation coverage to be terminated upon the coverage of the qualified beneficiary under the group health plan of an employer other than the employer providing the continuation coverage.

This provision is intended to carry out the purpose of the health care continuation rules, which was to reduce the extent to which certain events, such as the loss of one's job, could create a significant gap in health coverage The fact that a qualified beneficiary receiving group health coverage from another employer is willing to pay up to 102 percent of the applicable premium for continuation coverage (which he or she may be required to pay by the employer providing the continuation coverage) is a strong indication that the new employer group health coverage has left a significant gap in the qualified beneficiary's health coverage. This is especially true when the new employer group health coverage excludes coverage for a preexisting condition that is covered by the continuation coverage.

This provision generally applies to events occurring after December 31, 1989. In addition, the provision applies to qualified beneficiaries who elect continuation coverage in 1989, and who pay for and continue to pay for continuation coverage. Thus, the provision would prohibit the termination of continuation coverage other than in accordance with the provision in the case of qualified beneficiaries who receive continuation coverage at any time after October 3, 1989. The provision would not apply, however, to a qualified beneficiary who was receiving continuation coverage in 1989, and whose coverage terminated before October 4, 1989, except to the extent the beneficiary had paid for the coverage.

(3) Payment

Present Law

Under the health care continuation rules, if a qualified beneficiary elects continuation coverage under a plan, the plan is to permit payment for continuation coverage during the period preceding the election to be made within 45 days of the date of the election.

Explanation of Provision

The bill clarifies that a plan may not require the payment of any premium before the day which is 45 days after the day on which the qualified beneficiary made the initial election for continuation coverage. This delayed due date for the initial premium does not prevent the collection of a premium for the period of delay.

The provision is effective for plan years beginning after December 31, 1989.

(4) Multiple qualifying events

Present Law

Under present law, the maximum period of continuation coverage depends on the nature of the qualifying event. For example, if the qualifying event is the death of the covered employee or the covered employee's becoming entitled to medicare, the maximum period is 36 months. On the other hand, if an individual obtains health care continuation rights by virtue of a reduction of hours or separation from service of the covered employee, the maximum period of continuation coverage is 18 months.

If a qualified event that gives rise to 18 months of coverage is followed within the period of continuation coverage by an event that gives rise to 36 months of coverage, the period of coverage is extended to 36 months from the date of the original event. In addition, if the individual obtains health care continuation rights by virtue of a reduction of hours of the covered employee and the covered employee separates from service with 18 months following the reduction in hours, the maximum period of continuation coverage is 36 months from the date of reduction of hours even though both events give rise to only 18 months of continuation coverage.

Explanation of Provision

It is inappropriate to extend the period of continuation coverage to 36 months when a separation from service occurs following reduction in hours because the maximum period of coverage following either event is only 18 months.

Under the bill, if an individual obtains health care continuation rights by virtue of a reduction of hours and then, within 18 months, the employee separates from service, the maximum period of continuation coverage is 18 months from the date of the reduction of hours.

Under present law, if a covered employee who is still working is entitled to medicare coverage and then separates from service or has a reduction of hours, the separation or reduction in hours may be treated as the qualifying event. Thus, the spouse and dependents of the covered employee would only be entitled to 18 months of continuation coverage rather than 36 months as was intended. The provision provides that if a covered employee is entitled to medicare and within 18 months of such entitlement, separates from service or has a reduction in hours, the duration of continuation coverage for the spouse and dependents is 36 months from the date the covered employee became entitled to medicare.

The committee intends that if a covered employee has a qualifying event that results in 18 months of coverage and the covered employee becomes entitled to medicare coverage before the expiration of the 18 months, a qualified beneficiary (other than the covered employee) who is at that time covered under the group health plan is entitled to continuation coverage for a total of 36 months from the date of the original qualifying event. Thus, this rule is the same as if, for example, a reduction in hours were followed by the death of the employee. Failure to comply with this rule is not a good faith interpretation of the continuation coverage rules.

The provision is effective for plan years beginning after December 31, 1989.

d. Technical corrections to the Retirement Equity Act of 1984 (sec. 1898 of the Reform Act, sec. 417 of the Code, and sec. 205 of ERISA)

Present Law

Under present law, a plan is required to notify participants of their rights to decline a qualified preretirement survivor annuity before the applicable election period. Under the Act, the period during which notice is required to be provided to an individual is the latest of the following periods: (1) the period beginning with the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year in which the participant attains age 35; (2) a reasonable period of time after the individual becomes a plan participant; (3) a reasonable period of time after the survivor benefit applicable to a participant is no longer subsidized (as defined in sec. 417(a)(4)); (4) a reasonable period of time after the survivor benefit provisions (sec. 401(a)(11)) become applicable with respect to a participant; or (5) a reasonable period after separation from service in the case of a participant who separates from service before attaining age 35.

Explanation of Provision

The bill clarifies that the notice period in the case of a participant who separates from service before age 35 overrides any other period during which notice might be required. In such a case, the bill provides that the notification period is a reasonable period after separation from service without regard to any other required notice periods.

This provision is effective for distributions after the date of enactment of the bill.

2. Amendments Related to the Omnibus Reconciliation Act of 1986 (sec. 6871 of the bill, secs. 9202 and 9203 of the Reconciliation Act of 1986, sec. 411(a)(8) of the Code, and sec. 3(24)(B) of ERISA)

Present law

Under present law, for purposes of the qualified plan rules, the term "normal retirement age" means the earlier of (1) normal retirement age under the plan, or (2) the latest of (a) age 65, (b) in the case of a participant who commences participation in the plan within 5 years before attaining normal retirement age under the plan, the 5th anniversary of the commencement of participation, or (c) in the case of a participation not described in (b), the 10th anniversary of the commencement of participation.

Explanation of Provision

Under the bill, normal retirement age is defined to mean the later of (1) age 65, or (2) the 5th anniversary of the time a plan participant commenced participation in the plan.

3. Amendments Related to the Pension Protection Act (sec. 6881 of the bill)

a. Minimum funding standard and deductions

i. Modifications of minimum funding standard (sec. 9303 of the Pension Protection Act, secs. 404 and 412 of the Code, and sec. 302 of ERISA)

(1) Deficit reduction contribution

Present Law

Under the Act, additional minimum funding requirements apply to defined benefit plans (other than multiemployer plans) if the assets of the plan are less than 100 percent of current liability. For such plans, the amount otherwise required to be charged to the funding standard account is increased by the sum of (1) the excess of (a) the deficit reduction contribution over (b) certain charges and credits to the funding standard account, plus (2) the unpredictable contingent event amount. The deficit reduction contribution is equal to the sum of (1) the unfunded old liability amount, and (2) the unfunded new liability amount.

Unfunded old liability generally includes unfunded liabilities as of the beginning of the first plan year beginning after December 31, 1987 (determined without regard to plan amendments after October 16, 1987). The unfunded old liability amount is increased by the amount necessary to amortize over 18 plan years the unfunded existing benefit increase liability, which in general is certain increases in liabilities due to benefit increases under collective bargaining agreements ratified before October 17, 1987. Unfunded existing benefit increase liability is unfunded current liability determined by (1) taking into account only liabilities attributable to the benefit increase, and (2) by reducing plan assets by the plan's current liability determined without regard to the benefit increase.

Unfunded new liability is the unfunded current liability determined without regard to the unamortized portion of the unfunded old liability and the liability with respect to any unpredictable contingent event benefits (without regard to whether or not the event has occurred).

The Act's new funding rule for unpredictable contingent event benefits is effective with respect to plan years beginning after December 31, 1988. However, the new rule does not apply to benefits with respect to which the event on which the benefit is contingent occurred before October 17, 1987. Such benefits are funded under the pre-Act rules; that is, generally as an experience loss.

Explanation of Provision

Under the bill, as under the Act, unfunded existing benefit increase liability is unfunded current liability determined by (1) taking into account only liabilities attributable to the benefit increase, and (2) by reducing plan assets by the plan's current liability determined without regard to the benefit increase. The bill clarifies that the calculation in (2) does not reduce plan assets below zero.

Under the bill, unfunded new liability is the unfunded current liability determined without regard to (1) the unamortized portion of the unfunded old liability, (2) the unamortized portion of the unfunded existing benefit increase liability, and (3) the liability with respect to any unpredictable contingent event benefits (without regard to whether or not the event has occurred). The bill thus conforms the treatment of unamortized existing benefit increase liability to the treatment of unamortized old liability for purposes of determining unfunded new liability.

The bill provides that the new funding rule for unpredictable contingent event benefits applies to such benefits with respect to which the event on which the benefit is contingent occurs in a plan year beginning after December 31, 1988. Benefits with respect to which the contingency occurs in a plan year beginning before January 1, 1989, are subject to the otherwise applicable funding rules, generally as an experience loss. This change in the effective date is made to eliminate issues arising with respect to transition from the pre-Act funding rule to the Act's funding rule for benefits with respect to which the contingency occurs after October 16, 1987, and before a plan year beginning after December 31, 1988.

(2) Current liability

Present Law

The Act provides that, in determining current liability, certain preparticipation service is to be disregarded. Unfunded current liability is the excess of the plan's current liability over plan assets.

For this purpose, plan assets are reduced by any credit balance in the funding standard account.

Explanation of Provision

In accordance with the legislative history, the bill provides that the rule disregarding certain preparticipation service does not apply with respect to a participant who does not, at the time of becoming a participant, have years of service in excess of the years required for plan eligibility.

The bill also provides that the rule disregarding preparticipation service is elective. The rule was intended to provide relief for employers in certain situations, for example, if the employer establishes a new plan that takes into account past service. The rule does not need to be imposed where the employer does not need such relief. The bill provides that the election not to take advantage of the rule may be revoked only with the consent of the Secretary. Of course, if an employer does disregard preparticipation service, such service is disregarded for all purposes in calculating current liability. Thus, for example, it would be disregarded for purposes of the deduction rules as well as the minimum funding rules.

The bill provides that assets are to be reduced by any credit balance in the funding standard account for purposes of the new funding requirements (sec. 412(l)), and that, in other places where the term "unfunded current liability" is used, the Secretary may provide for such a reduction. Unfunded current liability is relevant not only for purposes of the new minimum funding requirements, but also for a number of other purposes under the Act. In calculating unfunded current liability, it is appropriate to reduce assets by any credit balance in the funding standard account for some purposes (such as the new funding rules) but not for others.

It is anticipated that no reduction will be made for purposes of the rule permitting deductions up to the amount of unfunded current liability (Code sec. 404(a)(1)(D)), the lien on missed contributions (Code sec. 412(n)), the security requirement for certain benefit increases (Code sec. 401(a)(29)), or the additional Pension Benefit Guaranty Corporation (PBGC) premium (ERISA sec. 4006(a)(3)(E)).

(3) Valuations

Present Law

Present law provides that a determination of experience gains and losses and a valuation of the plan's liability is to be made not less frequently than once every 3 years, except that such determination is to be made more frequently to the extent required in particular cases under regulations prescribed by the Secretary.

Explanation of Provision

The bill provides that plan valuations are to be made not less frequently than annually. Annual valuations are necessary under the Act's minimum funding rules and the new full funding limit because the minimum and maximum contributions for a plan year depend on the plan's funded status for that year.

(4) Steel employee plans

Present Law

The Act provides a special funding transition rule with respect to steel employee plans. The contribution required under this special rule is, in general, the sum of (1) the required percentage of the current liability of the plan, plus (2) a portion of the unpredictable contingent event benefit liability. The required percentage depends in part on the plan's funded current liability percentage. In calculating the funded current liability percentage for this purpose, the unpredictable contingent event benefit liability and contributions relating to such liability are disregarded.

Explanation of Provision

For purposes of calculating the funded current liability percentage under the steel employee plan rule, the bill provides that unpredictable contingent event benefit liability, contributions relating to such liability, and income on such contributions are disregarded. The exclusion of income on such contributions is consistent with the Act's intent to provide a separate funding rule for unpredictable contingent event benefit liability.

ii. Time for contributions (sec. 9304 of the Pension Protection Act, sec. 412(c) and (m) of the Code, and sec. 302(c) and (e) of ERISA)

Present Law

The Act requires that installment payments of estimated contributions be made throughout the plan year. This requirement applies to plans subject to the minimum funding standards other than multiemployer plans.

A special installment payment rule applies with respect to unpredictable contingent event benefits. Under this rule, the otherwise required installment is increased by the greater of (1) the amount of unpredictable contingent event benefits paid during the 3-month period preceding the month in which the installment is due, and (2) 25 percent of the amount which would be determined for the plan year if the unpredictable contingent event benefit liabilities were amortized in equal annual installments over 7 plan years.

If a required installment is not paid in full by the due date for the installment, then the funding standard account is charged with interest on the underpayment at the rate that is the greater of (1) 175 percent of the applicable Federal mid-term rate, or (2) the plan rate in effect under section 412(b)(5).

The Act clarifies that the employer is required to notify plan participants and beneficiaries and the PBGC if the employer fails to make required contributions with respect to a plan.

The Act provides that a lien arises if required contributions are not paid and the unpaid balance of required contributions exceeds $1 million. The lien provision is effective with respect to plan years beginning after December 31, 1987. Contributions originally due before the effective date, including contributions that would have been due before the effective date but were waived, are not subject to the lien, but are taken into account in determining whether the $1 million threshold is met.

Explanation of Provision

The bill clarifies that the installment payment requirement applies only to defined benefit plans (other than multiemployer plans) that are subject to the minimum funding requirements. Thus, under the bill, the installment payment requirement does not apply to money purchase pension plans. This is consistent with the general purpose of the pension provisions of the Act, which is to address problems associated with single employer defined benefit pension plans.

The bill modifies the special installment payment rule with respect to unpredictable contingent event benefits to conform the rule to the funding rule for such benefits. Under the bill, the otherwise required installment (determined without regard to unpredictable contingent event benefits) is increased by the greater of (1) the unfunded percentage (as determined under sec. 412(l)(5)(A)) of unpredictable contingent event benefits paid during the 3-month period preceding the month in which the installment is due, or (2) 25 percent of the amount required to be contributed for the plan year under the amortization rule for such benefits (sec. 412(l)(5)(A)(ii)).

The bill adds a sanction for failure to notify plan participants and beneficiaries of the failure to make required contributions. Under the bill, a court may require an employer who fails to comply to pay the affected participants and beneficiaries up to $100 per day from the date of the failure. This sanction is consistent with the existing sanctions under ERISA for failure to provide participants and beneficiaries with required information.

The bill conforms the Act to the legislative history by providing that the notice requirement with respect to participants and beneficiaries is effective with respect to plan years beginning after December 31, 1987.

The bill clarifies that the interest rate on underpayments of required installments is the greater of (1) 175 percent of the applicable Federal mid-term rate, or (2) the rate of interest used under the plan to determine costs (including any adjustments required for plans subject to the new funding rules under section 412(1)). Thus, under the bill, the interest rate on underpayments will be at least equal to the interest rate the plan is using under the minimum funding rules.

iii. Funding waivers (secs. 9306 and 9307 of the Pension Protection Act, sec. 412(f) of the Code, and sec. 303 of ERISA)

Present Law

Under the Act, the interest rate on waived contributions in the case of a plan other than a multiemployer plan is the greater of (1) 150 percent of the applicable Federal mid-term rate, or (2) the rate of interest used under the plan in determining costs.

Prior to the Act, a funding waiver could not be granted with respect to a plan for more than 5 of any 15 consecutive plan years. Under the Act, a waiver cannot be granted with respect to a plan for more than 3 of any 15 consecutive plan years. This provision of the Act applies to any waiver application submitted after December 17, 1987, and any waiver granted pursuant to such an application. In applying the Act's new limit on the number of waivers, the number of waivers which may be granted pursuant to applications submitted after December 17, 1987, is to be determined without regard to waivers granted with respect to plan years beginning before January 1, 1988.

Explanation of Provision

The bill provides that, for purposes of determining the interest rate on waived contributions, adjustments required for plans subject to the new funding rules under section 412(l) are taken into account in calculating the plan's interest rate. Thus, under the bill, the interest rate on waived contributions will be at least equal to the interest rate the plan is using under the minimum funding rules.

Under the bill, the reduction in the number of waivers that can be granted within a 15-year period is effective with respect to waivers for plan years beginning after December 31, 1987. In determining whether the new frequency requirement is satisfied, waivers granted with respect to plan years beginning before January 1, 1988, are not taken into account. Waivers for plan years beginning before January 1, 1988, are subject to the pre-Act frequency limit. Under the effective date provisions of the Act with respect to frequency of waivers, it would be possible to obtain a waiver that did not count for purposes of the pre-Act frequency limit or the Act's frequency limit. These changes address this situation.

iv. Limitation on interest rate (sec. 9307(e) of the Pension Protection Act, sec. 412(b) of the Code, and sec. 302(b) of ERISA)

Present Law

Under the Act, the interest rate used for certain purposes under the minimum funding rules is required to be (1) within a specific permissible range, and (2) within that range, consistent with the interest rate which would be used by an insurance company to establish the amount it would charge an employer to satisfy the liabilities under the employer's plan. The permissible range under the Code is, in general, not more than 10 percent above and not more than 10 percent below the weighted average of the rates of interest on 30-year Treasury securities during a 4-year period.

Explanation of Provision

To reflect the legislative history, the bill provides that these special interest rate rules apply for purposes of determining current liability and for purposes of determining a plan's required contribution under the funding rules applicable to plans with assets less than current liability. Thus, the bill clarifies that these special rules do not apply for all purposes under the minimum funding rules. For purposes for which these special rules do not apply, the plan's interest rate is required to be reasonable in light of the experience of the plan and reasonable expectations.

The bill conforms the definition of the permissible range in ERISA to the Code definition of the permissible range.

v. Effective date of changes relating to amortization periods (sec. 9307(f) of the Pension Protection Act)

Present Law

In the case of plans other than multiemployer plans, the Act reduced the period for amortizing experience gains and losses from 15 years under prior law to 5 years. This change is effective for years beginning after December 31, 1987. In Notice 89-52, the Internal Revenue Service provided transitional relief with respect to the effective date of the change in the amortization period for gains and losses.

Explanation of Provision

The bill provides that the change in the amortization period for experience gains and losses applies to gains and losses established in years beginning after December 31, 1987, to conform to the legislative history of the Pension Protection Act. The bill also provides a special transition rule for certain 1987 gains and losses. Under this rule, any experience gain or loss determined by a valuation occurring as of January 1, 1988, is treated as established in a year beginning before January 1, 1988. An employer may elect to amortize gains and losses (1) in accordance with the general effective date without regard to the special rule for valuations occurring as of January 1, 1989, (2) in accordance with the special rule, or (3) in accordance with the IRS Notice.

b. Employer access to plan assets; limitations on employer reversions upon plan termination (sec. 9311 of the Pension Protection Act, and sec. 4044(d) of ERISA)

Present Law

The Act provides that a plan amendment or provision providing for or increasing a reversion to the employer is not effective before the end of the fifth calendar year following the date the provision or amendment is adopted. The Act also provides a transition rule for certain plans that allows plan amendments within one year of the effective date to take effect without regard to the 5-year rule.

The Act also made other changes relating to the distribution of assets on termination that are effective, in general, with respect to distress terminations with regard to which notices of intent to terminate are provided after December 17, 1987, and plan terminations instituted by the PBGC after December 17, 1987.

Explanation of Provision

The bill clarifies the effective date of the 5-year rule. First, the bill clarifies that the rule applies, in general, to plan provisions or amendments adopted after December 17, 1987.

Second, the bill clarifies the transition rule. Under the bill, a plan that does not contain any provision regarding the distribution of residual assets can be amended, within one year from December 17, 1987, to provide for an employer reversion without regard to the 5-year rule. If, however, after December 17, 1987, a plan provides for distribution of residual assets to employees, then the transition rule does not apply.

With respect to the other changes relating to distribution of assets, the bill clarifies that the changes also apply to standard terminations with respect to which the notice of intent to terminate is issued after December 17, 1987.

c. Treatment of plan terminations

i. Elimination of ERISA section 4049 trust (sec. 9312 of the Pension Protection Act, and sec. 4022 of ERISA)

Present Law

Prior to the Act, the employer's liability payments for unfunded benefits in excess of guaranteed benefits were paid to a special trust established under section 4049 of ERISA. The Act eliminates the section 4049 trust, and provides that the employer's entire liability following plan termination is to be paid to the PBGC. The PBGC then is to pay both guaranteed and nonguaranteed benefits to participants and beneficiaries. The amount of nonguaranteed benefits paid to participants and beneficiaries depends on the applicable recovery ratio.

In the case of terminations where the unfunded benefit liabilities exceed a certain amount, the applicable recovery ratio is based on the actual recovery from the employer (the "large plan" rule). In the case of other terminations, the applicable recovery ratio is based on the average recovery from prior terminations with respect to which the notice of intent to terminate is provided after December 17, 1987 (the "small plan" rule). In order to enable the PBGC to establish the recovery ratio for plans subject to the small plan rule, in the case of terminations with respect to which notices of intent to terminate are provided on or before December 17, 1990, payments to participants and beneficiaries are based on recovery from the particular termination. The Act provides that the transition rule does not apply if the recovery ratio is not finally determined as of December 17, 1990.

The provisions relating to the elimination of the section 4049 trust apply to distress terminations with respect to which notices of intent to terminate are provided after December 17, 1987, and terminations instituted by the PBGC after such date.

Explanation of Provision

The bill provides that, in determining the recovery ratio under the small plan rule, the terminations taken into account are those with respect to which the notice of intent to terminate was provided after December 17, 1987, and within the 5 fiscal years of the Federal Government ending before the year in which the date the notice of intent to terminate the plan for which the recovery ratio is being determined was provided.

The bill provides that the transition rule for small plans applies to all terminations with respect to which the notice to terminate is provided after December 17, 1987, and on or before December 17, 1990. Thus, the transition rule is not limited to situations where the recovery ratio is finally determined as of December 17, 1990. This limit on the transition rule unduly limited the application of the transition rule.

The bill clarifies that the provisions apply to all terminations where notice of intent to terminate is provided after December 17, 1987. The bill also makes additional conforming changes needed to reflect the elimination of the section 4049 trust.

ii. Standards for termination (sec. 9313 of the Pension Protection Act, and sec. 4041(c) of ERISA)

Present Law

In order to terminate a plan in a distress termination, the plan sponsor and each member of the sponsor's controlled group must demonstrate that it meets one of several distress criteria as of the date of plan termination. In a distress termination, the plan administrator is required to provide certain information relating to plan assets and benefits to the PBGC.

Explanation of Provision

The bill provides that the distress criteria must be satisfied as of the proposed date of plan termination, and clarifies that the information relating to plan assets and benefits is to be provided as of the proposed termination date and, if applicable, the proposed distribution date.

d. PBGC premiums (sec. 9331 of the Pension Protection Act, and sec. 4006 of ERISA)

Present Law

Under present law, an additional PBGC premium is required to be paid with respect to a single-employer defined benefit pension plan if the plan has unfunded vested benefits. Also under present law, contributions to a plan are not deductible if they exceed the full funding limitation (sec. 404). Under the Omnibus Reconciliation Act of 1987, the full funding limitation is the excess (if any) of (1) the lesser of (a) 150 percent of current liability, or (b) the accrued liability under the plan (determined in a specified manner), over (2) the value of the assets of the plan (sec. 412(c)(7)).

Explanation of Provision

Under present law, it is possible that deductible contributions to a plan cannot be made to a plan for a plan year because of the full funding limitation, but that an additional PBGC premium is required with respect to the plan. In order to avoid this result, the bill provides that if deductible contributions to a plan cannot be made for a plan year because of the full funding limitation, no additional premium is required with respect to the next year.

e. Miscellaneous pension provisions

i. Security rules for underfunded plans (sec. 9341 of the Pension Protection Act, sec. 401(a)(29) of the Code, and sec. 307 of ERISA)

Present Law

In the case of a defined benefit plan (other than a multiemployer plan), if a plan amendment is adopted and the funded current liability percentage of the plan (taking into account the amendment) is less than 60 percent, then the contributing sponsor (or any member of the contributing sponsor's controlled group) is required to provide security to the plan. The amount of the security is the excess of (1) the lesser of (a) the amount of plan assets necessary to increase the funded current liability percentage under the plan to 60 percent, or (b) the amount of the increase in current liability under the plan attributable to the plan amendment, over (2) $10 million.

The security provisions are contained both in the Code (as a qualification requirement) and in ERISA. The Code provision provides that the Secretary of the Treasury may issue regulations with respect to partial releases of the security by reason of increases in the funded current liability percentage.

The provisions generally apply to plan amendments after December 22, 1987. Under a special rule, in the case of a plan maintained pursuant to one or more collective bargaining agreements ratified before December 22, 1987, the provisions do not apply to plan amendments adopted pursuant to such collective bargaining agreements.

Explanation of Provision

The bill clarifies that, in determining the amount of security that must be provided, the increase in current liability attributable to the plan amendment and all plan amendments after December 22, 1987, are taken into account. Thus, for example, an employer cannot avoid the security requirement by adopting a series of plan amendments, each one of which separately results in an increase in current liability that is below the $10 million threshold but which together increase current liability by more than the $10 million threshold.

The bill provides that the security provision does not apply to plans that are not subject to the minimum funding requirements. Thus, for example, the provision does not apply to church or governmental plans.

The bill conforms the ERISA provision to the Code provision by clarifying that the Secretary of the Treasury has regulatory authority with respect to partial release of the security.

The bill provides that a contributing sponsor that is required to provide security is required to notify the PBGC of the plan amendment. This change conforms the statutory provisions to the legislative history. The PBGC may assess a penalty, payable to the PBGC, of up to $1,000 for each day the required notice is not provided. This penalty is consistent with the penalty added by the Act for the failure to provide certain other information to the PBGC. Under the bill, as under the Act, the penalty is to reflect the materiality of the failure to provide the required information.

With respect to the special effective date for collectively bargained plans, the bill provides that extensions, amendments, or modifications of the bargaining agreement on or after December 22, 1987, are disregarded.

The bill also extends the $1,000 penalty, described above, to failures to notify the PBGC of the failure to make required contributions.

ii. Reporting requirements (sec. 9342 of the Pension Protection Act, and sec. 103(d) of ERISA)

Present Law

Under the Act, the annual report for the plan must contain additional information regarding the funded status of the plan if the value of plan assets is less than 60 percent of current liability.

The Act authorizes the Secretary of Labor to assess a civil penalty of up to $1,000 for each day the plan administrator fails to file an annual report.

Explanation of Provision

The bill reflects the legislative history by providing that the reporting requirement applies with respect to a plan if the value of plan assets is less than 70 percent of current liability. The bill also clarifies that, in the case of plans with assets less than 70 percent of current liability, the annual report is to include the percentage which the value of plan assets is of current liability.

The bill authorizes the Secretary of Labor to bring a civil action to collect the penalty for failure to file an annual report. The bill also clarifies that the plan administrator is liable for the penalty.

iii. Coordination of provisions of the Internal Revenue Code of 1986 with provisions of ERISA (sec. 9343 of the Pension Protection Act, and sec. 403 of ERISA)

Present Law

Under ERISA, plan assets cannot be returned to the employer prior to termination of the plan, except in certain limited circumstances. Prior to the Act, section 403(c)(3) of ERISA provided for the return of contributions which would otherwise be excess contributions as defined in section 4972(b) of the Code, to the extent that section 4972 provides for return of the contributions. In a conforming change, the Act replaced the references to section 4972 of the Code with a reference to section 4979 of the Code, which relates to contributions that do not satisfy the special nondiscrimination rules applicable to qualified cash or deferred arrangements and similar arrangements.

Explanation of Provision

The bill deletes section 403(c)(3) of ERISA. It is no longer necessary in light of recent changes in the Code.

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), section 4972 of the Code provided an excise tax on excess contributions to certain plans maintained by self-employed individuals, and for the return of such contributions in order to avoid the excise tax. As part of TEFRA's changes conforming the rules applicable to plans maintained by self-employed persons generally to the rules applicable to other qualified plans, section 4972 (in its then present form) was repealed.

Neither present-law section 4972 of the Code nor present-law section 4979 of the Code provides for return of contributions to the employer. Thus, neither section should be a basis for the exception to the general rule prohibiting return of assets to the employer prior to plan termination.

iv. Plan investment in employer securities (sec. 9345 of the Pension Protection Act, and sec. 407 of ERISA)

Present Law

The Act amended the definition of qualifying employer security. This change was intended to apply only to plans that are not individual account plans.

Explanation of Provision

The bill clarifies that the new definition of qualifying employer security applies only to plans that are not individual account plans.

v. Interest rate on accumulated contributions (sec. 9346 of the Pension Protection Act, sec. 411(c)(2) of the Code, and sec. 204(c)(2) of ERISA)

Present Law

Present law prescribes rules for determining what portion of an employee's total accrued benefit under a defined benefit pension plan is derived from employer contributions and what part is derived from employee contributions. Present law provides that the accrued benefit derived from employer contributions is the excess of the total accrued benefit over the accrued benefit derived from employee contributions.

In the case of a defined benefit pension plan providing an annual benefit in the form of a single life annuity beginning at normal retirement age, the accrued benefit derived from employee contributions is, in general, an annual benefit equal to the employee's accumulated contributions multiplied by the applicable conversion factor.

An employee's accumulated contributions are equal to the sum of (1) mandatory contributions made by the employee; (2) interest under the plan to the end of the last plan year to which ERISA does not apply; and (3) with respect to each subsequent plan year, interest on the amounts determined under (1) and (2) at a rate equal to 120 percent of the mid-term applicable Federal rate (AFR) as in effect for the first month of the plan year. Prior to the Pension Protection Act, the interest rate in (3) is 5 percent. However, the accrued benefit derived from employee contributions cannot exceed the greater of (1) the employee's accrued benefit under the plan, or (2) the accrued benefit derived from employee contributions determined without regard to interest.

Explanation of Provision

There has been some uncertainty as to the effect of the Pension Protection Act interest rate rules for employee contributions, and the proper method for determining the accrued benefit derived from employee contributions. In addition, the present-law rules for determining an employee's accrued benefit produce inconsistencies in some cases. In order to resolve these issues, the bill modifies the rules relating to the accrued benefit derived from employee contributions.

The bill provides that, in calculating an employee's accumulated contributions, interest on mandatory contributions is credited (1) for the period up to the date for which the determination is being made at the rate determined under the present-law rules, and (2) for the period beginning with the determination date and ending on the date on which the employee attains normal retirement age, at the interest rate used under the plan in calculating the present value of accrued benefits (sec. 417(e)(3)). The conversion of the employee's contributions (plus interest) to an annuity is calculated using the interest rate used under the plan in determining the present value of accrued benefits (sec. 417(e)(3)).

The bill also eliminates the present-law limitation on the accrued benefit derived from employee contributions.

Some employers may have already amended their plans to conform to the interest rate rule of the Pension Protection Act, or may have adopted a new plan that conforms to such rule. If such plans are amended to conform to the bill, in some cases this might be considered a prohibited reduction in accrued benefits (sec. 411(d)(6)). Accordingly, the bill provides a transition rule that permits such plans to be amended to conform to the new rules without violating the reduction in accrued benefit rules.

Subtitle I. Child Care and Earned Income Credit Provisions

1. Credit for dependent care expenses and certain health insurance premiums (secs. 6901, 6902, and 6904 - 6906 of the bill and secs. 21, 6401, and new sec. 3507A of the Code)

Present Law

Child and dependent care credit

Under present law, an individual who maintains a household that includes one or more qualifying individuals is entitled to a nonrefundable tax credit equal to a percentage of the employment-related child or dependent care expenses paid by the individual for the taxable year to enable the individual to work (sec. 21). The maximum amount of the credit is 30 percent of allowable employment-related expenses. This 30 percent is reduced by one percentage point for each $2,000 (or fraction thereof) of the taxpayer's adjusted gross income (AGI) between $10,000 and $28,000. The credit rate is 20 percent for taxpayers with AGI in excess of $28,000.

The maximum amount of expenses that may be taken into account in calculating the credit is limited to $2,400 per year in the case of one qualifying individual and $4,800 in the case of more than one qualifying individual. In addition, the maximum amount of expenses taken into account cannot exceed the individual's earned income or, in the case of married taxpayers, the lesser of the individual's earned income or the earned income of his or her spouse. A special rule applies for determining the income of the taxpayer's spouse if the spouse is a full-time student or mentally or physically incapable of caring for himself or herself.

A "qualifying individual" is (1) a dependent of the taxpayer who is under the age of 13 and with respect to whom the taxpayer is entitled to claim a dependent exemption, (2) a dependent of the taxpayer who is physically or mentally incapable of caring for himself or herself, or (3) the spouse of the taxpayer, if the spouse is physically or mentally incapable of caring for himself or herself.

Tax provisions relating to individual health insurance

Present law generally does not provide tax benefits specifically designed to encourage the purchase of health insurance by individuals; however, present law does provide certain tax benefits for health insurance in particular circumstances.

Under present law, health insurance that is paid by an employer is generally excluded from an employee's gross income. This exclusion also applies for employment tax purposes. In addition, self-employed individuals are entitled to deduct 25 percent of the amount paid for medical insurance for the individual or his or her spouse or dependents; this provision is scheduled to expire for taxable years beginning after December 31, 1989. These provisions are subject to the application of nondiscrimination rules and certain other requirements.

Taxpayers who itemize deductions may deduct expenses for medical care (not compensated by insurance or otherwise) of the taxpayer or his or her spouse or dependents to the extent such expenses exceed 7.5 percent of the taxpayer's adjusted gross income. Premiums paid for health insurance qualify for the deduction.

Reasons for Change

The committee intends to address two important needs of low-income working families—health insurance and child care. The committee recognizes the financial strain that the costs of these items place on low-income families and is concerned that low-income working families obtain assistance in obtaining child care and health insurance.

The committee makes two major changes to the dependent care credit in order to achieve its goals. First, the dependent care credit is modified to provide a refundable credit for expenses for health insurance that covers a child. The committee is concerned that low-income families, especially the children in these families, have adequate access to health care and are protected from the financial burden that large medical bills can place on low-income families.

Second, the bill makes the existing dependent care credit 90 percent refundable. The committee believes that the credit should be refundable so that low-income families with children obtain financial assistance in caring for the children while the parents are employed. The committee believes that refundability of the credit will remove an important barrier to the economic advancement of low-income families in that adequate child care while parents work will now be more affordable.

Explanation of Provision

The bill allows an additional credit for expenditures for certain health insurance policies and makes the present-law dependent care credit partially refundable for certain taxpayers.

Health insurance credit

The bill amends the dependent care credit to add a new refundable credit for health insurance expenses. The bill provides that an individual who maintains a household containing one or more qualifying individuals is entitled to a credit equal to a percentage of the individual's qualified health insurance expenses. The maximum credit percentage is 50 percent of the qualified health insurance expenses. This 50 percent is reduced by 5 percentage points for each $1,000 (or fraction thereof) by which the taxpayer's adjusted gross income (AGI) exceeds $12,000. Thus, the credit is zero for taxpayers with AGI in excess of $21,000.

Qualified health insurance expenses are amounts paid during the taxable year for health insurance that includes coverage for one or more qualifying individuals. For purposes of this credit, a qualifying individual is a dependent of the taxpayer who is under age 19 and with respect to whom the taxpayer can claim a dependent exemption.

Up to $1,000 of qualified health insurance expenses may be taken into account in calculating the credit. However, the maximum expenses taken into account cannot exceed the earned income of the taxpayer, reduced by employment-related expenses taken into account in determining the child care credit. Expenses, to the extent paid, reimbursed, or subsidized by the Federal government or a State or local government, are not eligible for the credit. Also, expenses for which the health insurance credit is claimed may not be deducted under the rules for health insurance of the self-employed.

Eligible taxpayers may claim credits for both dependent care and health insurance expenses.

For taxable years beginning after December 31, 1991, the health insurance credit will be refundable on an advance payment basis (similar to the present-law earned income credit).

Refundable dependent care credit

The bill makes the present-law dependent care credit partially refundable. That is, taxpayers who do not have sufficient taxable income to offset the credit will be entitled to receive in cash 90 percent of the amount of the credit not offset against tax liability. However, under the provision, taxpayers with adjusted gross income (AGI) in excess of $28,000 are not entitled to claim the refundable credit, but instead are eligible for the nonrefundable dependent care credit as under present law.

For purposes of determining the amounts of credit that are refundable and nonrefundable, other credits and deductions are applied before the dependent care credit, except for the earned income tax credit which is applied after the dependent care credit.

For example, suppose a taxpayer has tax liability of $70 after the application of all credits and deductions except the dependent care tax credit and the earned income tax credit, $100 of dependent care credit (before the refundability limitation), and $150 of earned income tax credit. The taxpayer offsets $70 of tax liability with $70 of the dependent care tax credit. Of the remaining $30 of dependent care credit, $27 (90 percent of $30) may be obtained as a refund while all of the $150 of earned income credit is refundable.

For taxable years beginning after December 31, 1990, the dependent care credit will be refundable in the manner described. For taxable years beginning after December 31, 1991, the dependent care credit will be available on an advance payment basis (similar to the present-law earned income credit).

Expenses, to the extent paid, reimbursed, or subsidized by the Federal government or a State or local government, are not eligible for the credit. For example, child care expenses that are disregarded for purposes of calculating payments under the Aid to Families with Dependent Children Program which would otherwise have reduced payments under such program and expenses reimbursed under the transitional child care assistance program of the Family Support Act of 1988 are not expenses eligible for the credit.

The committee expects that the Secretary of the Treasury will provide regulations to prevent abuse of the dependent care tax credit. The committee, for example, does not intend the dependent care credit to be available in certain reciprocal dependent care arrangements that do not enable gainful employment beyond the child care arrangement.

For example, assume two neighbors agree to pay each other to care for the other's children and the child care expenses incurred by each neighbor do not enable each individual to be gainfully employed in some manner aside from providing care to the neighbor's children. In such a case, the committee does not intend the expenses to be eligible for the credit. However, the committee does not intend to prevent individuals otherwise legitimately employed as dependent care providers from obtaining the credit on eligible dependent care expenses.

Child health demonstration projects

The bill authorizes the appropriation of $25 million for each of the fiscal years 1990 through 1994 to enable the Secretary of Health and Human Services to conduct demonstration projects to evaluate and extend health insurance to children under age 19 who are not covered by other public or private health programs.

The Secretary is authorized to enter into agreements with public and private organizations (for example, schools and hospitals) to provide health insurance coverage to such children. The Federal government is to share up to 50 percent of the cost of programs under such agreements.

The health care program provided by an organization pursuant to such an agreement cannot restrict enrollment on the basis of a child's medical condition or impose waiting periods or exclusions for preexisting conditions. The program can also cover the parents of the child. The Secretary may permit the organization to charge for the health care.

The Secretary is directed to publish criteria governing the eligibility and participation of organizations in the demonstration projects by January 1, 1990.

GAO Study/IRS Information Program

The General Accounting Office (GAO), in consultation with the Internal Revenue Service (IRS), under the provision, is required to conduct a study to determine (1) the effectiveness of the advance payment system and (2) how to implement such a system to avoid administrative complexity for small business. A report to the Committee on Finance and the Committee on Ways and Means with recommendations is required within one year after enactment.

The IRS is required to undertake efforts to inform the public of the availability of the credit in order to assure that persons who may be eligible will know the requirements for receiving the credit and how to apply for it.

Effective Dates

The refundability feature and the modifications to the present-law dependent care credit, including the credit for health insurance expenses, generally are effective with respect to taxable years beginning after December 31, 1990. The availability of the advance payments of credit is effective for taxable years beginning after December 31, 1991.

2. Modification and expansion of earned income credit for families with young children (sec. 6903 of the bill and secs. 32 and 3507 of the Code)

Present Law

An eligible individual who maintains a home for one or more children is allowed an advance refundable tax credit based on the taxpayer's earned income (sec. 32). In 1989, the earned income tax credit (EITC) is equal to 14 percent of the first $6,500 of earned income. The credit is phased out at a rate of 10 percent of the amount of adjusted gross income (or, if greater, the earned income) that, in 1989, exceeds $10,240. The $6,500 and $10,240 amounts are adjusted annually for inflation, so that the maximum amount of credit and the maximum amount of income eligible for the credit increase with inflation.

The credit is available to married individuals filing a joint return who are entitled to a dependency exemption for a child, a head of household, and a surviving spouse.

Because the earned income credit is refundable, eligible individuals may have no Federal income tax liability and yet receive monies from the Federal government. Certain Federally-supported means-tested programs disregard the earned income credit for purposes of determining eligibility for the program. Aid to Families with Dependent Children, for example, is one such program.

Reasons for Change

The earned income tax credit is intended to provide relief through the tax system to low-income working families with children. The committee recognizes that the obligation of caring for young children places additional financial burdens on low-income working families. The earned income credit is adjusted, therefore, to provide an additional amount of credit to families with a young child. Since the committee recognizes that the financial obligations of families with more than one young child are even more substantial, the credit amount is increased further if the family supports more than one young child.

The committee also believes that the interaction of the earned income credit with Federally-supported housing assistance programs should not act as a disincentive for work and, therefore, the earned income credit should be disregarded in determining eligibility for housing assistance.

Explanation of Provisions

Supplemental credit for families with young children

The bill provides a supplemental earned income credit amount if any of the taxpayer's children are under the age of 4. The credit amount is calculated as 7 percent of earned income up to the present law breakpoint of $6,500 (as adjusted for inflation) for taxpayer's with one child under age 4; the credit percentage for taxpayers with two or more children under age 4 is 10 percent.

Under the bill, the supplemental earned income credit is reduced by 10 percent (15 percent for taxpayers with two or more children under age 4) of the adjusted gross income (or earned income, if greater) that exceeds $10,000. The $10,000 amount is adjusted for inflation that occurs after 1991, but in no case will the phase out of the supplemental credit start at less than $12,000. In addition, the maximum amount of the credit is limited to $500 for taxpayers with one child under age 4, $750 for those with two.

The supplemental earned income credit is advance refundable in the same manner as the present-law earned income credit.

Treatment of earned income credit for housing assistance

A modification of the earned income credit provides that the earned income credit is not treated as income for purposes of determining eligibility for Federal housing assistance programs.

Effective Date

The provisions generally are effective for taxable years beginning after December 31, 1990, except that the provision concerning the treatment of the credit for housing assistance programs is effective for determinations made after December 31, 1989.

Subtitle J. Individual Retirement Accounts (IRAs) (secs. 6921 - 6923 of the bill and secs. 219 and 72(t) of the Code)

Present Law

Under present law, the maximum deductible contribution that can be made to an individual retirement account (IRA) is generally the lesser of $2,000 or 100 percent of an individual's compensation. Individuals who are not active participants in an employer-sponsored retirement plan, single taxpayers with adjusted gross income (AGI) of less than $25,000, and married taxpayers with AGI of less than $40,000, may make the maximum deductible contribution. For taxpayers who are active participants in employer-sponsored retirement plan , the IRA deduction is phased out for single taxpayers with AGI between $25,000 and $35,000, and for married taxpayers with AGI between $40,000 and $50,000.

Taxpayers who are not entitled to the maximum IRA deduction may make nondeductible contributions to IRAs. As is the case with earnings on deductible IRA contributions, earnings on nondeductible contributions accumulate on a tax-deferred basis.

Amounts withdrawn from IRAs (other than nondeductible contributions) are includible in income when withdrawn. Early withdrawals, e.g., withdrawals prior to age 59½, death, or disability, are generally subject to an additional 10-percent income tax (sec. 72(t)).

Reasons for Change

The committee is concerned about the national rate of personal savings, and believes that individuals should be encouraged to save. The committee believes that the ability to make deductible contributions to an IRA is a significant savings incentive. Under present law, however, this incentive is not available to all taxpayers. Further, the present-law income thresholds for IRA deductions are not indexed for inflation, so that fewer Americans will be eligible to make a deductible IRA contribution each year.

The committee believes it is appropriate to encourage individual savings by making an IRA deduction available to all taxpayers. Expanding the IRA deduction will provide all Americans with a meaningful incentive to save for their retirement years.

The committee is also concerned that Americans are not saving enough to ensure that their children will be able to afford a college education. College costs have risen dramatically in recent years. The ability to obtain a college education is an important factor in ensuring that the United States remains competitive with other nations. Housing costs have also increased, reducing the ability of many to purchase a home. Accordingly, the committee believes that there should be appropriate incentives to save for education and home ownership, and that taxpayers should be able to use without penalty amounts saved in an IRA for such purposes.

Explanation of Provision [111]

In general

The deductibility of an individual's contributions to an IRA is expanded under the provision. In general, the provision permits a deduction of one-half of the otherwise nondeductible portion of the contribution made by an individual. The provision also allows withdrawals from an IRA without imposition of the additional 10-percent income tax to the extent the amount withdrawn is used for either the purchase of a first home or certain education expenses.

Expansion of present-law deduction rules

Under the provision, an individual who contributes to an IRA may deduct the amount of the contribution that is deductible under present law, plus 50 percent of the contribution that is not deductible under present law. This additional 50-percent deduction is only allowed with respect to contributions that would otherwise have been deductible but for the active participant rule. The present-law maximum dollar limitation ($2,000) and other limitations relating to deductibility (e.g., the requirement that the IRA owner be under the age of 70½) continue to apply.

For example, assume that the combined AGI of a married taxpayer and the taxpayer's spouse is $45,000, and that the individual is an active participant in an employer-sponsored retirement plan. Assume further that the taxpayer makes a $2,000 contribution to an IRA. Under the present-law active participant rule, the taxpayer may deduct $1,000 of the contribution. Under the provision, the taxpayer may deduct $1,500, that is, the amount deductible under present law ($1,000), plus one-half of the amount of the contribution that is not presently deductible ($500). Alternatively, if the same taxpayer made a contribution of only $1,500, then the taxpayer could deduct $1,250 [$1,000 + (.50 × $500)].

The provision also provides that interest on loans the proceeds of which are *directly traceable* to an IRA contribution is nondeductible.

Withdrawals by first-time home buyers

Under the provision, withdrawals by first-time homebuyers that are used within 60 days to acquire, construct, or reconstruct the taxpayer's principal residence are not subject to the 10-percent additional income tax. A first-time homebuyer is an individual who has not had an ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which the withdrawal relates. The date of acquisition is the date the individual enters into a contract to purchase a principal residence or begins construction or reconstruction of such a residence. The provision requires that the spouse of the taxpayer is

---

[111] This provision is substantially the same as the provisions of S. 1678, The Savings and Investment Incentive Act of 1989, which was introduced on September 27, 1989, by Senator Bentsen and others.

also required to meet this requirement as of the date of acquisition. Principal residence is defined as under the provisions relating to the rollover of gain on the sale of a principal residence (sec. 1034).

The expansion of the deduction provisions is effective for taxable years beginning after December 31, 1990. The provisions relating to the exceptions to the 10-percent additional income tax apply to distributions after December 31, 1989, in taxable years ending after such date. The provision relating to interest on funds borrowed to make IRA contributions is effective for debt incurred after the date of enactment, in taxable years ending after such date.

Subtitle K. Amendments to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989

1. Treatment of transactions in which Federal financial assistance provided (sec. 6931 of the bill and sec. 597(b)(2) of the Code)

Present Law

Under present law, in the case of transactions other than taxable asset acquisitions, the Treasury Department has the regulatory authority to provide for the proper treatment of Federal financial assistance and appropriate adjustments to basis or other tax attributes to reflect such treatment.

Reasons for Change

The committee wishes to clarify that it was not intended that the Treasury Department's regulatory authority to provide for appropriate adjustments to basis or other tax attributes be limited to adjustments which directly reflect the proper tax treatment of Federal financial assistance.

Explanation of Provision

The provision clarifies that, in the case of transactions other than taxable asset acquisitions, the Treasury Department has the regulatory authority to prescribe rules for appropriate adjustments to basis or other tax attributes to properly take into account collateral tax effects of Federal financial assistance.

Effective Date

The provision is effective as if included in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

2. Tax-exempt debt of State housing finance agencies (sec. 6932 of the bill and sec. 141 of the Code and new sec. 145 of the Code)

Present Law

In general, interest on private activity bonds issued by State or local governments is taxable. Bonds, the proceeds of which are used directly or indirectly to make or finance loans to persons other than government units are private activity bonds. In contrast, interest on qualified private activity bonds (a subset of private activity bonds) is tax-exempt. There are a number of categories of qualified private activity bonds, including: (1) exempt facility bonds; (2) qualified mortgage revenue bonds; (3) qualified small issue bonds; (4) qualified student loan bonds; (5) qualified redevelopment bonds; and (6) qualified 501(c)(3) bonds. Qualified private activity bonds generally are subject to annual State volume caps of the larger of (1) $50 multiplied by the State population; or (2) $150 million.

State and local bonds issued to provide mortgages to finance the disposition of single family residences owned by a State housing finance agency are not qualified private activity bonds unless all provisions of Code section 143 relating to qualified mortgage revenue bonds are met. State and local bonds issued to provide mortgages to finance the disposition of residential rental projects owned by a State housing finance agency to a private business user are not qualified private activity bonds.

State and local bonds issued to purchase single family residences or multi-family rental housing could be considered arbitrage bonds (as defined in Code section 148(a)) to the extent the property purchased is investment property with a yield higher than that of the bonds issued.

Reasons for Change

The committee believes the extension of the implicit subsidy of tax-exempt finance for the acquisition of residential properties from the Resolution Trust Corporation and other United States Government agencies would facilitate the purchase of these assets by State housing finance agencies. By encouraging a market in these residential properties, the committee believes receivership proceeds will be enhanced, reducing the ultimate cost of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Moreover, by providing for the tax-exempt financing of specified purchases of these residential properties from State housing finance agencies, the committee intends to make available additional affordable housing.

Explanation of Provision

The provision creates exceptions to the private business use test, the private security or payment test, and the private loan financing test (all related to private activity bonds) for certain State housing finance agency bonds. A State housing finance agency bond issue would qualify for this exception if at least 95 percent of the proceeds were used to: (1) acquire single family residences or residential rental projects from the Resolution Trust Corporation, the Federal Deposit Insurance Corporation, the Federal Housing Authority, the Department of Veterans Affairs, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Government National Mortgage Association, or any other agency of the United States Government; (2) issue mortgages to finance the disposition of single family residences acquired by a State housing finance agency from the above agencies to purchasers who meet the owner-occupancy requirements, the purchase price restrictions, and the family income restrictions of Code section 143 (related to qualified mortgage revenue bonds); or (3) finance the disposition of multi-family residential rental projects acquired by the State housing finance agency from the above agencies to private owners who would comply with the low-income targeting requirements of Code section 142(d). In all cases, all the dwellings being acquired or financed must be located within the jurisdiction of the State housing finance agency.

In order for these State housing finance agency bonds to be utilized as intended, the bonds are subject to the same restrictions as mortgage revenue bonds (Code section 147(h)(1)). However, the arbitrage restrictions, the State volume limitations, and all other requirements for tax-exempt private activity bonds continue to apply to these State housing finance agency bonds unless specifically exempted.

Effective Date

The provision is effective on the date of enactment.

ESTIMATED REVENUE EFFECTS OF ITEMS REPORTED PURSUANT TO BUDGET RECONCILIATION INSTRUCTIONS—FISCAL YEARS 1990-1994

[Millions of dollars]

Item	Effective date	1990	1991	1992	1993	1994	1990-94
I. Repeal Financial Institution (FSLIC & FDIC) Tax Benefits (P.L. 101-73) (1)	5/10/89	568	31	351	310	213	1,473
II. Corporate Provisions							
A. Defer interest deduction on certain high-yield original issue discount (OID) obligations until interest is paid.	(*)	18	44	86	120	141	409
B. Limit dividends received deduction with respect to certain nontaxed income of consolidated subsidiaries (effective for stock issued after effective date).	10/3/89	45	92	154	209	271	771
C. Repeal nonrecognition treatment when securities are received in a section 351 transaction.	(2)	164	288	289	316	359	1,416
D. Reduce built-in gain or loss threshold of sections 382 and 384 to lesser of 15% or $25 million.	10/3/89	12	18	17	18	19	84
E. Require basis reduction for nontaxed portion of dividends on self-liquidating ("wasting") stock.	(*)	6	10	11	12	13	52
F. Modify consolidated return excess loss account recapture rules to prevent shifting of basis to debt.	(*)	54	69	61	52	42	278
G. Clarify Treasury regulation authority relating to bifurcation of an instrument into debt and equity portions (section 385).	(**)	(3)	(3)	(3)	(3)	(3)	(3)
H. Require reporting to IRS of acquisitions and recapitalizations.	D/o/E	(3)	(3)	(3)	(3)	(3)	(3)
I. Require Treasury study of "debt versus equity" and integration issues.	D/o/E						
J. Limit net operating loss carrybacks attributable to interest expense in certain circumstances (S. 1506).	ty/e/a: 8/2/89	226	406	420	384	343	1,779
K. Require regulated investment companies (mutual funds) to distribute 98% of ordinary income to their shareholders.	ty/e/a: 7/10/89	50	5	5	5	5	70

L. Adjust basis for mutual fund load charge only if shareholder holds shares for more than six months.	10/4/89	28	46	22	7	5	108
M. Include dividends in income of regulated investment companies on ex-dividend date (effective for ex-dividend dates after D/o/E.	D/o/E	110	20	20	20	20	190
Subtotal		713	998	1,085	1,143	1,218	5,157
III. Employee Benefit Provisions							
A. Repeal partial exclusion for interest paid on ESOP loans if ESOP owns less than 30% of the employer's stock (section 133).	Generally: 6/7/89	1,101	1,400	1,774	2,123	2,488	8,886
B. Permit limited use of excess pension funds to pay current retiree health benefits; reverse 401(h) letter ruling (effective 10/4/89).	Generally: 1/1/89	585	417	380	345	321	2,048
Subtotal		1,686	1,817	2,154	2,468	2,809	10,934
IV. Foreign Provisions							
A. Conform tax years of certain controlled foreign corporations and foreign persons holding companies to the tax years of certain U.S. shareholders (with one-month exception).	ty/b/a: 7/10/89	48	71	71	71	36	297
B. Change the sourcing of income of certain corporations in commonly-controlled groups.	ty/b/a: 7/10/89	20	37	41	45	49	192
C. Improve information reporting by U.S. subsidiaries and branches of foreign corporations.	ty/b/a: 7/10/89	55	75	80	85	90	385
Subtotal		123	183	192	201	175	874
V. Excise Tax Provisions							
A. Repeal Airport and Airway Trust Fund tax reduction trigger (10).	1/1/90	851	1,505	1,630	1,762	1,907	7,655
B. Increase international air passenger departure tax from $3.00 to $6.00 per person (10).	1/1/90	51	89	94	100	106	440
C. Impose $3.00-per-passenger tax on international departures by commercial ships.	1/1/90	5	7	8	8	8	36
D. Impose Oil Spill Liability Trust Fund petroleum tax at $0.03/barrel (cap at $300 million).	1/1/90	43	114	60	8	....	225
E. Impose tax on ozone-depleting chemicals subject to the Montreal Protocol.	1/1/90	384	560	753	1,171	1,442	4,310

ESTIMATED REVENUE EFFECTS OF ITEMS REPORTED PURSUANT TO BUDGET RECONCILIATION INSTRUCTIONS—FISCAL YEARS 1990–1994—Continued

[Millions of dollars]

Item	Effective date	1990	1991	1992	1993	1994	1990–94
F. Impose Wetlands Trust Fund tax on oil and gas produced offshore at $0.03/barrel of oil and $0.02/thousand cubic feet of natural gas.	1/1/90	47	80	83	85	88	383
G. Change collection of gasoline excise from semi-monthly to weekly deposits.	1/1/90	111	4	1	2	4	122
H. Modify collection period for airline ticket tax (taxes billed after 6/30/90.		110	6	6	7	7	136
Subtotal		1,602	2,365	2,635	3,143	3,562	13,307
VI. Accounting Provisions							
A. Repeal remaining portion of completed contract method of accounting.	(*)	171	390	262	116	28	967
B. Modify treatment of cost of acquiring franchises, trademarks, and trade names (20-year amortization election for fixed and contingent payments).	10/3/89	51	108	144	157	185	645
Subtotal		222	498	406	273	213	1,612
VII. Employment Tax Provisions							
A. Impose income tax withholding on the wages of certain agricultural workers.	1/1/90	270	68	21	22	23	404
B. Payroll tax speedup ($250,000 threshold; next-day deposit in 1990, third-day deposit in 1991 and 1992, and next-day deposit thereafter).	6/30/90	2,366	−694	100	106	1,108	2,986
Subtotal		2,636	−626	121	128	1,131	3,390
VIII. Other Revenue-Raising Provisions							
A. Tax pre-contribution on certain in-kind partnership distributions made within three years of contribution.	10/4/89	6	12	16	19	20	73

B. Restrict like-kind exchange basis shifting techniques between related parties.			7/10/89	100	120	130	140	151	641
Subtotal				106	132	146	159	171	714

	Code Section	Current Law Expiration							
IX. Expiring Provisions									
A. Employer-provided education assistance (through 1991).	Sec. 127	12/31/88	1/1/89	−439	−316	−96			−851
B. Group legal services (through 1991).	Sec. 120	12/31/88	1/1/89	−127	−82	−29			−238
C. Targeted jobs tax credit (with modifications) (through 1991).	Sec. 51	12/31/89	1/1/90	−47	−134	−144	−80	−37	−442
D. Research and experimentation credit (with modifications) (Permanent).	Sec. 41	12/31/89	1/1/90	−398	−782	−968	−1,063	−1,194	−4,405
E. Research and experimentation cost allocation rules (64% allocation) (for 2 years).	Sec. 861	(+)	ty/b/a: 8/1/89	−335	−625	−275			−1,235
F. Business energy credits (solar, geothermal, and ocean thermal) (Permanent).	Sec. 46	12/31/89	1/1/90	−56	−81	−51	−38	−40	−266
G. Mortgage revenue bonds (Permanent).	Sec. 143	12/31/89	1/1/90	−11	−55	−128	−205	−269	−668
H. Small-issue manufacturing bonds (through 1991).	Sec. 144	12/31/89	1/1/90	−7	−39	−58	−78	−76	−258
I. Low-income housing credit (with modifications) (Permanent).	Sec. 42	12/31/89	1/1/90	−79	−333	−681	−1,058	−1,448	−3,599
J. Health insurance for self-employed (through 1991).	Sec. 162	12/31/89	1/1/90	−244	−411	−151			−806
Subtotal				−1,753	−2,878	−2,591	−2,522	−3,064	−12,808

22-661 O—89—11

ESTIMATED REVENUE EFFECTS OF ITEMS REPORTED PURSUANT TO BUDGET RECONCILIATION INSTRUCTIONS—FISCAL YEARS 1990–1994—Continued

[Millions of dollars]

Item	Effective date	1990	1991	1992	1993	1994	1990–94
X. Child Care, S Corporation Estimated Tax, and Telephone Excise Tax							
A. Child care initiative:							
1. Dependent care credit, refundable, advanced refundable 1/1/92; 90% refundability limit.	1/1/91		−51	−1,090	−1,130	−1,229	−3,500
2. Health insurance credit; Rate: 50%; Phaseout: $12,000–$21,000.	1/1/91		−46	−964	−903	−882	−2,795
3. EITC supplemental for children under 4 years old; Rates: 7% for 1 child, 10% for 2+ children; Phaseout rates: 10%, 15%; Phaseout income levels: $10–$15,000 indexed.	1/1/91		−63	−632	−681	−732	−2,108
B. Require corporate estimated tax payments on tax liability for certain Subchapter S income.	1/1/90	25	(3)	(3)	(3)	(3)	25
C. Telephone excise tax:							
1. Permanent extension	1/1/91		1,612	2,732	2,930	3,143	10,417
2. Modify collection period (100% speedup, effective for taxes billed by service providers after 6/30/90).	7/31/90	102	5	5	6	6	124
Subtotal		127	1,457	51	222	306	2,163
XI. Individual Retirement Accounts (IRAs)							
Provide for 50% Deductibility of Contributions (effective 1/1/91), and Allow Penalty-Free Withdrawals for First-Time Homes and Higher Education Expenses (effective 1/1/90).	1/1/91 and 1/1/90	−192	−1,560	−3,265	−3,613	−4,055	−12,685
XII. Other Provisions							
A. Repeal section 89	1/1/89	−154	−156	−170	−185	−202	−867

C. Require exercise of Treasury regulatory authority with respect to full-funding limitation on a revenue-neutral basis.	D/o/E						
D. Treat income from personal injury awards to children as earned income not subject to tax at parent's rates.	1/1/87	(3)	(3)	(3)	(3)	(3)	(5)
E. Permit private foundations to use common investment funds.	ty/b/a: 12/31/89	−1	−4	−8	−11	−15	−39
F. Modify rules concerning recapture of bad-debt reserves of mutual savings banks and other thrift institutions.	D/o/E	1	3	10	13	20	47
G. Deny retroactive certification of WIN credit	(7)	38	28	12			78
H. Estate, gift, and generation-skipping tax provisions:							
1. Estate tax marital deduction—Overrule Howard Estate.	10/4/89	−(6)	−(6)	−(6)	−(6)	−(6)	−(6)
2. Exclude annual exclusion gifts under section 2035	D/o/E	−1	−2	−2	−3	−3	−11
3. Allow waiver of right of contribution (section 2207A) in limited circumstances.	D/o/E	−(6)	−(6)	−(6)	−(6)	−(6)	−(6)
4. Repeal estate freeze rules (section 2036(c))	12/31/87	−27	−72	−146	−249	−384	−878
5. Generation-skipping transfer tax—Make $2-million exemption permanent, with modifications.	10/4/89	−1	−15	−23	−31	−42	−112
6. Marital deduction rules for nonresident aliens:							
a. Eliminate income requirement and other minor changes.	11/10/88	−(6)	−2	−2	−2	−2	−8
b. Permit trustee discretion to make distributions to surviving spouse in case of hardship.	11/10/88	−4	−2	−2	−3	−3	−14
I. Allow deduction for certain adoption expenses	1/1/90	−2	−3	−3	−3	−3	−14
J. Reinstate income averaging for farmers	1/1/90	−5	−65	−70	−75	−80	−295
K. Extend one-year deferral rule to crop payments made pursuant to Disaster Assistance Act of 1989.		−12					−12
L. Provide relief to wholesale distributors of diesel fuel	4/1/88	(6)	−1	−1	+(6)	−1+(6)	−2
M. Modify treatment of hedging transactions by REITs	D/o/E	(8)	(8)	(8)	(8)	(8)	(8)
N. Cost recovery:							
1. Establish 2-year class life for rental tuxedos	1/1/90	−2	−7	−8	−7	−5	−29
2. Revenue-neutral change to deduction for expenditures incurred to assist disabled.	1/1/90						
O. Employee benefit provisions:							
1. Make section 401(k) plans available to tax-exempt organizations.	1/1/90	−15	−32	−38	−42	−56	−183
2. Change integration rules	1/1/89	(9)	(9)	(9)	(9)	(9)	(9)

ESTIMATED REVENUE EFFECTS OF ITEMS REPORTED PURSUANT TO BUDGET RECONCILIATION INSTRUCTIONS—FISCAL YEARS 1990–1994—Continued

[Millions of dollars]

Item	Effective date	1990	1991	1992	1993	1994	1990–94
3. Modify geographic limitation for VEBAs	10/3/89	−5	−9	−13	−17	−20	−64
4. Modify leased employee rules per S. 5	1/1/84	([9])	([9])	([9])	([9])	([9])	([9])
5. Modify nondiscriminatory rules for dependent care exclusion per S. 5.	1/1/89	([9])	([9])	([9])	([9])	([9])	([9])
P. Tax-exempt bonds:							
1. Permit State housing agencies to issue tax-exempt bonds in connection with purchase of certain assets from troubled financial institutions.	D/o/E	−1	−4	−7	−11	−16	−39
2. Permit refunding of bonds issued by certain municipal authorities.	D/o/E	−1	−4	−6	−9	−11	−31
3. Modify rules concerning tax-exempt bonds issued by 501(c)(3) organizations.	1/1/90	−4	−9	−15	−22	−29	−79
4. Extend period allowed for issuance of Mortgage Credit Certificates.	D/o/E	−([6])	−([6])	−([6])	−([6])	−([6])	−([6])
5. Permit financing of sports facilities with tax-exempt bonds.	1/1/90	−2	−6	−11	−16	−23	−58
Q. Provide guidance for Treasury regulatory authority concerning treatment of split annuities.	10/21/88	−([6])	−([6])	−([6])	−([6])	−([6])	−([6])
R. Reduce BATF alcohol occupational tax for small retail dealers.	1/1/90	−5	−5	−5	−6	−6	−27
S. Provide statute of limitations for alcohol occupational taxes for periods prior to 1986.	D/o/E	−2	−2	−2	−2	−2	−10
T. Increase excise tax on pension reversions to 20%	10/4/89	9	4	2	1	1	17
U. Add authorization for essential air service to Airport and Airway Trust Fund.	D/o/E						
V. Foreign provisions:							
1. Consider certain leased assets for purposes of the passive foreign investment company asset test.	ty/b/a: 12/31/88	−6	−5	−5	−5	−5	−26
2. Modify application of passive foreign investment company rules for export trade corporations.	ty/b/a: 12/31/88	−6	−4	−4	−4	−4	−22
3. Modify treatment of certain scholarships and fellowships received by nonresident aliens.	ty/b/a: 12/31/89	−8	−11	−13	−13	−14	−59

W. Accounting provisions:							
1. Modify treatment of safe-harbor leases entered into by rural electric cooperatives.	([11])	−12	−7	−7	−7	−6	−39
2. Farm debt relief—Limited exclusion from discharge of indebtedness income.	1/1/87	−45	−18	−20	−23	−26	−132
3. Contributions for facilities to replace contaminated water supplies.	1/1/89	−1	−1	−2	−2	−2	−8
4. Modify percentage of completion method of accounting for long-term contracts.	1/1/90	−83	−119	−57	−35	−22	−316
5. Timber passive loss material participation exception.	ty/b/a: 12/31/89	−8	−26	−30	−36	−40	−140
6. Annual accrual method of accounting not limited to sugar cane.	1/1/87	−8	−8	−3	−3	−3	−25
7. Installment sales of residential lots and timeshares by C corporations (regular and minimum tax).	1/1/90	−13	−17	−12	−7	−6	−55
X. Energy/excise tax provisions:							
1. Extend section 29 credit through 12/31/92 and include production from tight sands.	1/1/90	−40	−99	−168	−198	−180	−685
2. Gasohol—Provide tolerance limits for blending	1/1/90	−([6])	−([6])	−([6])	−([6])	−([6])	−([6])
3. Facilitate tax-free purchase of fuels by crop dusters.	1/1/90	−3	−4	−4	−4	−4	−19
V. Allow exclusion preferences as part of the alternative minimum tax credit.	ty/b/a: 12/31/89		−24	−61	−92	−119	−296
Z. Small business exemption from recognition of gain or loss on liquidating sales or distributions (exemption from repeal of General Utilities doctrine).	1/1/89	3	1	−5	−11	−15	−27
AA. Penalty reform	1/1/90		−51	−82	−58	−25	−216
BB. IRS notice to taxpayers concerning withholding per S. 811 and S. 753.	D/o/E						
CC. Increase Joint Committee on Taxation refund review threshold to $1 million.	D/o/E						
DD. Technical corrections							
Subtotal		−426	−758	−981	−1,178	−1,352	−4,695
XIII. Other Provisions Adopted by the Committee							
A. Modify rules for determining cooperative patronage source income and loss from asset sales.	([11])	−18	−23	−9	10		−40

ESTIMATED REVENUE EFFECTS OF ITEMS REPORTED PURSUANT TO BUDGET RECONCILIATION INSTRUCTIONS—FISCAL YEARS 1990–1994—Continued

[Millions of dollars]

Item	Effective date	1990	1991	1992	1993	1994	1990–94
B. Modify application of self-dealing rules for public charities that become private foundations.	ty/b/a; D/o/E	[8]	[8]	[8]	[8]	[8]	[5]
C. Modify treatment of employer-provided qualified transportation expenses.	1/1/90	−7	−9	−9	−10	−10	−45
D. Deny amortization of life estate in related-party joint purchases.	7/27/89	3	5	9	14	22	53
E. Remove gifts of appreciated property as a tax preference for one year.	ty/b/a/; 12/31/89	−13	−60				−73
F. Allow dividend received deduction from ACE for 20%–80% stock ownership.	ty/b/a; 12/31/89	−15	−24	−20	−17	−14	−90
G. Allow alcohol fuels credit for ethyl tertiary butyl ether (ETBE).	1/1/90	−18	−51	−106	−58	−9	−242
H. Provide exception from income phaseout of passive loss rule for $25,000 exemption for rehabilitation credit and low-income housing credit.	1/1/90	−8	−21	−29	−39	−48	−145
I. Allow reserve deductions for certain minimum premium plans.	[11]	[8]	[8]	[8]	[8]	[8]	[8]
J. Modification of empty-seat rule for fringe benefit purposes.	1/1/90	−4	−9	−11	−12	−13	−49
K. Allow family farm corporations that were required to use an accrual method of accounting, by reason of the 1987 Act, to elect a 10-year spread rather than a suspense account.	ty/b/a; 12/31/87	−18	−14	−15	−16	−17	−80
L. Oil and gas percentage depletion: Repeal net income limitation for production from marginal wells.	ty/b/a; 12/31/90		−24	−50	−50	−49	−173
M. Exclusion for certain overseas allowances received by certain Defense Department personal.	1/1/89	[8]	[8]	[8]	[8]	[8]	[5]
N. Eliminate the excise tax imposed on the Inactivated Polio Vaccine, conditional upon action of the Labor and Human Resources Committee.							

O. Tax exemption for Overseas Private Investment Corporation (OPIC).	D/o/E						
P. Continue IRS authority to assist other law enforcement agencies with undercover operations for two years.	D/o/E						
Q. Require Treasury study of standards for tax exemption of certain health insurance organizations.	D/o/E						
R. Clarify Treasury regulatory authority concerning variable contracts issued by controlled foreign corporations.	ty/b/a; 12/31/89						
S. Technical amendments to the Financial Institutions Reform, Recovery, and Enforcement Act.							
Subtotal		−98	−230	−240	−178	−138	−884

ADDENDUM: SUMMARY

Item date	1990	1991	1992	1993	1994	1990–94
I. REPEAL FSLIC & FDIC TAX BENEFITS [1]	568	31	351	310	213	1,473
II. CORPORATE PROVISIONS	713	998	1,085	1,143	1,218	5,157
III. EMPLOYEE BENEFIT PROVISIONS	1,686	1,817	2,154	2,468	2,809	10,934
IV. FOREIGN PROVISIONS	123	183	192	201	175	874
V. EXCISE TAX PROVISIONS	1,602	2,365	2,635	3,143	3,562	13,307
VI. ACCOUNTING PROVISIONS	222	498	406	273	213	1,612
VII. EMPLOYMENT TAX PROVISIONS	2,636	−626	121	128	1,131	3,390
VIII. OTHER REVENUE-RAISING PROVISIONS	106	132	146	159	171	714
Subtotal: REVENUE-RAISING PROVISIONS (I-VIII)	7,656	5,398	7,090	7,825	9,492	37,461
IX. EXPIRING PROVISIONS	−1,753	−2,878	−2,591	−2,522	−3,064	−12,808
X. CHILD CARE, S CORPORATION, ESTIMATED TAX, AND TELEPHONE EXCISE TAX	127	1,457	51	222	306	2,163
XI. INDIVIDUAL RETIREMENT ACCOUNTS (IRAs)	−192	−1,560	−3,265	−3,613	−4,055	−12,685
XII. OTHER PROVISIONS	−426	−758	−981	−1,178	−1,352	−4,695
XIII. OTHER PROVISIONS ADOPTED BY THE COMMITTEE	−98	−230	−240	−178	−138	−884
GRAND TOTAL	5,314	1,429	64	556	1,189	8,552

Notes: In "Effective" column—D/o/E denotes provision effective on date of enactment; ty/b/a denotes "taxable years beginning after" effective date given; ty/e/a donotes "taxable years ending after" effective date given; *denotes provision is effective for transactions after 7/10/89. Unless otherwise noted; **denotes this regulatory authority is to be exercised on a prospective basis.

*Rules expire 4 months after start of a firm's first tax year beginning after 8/1/87.

[1] Estimate reflects net budget effects, including outlay effects, as estimated by the Congressional Budget Office.

[2] Provision generally would apply to transfers made by corporations after 7/11/89 and to transfers made by all other persons after 10/2/89.

[3] Gain of less than $5 million.

[4] Gain of less than $500,000.

[5] Total is not available for estimates represented by footnotes.

[6] Negligible amount.

[7] Credits first claimed after March 11, 1987.

[8] Loss of less than $5 million.

[9] Loss of less than $500,000.

[10] Under the Gramm-Rudman-Hollings Act, excise taxes that are dedicated to trust funds are carried as though they are extended without change after the scheduled expiration date.

[11] Generally effective for taxable years beginning after 12/31/88; in additon, applies to all taxable years beginning before 1/1/90, if the taxpayer so elects in its return for a taxable year beginning before 1/1/90.

Further Note: The provisions in this revenue table do not follow the order of the explanation of the revenue provisions.

APPENDIX: STATUTORY LANGUAGE

TITLE VI—REVENUE MEASURES

SEC. 6001. SHORT TITLE; ETC.

(a) Short Title.—This title may be cited as the "Revenue Reconciliation Act of 1989".

(b) Amendment of 1986 Code.—Except as otherwise expressly provided, whenever in this title an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

(c) Table of Contents.—

Subtitle E—Excise Tax Provisions

Subtitle F—Miscellaneous Provisions

PART I—LIKE KIND EXCHANGES BETWEEN RELATED PERSONS

PART II—MINIMUM TAX PROVISIONS

PART III—ACCOUNTING PROVISIONS

Subtitle A—Extension of Expiring Tax Provisions

PART I—TEMPORARY EXTENSIONS

SEC. 6101. EXTENSION OF EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE.

(a) IN GENERAL.—Subsection (d) of section 127 (relating to educational assistance programs) is amended by striking "December 31, 1988" and inserting "December 31, 1991".

(b) CERTAIN OTHERWISE TAXABLE EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE MAY BE EXCLUDABLE AS WORKING CONDITION FRINGE.—Subsection (h) of section 132 (relating to certain fringe benefits) is amended by adding at the end thereof the following new paragraph:

"(9) APPLICATION OF SECTION TO OTHERWISE TAXABLE EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE.—Amounts which would be excludable from gross income under section 127 but for subsection (a)(2) thereof or the last sentence of subsection (c)(1) thereof shall be excluded from gross income under this section if (and only if) such amounts are a working condition fringe."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1988.

SEC. 6102. EXTENSION OF EMPLOYER-PROVIDED GROUP LEGAL SERVICES.

(a) IN GENERAL.—Subsection (e) of section 120 (relating to group legal services plans) is amended by striking "ending after December 31, 1988" and inserting "beginning after December 31, 1991".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years ending after December 31, 1988.

SEC. 6103. EXTENSION AND MODIFICATION OF TARGETED JOBS CREDIT.

(a) 2-YEAR EXTENSION.—Paragraph (4) of section 51(c) (relating to termination) is amended by striking "December 31, 1989" and inserting "December 31, 1991".

(b) EXTENSION OF AUTHORIZATION.—Paragraph (2) of section 261(f) of the Economic Recovery Tax Act of 1981 is amended by striking "and 1989" and inserting "1989, 1990, and 1991".

(c) MODIFICATION OF REQUEST FOR CERTIFICATION.—

(1) IN GENERAL.—Paragraph (16) of section 51(d) is amended by adding at the end thereof the following new subparagraph:

"(C) EMPLOYER REQUEST MUST SPECIFY POTENTIAL BASIS FOR ELIGIBILITY.—In any request for a certification of an individual as a member of a targeted group, the employer shall—

"(i) specify each subparagraph (but not more than 2) of paragraph (1) by reason of which the employer believes that such individual is such a member, and

"(ii) certify that a good faith effort was made to determine that such individual is such a member."

(2) EFFECTIVE DATE.—The amendments made by this subsection shall apply to individuals who begin work for the employer after December 31, 1989.

SEC. 6104. ALLOCATION OF RESEARCH AND EXPERIMENTAL EXPENDITURES.

Section 864 (relating to definitions and special rule) is amended by adding at the end thereof the following new subsection:

"(f) ALLOCATION OF RESEARCH AND EXPERIMENTAL EXPENDITURES.—

"(1) IN GENERAL.—For purposes of sections 861(b), 862(b), and 863(b), qualified research and experimental expenditures shall be allocated and apportioned as follows:

"(A) Any qualified research and experimental expenditures expended solely to meet legal requirements imposed by a political entity with respect to the improvement or marketing of specific products or processes for purposes not reasonably expected to generate gross income (beyond de minimis amounts) outside the jurisdiction of the political entity shall be allocated only to gross income from sources within such jurisdiction.

"(B) In the case of any qualified research and experimental expenditures (not allocated under subparagraph (A)) to the extent—

"(i) that such expenditures are attributable to activities conducted in the United States, 64 percent of such expenditures shall be allocated and apportioned to income from sources within the United States and deducted from such income in determining the amount of taxable income from sources within the United States, and

"(ii) that such expenditures are attributable to activities conducted outside the United States, 64 percent of such expenditures shall be allocated and apportioned to income from sources outside the United States and deducted from such income in determining the amount of taxable income from sources outside the United States.

"(C) The remaining portion of qualified research and experimental expenditures (not allocated under subparagraphs (A) and (B)) shall be apportioned, at the annual election of the taxpayer, on the basis of gross sales or gross income, except that, if the taxpayer elects to apportion on the basis of gross income, the amount apportioned to income from sources outside the United States shall at least be 30 percent of the amount which would be so apportioned on the basis of gross sales.

"(2) QUALIFIED RESEARCH AND EXPERIMENTAL EXPENDITURES.—For purposes of this section, the term 'qualified research and experimental expenditures' means amounts which are research and experimental expenditures within the meaning of section 174. For purposes of this paragraph, rules similar to the rules of subsection (c) of section 174 shall apply. Any qualified research and experimental expenditures treated as deferred expenses under subsection (b) of section 174 shall be taken into account under this subsection for the taxable year for which such expenditures are allowed as a deduction under such subsection.

"(3) SPECIAL RULES FOR EXPENDITURES ATTRIBUTABLE TO ACTIVITIES CONDUCTED IN SPACE, ETC.—

"(A) IN GENERAL.—Any qualified research and experimental expenditures described in subparagraph (B)—

"(i) if incurred by a United States person, shall be allocated and apportioned under this section in the same manner as if they were attributable to activities conducted in the United States, and

"(ii) if incurred by a person other than a United States person, shall be allocated and apportioned under this section in the same manner as if they were attributable to activities conducted outside the United States.

"(B) DESCRIPTION OF EXPENDITURES.—For purposes of subparagraph (A), qualified research and experimental expenditures are described in this subparagraph if such expenditures are attributable to activities conducted—

"(i) in space,

"(ii) on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States, or

"(iii) in Antarctica.

"(4) AFFILIATED GROUP.—

"(A) Except as provided in subparagraph (B), the allocation and apportionment required by paragraph (1) shall be determined as if all members of the affiliated group (as defined in subsection (e)(5)) were a single corporation.

"(B) For purposes of the allocation and apportionment required by paragraph (1)—

"(i) sales and gross income from products produced in whole or in part in a possession by an electing corporation (within the meaning of section 936(h)(5)(E)), and

"(ii) dividends from an electing corporation,

shall not be taken into account, except that this subparagraph shall not apply to sales of (and gross income and dividends attributable to sales of) products with respect to which an election under section 936(h)(5)(F) is not in effect.

"(C) The qualified research and experimental expenditures taken into account for purposes of paragraph (1) shall be adjusted to reflect the amount of such expenditures included in computing the cost-sharing amount (determined under section 936(h)(5)(C)(i)(I)).

"(D) The Secretary may prescribe such regulations as may be necessary to carry out the purposes of this paragraph, including regulations providing for the source of gross income and the allocation and apportionment of deductions to take into account the adjustments required by subparagraph (C).

"(E) Paragraph (6) of subsection (e) shall not apply to qualified research and experimental expenditures.

"(5) APPLICATION OF SUBSECTION.—This subsection shall apply to taxable years beginning after August 1, 1989, and beginning before August 2, 1991."

SEC. 6105. EXTENSION OF QUALIFIED SMALL ISSUE BONDS.

Subparagraph (B) of section 144(a)(12) is amended by striking "1989" and inserting "1991".

SEC. 6106. EXTENSION OF SPECIAL RULES FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS.

(a) GENERAL RULE.—Paragraph (5) of section 162(l) (relating to special rules for health insurance costs of self-employed individuals) is amended by striking "December 31, 1989" and inserting "December 31, 1991".

(b) SPECIAL RULE FOR CERTAIN S CORPORATION SHAREHOLDERS.—Subsection (l) of section 162 (as amended by subsection (a)) is amended by redesignating paragraph (5) as paragraph (6) and by inserting after paragraph (4) the following new paragraph:

"(5) TREATMENT OF CERTAIN S CORPORATION SHAREHOLDERS.—This subsection shall apply in the case of any individual treated as a partner under section 1372(a), except that—

"(A) for purposes of this subsection, such individual's wages (as defined in section 3121) from the S corporation shall be treated as such individual's earned income (within the meaning of section 401(c)(1)), and

"(B) there shall be such adjustments in the application of this subsection as the Secretary may by regulations prescribe."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1989.

SEC. 6107. EXTENSION OF WAIVER OF EARLY WITHDRAWAL TAX FOR ESOPS.

Subparagraph (C) of section 72(t)(2) is amended by striking "January 1, 1990" and inserting "January 1, 1992".

SEC. 6108. EXTENSION OF IRS ASSISTANCE IN UNDERCOVER OPERATIONS.

Paragraph (3) of section 7601(c) of the Anti-Drug Abuse Act of 1988 is amended by striking "December 31, 1989" and "January 1, 1990" and inserting "December 31, 1991" and "January 1, 1992", respectively.

SEC. 6109. EXTENSION OF TRANSFER TO RAILROAD RETIREMENT ACCOUNT.

Subsection (c)(1)(A) of section 224 of the Railroad Retirement Solvency Act of 1983, as amended by section 9034 of the Omnibus Budget Reconciliation Act of 1987, is amended by striking "1989" and inserting "1991".

SEC. 6110. EXTENSION AND MODIFICATION OF CREDIT FOR NONCONVENTIONAL FUELS.

(a) 2-YEAR EXTENSION.—Subparagraph (A) of section 29(f)(1) (relating to application of section) is amended by striking "January 1, 1991" each place it appears and inserting "January 1, 1993".

(b) APPLICATION OF CREDIT TO TIGHT SANDS FORMATION PRODUCTION.—

(1) IN GENERAL.—Paragraph (2) of section 29(c) (relating to definition of qualified fuels) is amended to read as follows:

"(2) GAS FROM GEOPRESSURED BRINE, ETC.—The determination of whether any gas is produced from geopressured brine, Devonian shale, coal seams, or a tight formation shall be made in accordance with section 503 of the Natural Gas Policy Act of 1978."

(2) EFFECTIVE DATE.—The amendment made by this subsection shall apply to gas from wells drilled after December 31, 1989.

PART II—PERMANENT EXTENSIONS

SEC. 6111. LOW-INCOME HOUSING CREDIT MADE PERMANENT; MODIFICATIONS TO CREDIT.

(a) CREDIT MADE PERMANENT.—Subsection (n) of section 42 (relating to low-income housing credit) is hereby repealed.

(b) 1-YEAR CARRYOVER OF UNUSED CREDIT AUTHORITY.—

(1) IN GENERAL.—Section 42(h)(3) (relating to housing credit dollar amount for agencies) is amended by redesignating subparagraphs (D), (E), and (F) as subparagraphs (E), (F), and (G), respectively, and by striking subparagraph (C) and inserting the following new subparagraphs:

"(C) STATE HOUSING CREDIT CEILING.—The State housing credit ceiling applicable to any State for any calendar year shall be an amount equal to the sum of—

"(i) $1.25 multiplied by the State population,

"(ii) the unused State housing credit ceiling (if any) of such State for the preceding calendar year,

"(iii) the amount of State housing credit ceiling returned in the calendar year, plus

"(iv) the amount (if any) allocated under subparagraph (D) to such State by the Secretary.

For purposes of clause (ii), the unused State housing credit ceiling for any calendar year is the excess (if any) of the amount described in clause (i) over the aggregate housing credit dollar amount allocated for such year. For purposes of clause (iii), the amount of State housing credit ceiling returned in the calendar year equals the housing credit dollar amount previously allocated within the State to any project which does not become a qualified low-income housing project within the period required by this section or the terms of the allocation or to any project with respect to which an allocation is cancelled by mutual consent of the housing credit agency and the allocation recipient.

"(D) UNUSED HOUSING CREDIT CARRYOVERS ALLOCATED AMONG CERTAIN STATES.—

"(i) IN GENERAL.—The unused housing credit carryover of a State for any calendar year shall be assigned to the Secretary for allocation among qualified States for the succeeding calendar year.

"(ii) UNUSED HOUSING CREDIT CARRYOVER.—For purposes of this subparagraph, the unused housing credit carryover of a State for any calendar year is the excess (if any) of the unused State housing credit ceiling for such year (as defined in subparagraph (C)(ii)) over the excess (if any) of—

"(I) the aggregate housing credit dollar amount allocated for such year, over

"(II) the amount described in clause (i) of subparagraph (C).

"(iii) FORMULA FOR ALLOCATION OF UNUSED HOUSING CREDIT CARRYOVERS AMONG QUALIFIED STATES.—The amount allocated under this subparagraph to a qualified State for any calendar year shall be the amount determined by the Secretary to bear the same ratio to the aggregate unused housing credit carryovers of all States for the preceding calendar year as such State's population for the calendar year bears to the population of all qualified States for the calendar year. For purposes of the preceding sentence, population shall be determined in accordance with section 146(j).

"(iv) QUALIFIED STATE.—For purposes of this subparagraph, the term 'qualified State' means, with respect to a calendar year, any State—

"(I) which allocated its entire State housing credit ceiling for the preceding calendar year, and

"(II) for which a request is made (not later than May 1 of the calendar year) to receive an allocation under clause (iii)."

(2) CONFORMING AMENDMENTS.—

(A) Subparagraph (E) of section 42(h)(5) is amended by striking "subparagraph (E)" and inserting "subparagraph (F)".

(B) Paragraph (6) of section 42(h) is amended by striking subparagraph (B) and by redesignating subparagraphs (C), (D), and (E) as subparagraphs (B), (C), and (D), respectively.

(c) BUILDINGS ELIGIBLE FOR CREDIT ONLY IF MINIMUM LONG-TERM COMMITMENT TO LOW-INCOME HOUSING.—

(1) IN GENERAL.—Section 42(h) (relating to limitation on aggregate credit allowable with respect to projects located in a State) is amended by redesignating paragraphs (6) and (7) as paragraphs (7) and (10), respectively, and by inserting after paragraph (5) the following new paragraph:

"(6) BUILDINGS ELIGIBLE FOR CREDIT ONLY IF MINIMUM LONG-TERM COMMITMENT TO LOW-INCOME HOUSING.—

"(A) IN GENERAL.—No credit shall be allowed by reason of this section with respect to any building for the taxable year unless an extended low-income housing commitment is in effect as of the end of such taxable year.

"(B) EXTENDED LOW-INCOME HOUSING COMMITMENT.—For purposes of this paragraph, the term 'extended low-income housing commitment' means any agreement between the taxpayer and the housing credit agency—

"(i) which requires that the applicable fraction (as defined in subsection (c)(1)) for the building for each taxable year in the extended use period will not be less than the applicable fraction specified in such agreement,

"(ii) which allows individuals who meet the income limitation applicable to the building under subsection (g) (whether prospective, present, or former occupants of the building) the right to enforce in any State court the requirement of clause (i),

"(iii) which is binding on all successors of the taxpayer, and

"(iv) which, with respect to the property, is recorded pursuant to State law as a restrictive covenant.

"(C) ALLOCATION OF CREDIT MAY NOT EXCEED AMOUNT NECESSARY TO SUPPORT COMMITMENT.—

"(i) IN GENERAL.—The housing credit dollar amount allocated to any building may not exceed the amount necessary to support the applicable fraction specified in the extended low-income housing commitment for such building, including any increase in such fraction pursuant to the application of subsection (f)(3) if such increase is reflected in an amended low-income housing commitment.

"(ii) BUILDINGS FINANCED BY TAX-EXEMPT BONDS.—If paragraph (4) applies to any building the amount of credit allowed in any taxable year may not exceed the amount necessary to support the applicable fraction specified in the extended low-income housing commitment for such building. Such commitment may be amended to increase such fraction.

"(D) EXTENDED USE PERIOD.—For purposes of this paragraph, the term 'extended use period' means the period—

"(i) beginning on the 1st day in the compliance period on which such building is part of a qualified low-income housing project, and

"(ii) ending on the later of—

"(I) the date specified by such agency in such agreement, or

"(II) the date which is 15 years after the close of the compliance period.

"(E) EXCEPTIONS IF FORECLOSURE OR IF NO BUYER WILLING TO MAINTAIN LOW-INCOME STATUS.—

"(i) IN GENERAL.—The extended use period for any building shall terminate—

"(I) on the date the building is acquired by foreclosure (or instrument in lieu of foreclosure), or

"(II) on the last day of the period specified in subparagraph (I) if the housing credit agency is unable to present during such period a qualified contract for the acquisition of the low-income portion of the building by any person who will continue to operate such portion as a qualified low-income building.

Subclause (II) shall not apply to the extent more stringent requirements are provided in the agreement or in State law.

"(ii) EVICTION, ETC. OF EXISTING LOW-INCOME TENANTS NOT PERMITTED.—The termination of an extended use period under clause (i) shall not be construed to permit—

"(I) the eviction or the termination of tenancy (other than for good cause) of an existing tenant of any low-income unit, or

"(II) any increase in the gross rent with respect to such unit, except if such tenant's income exceeds 100 percent of the income limitation under subsection (g)(1), then only to the extent such increase does not exceed 30 percent of such tenant's income.

"(F) QUALIFIED CONTRACT.—For purposes of subparagraph (E), the term 'qualified contract' means a bona fide contract to acquire (within a reasonable period after the contract is entered into) the low-income portion of the building for an amount not less than the applicable fraction (specified in the extended low-income housing commitment) of—

"(i) the sum of—

"(I) the outstanding indebtedness secured by, or with respect to, the building,

"(II) the adjusted investor equity in the building, plus

"(III) other capital contributions not reflected in the amounts described in subclause (I) or (II), reduced by

"(ii) cash distributions from (or available for distribution from) the project.

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this paragraph, including regulations to prevent the manipulation of the amount determined under the preceding sentence.

"(G) ADJUSTED INVESTOR EQUITY.—

"(i) IN GENERAL.—For purposes of subparagraph (E), the term 'adjusted investor equity' means, with respect to any calendar year, the aggregate amount of cash taxpayers invested with respect to the project increased by the amount equal to—

"(I) such amount, multiplied by

"(II) the cost-of-living adjustment for such calendar year, determined under section 1(f)(3) by substituting the base calendar year for 'calendar year 1987'.

An amount shall be taken into account as an investment in the project only to the extent there was an obligation to invest such amount as of the beginning of the credit period and to the extent such amount is reflected in the adjusted basis of the project.

"(ii) COST-OF-LIVING INCREASES IN EXCESS OF 5 PERCENT NOT TAKEN INTO ACCOUNT.—Under regulations prescribed by the Secretary, if the CPI for any calendar year (as defined in section 1(f)(4)) exceeds the CPI for the preceding calendar year by more than 5 percent, the CPI for the base calendar year shall be increased such that such excess shall never be taken into account under clause (i).

"(iii) BASE CALENDAR YEAR.—For purposes of this subparagraph, the term 'base calendar year' means the calendar year with or within which the 1st taxable year of the credit period ends.

"(H) LOW-INCOME PORTION.—For purposes of this paragraph, the low-income portion of a building is the portion of such building equal to the applicable fraction specified in the extended low-income housing commitment for the building.

"(I) PERIOD FOR FINDING BUYER.—The period referred to in this subparagraph is the 1-year period beginning on the date (after the 14th year of the compliance period) the taxpayer submits a written request to the housing credit agency to find a person to acquire the taxpayer's interest in the low-income portion of the building.

"(J) SALES OF LESS THAN LOW-INCOME PORTION OF BUILDING.—In the case of a sale or exchange of only a portion of the low-income portion of the building, only the same portion (as the portion sold or exchanged) of the amount determined under subparagraph (F) shall be taken into account thereunder.

"(K) EFFECT OF NONCOMPLIANCE.—If, during a taxable year, there is a determination that an extended low-income housing agreement was not in effect as of the beginning of such year, such determination shall not apply to any period before such year and subparagraph (A) shall be applied without regard to such determination if the failure is corrected within 1 year from the date of the determination.

"(L) PROJECTS WHICH CONSIST OF MORE THAN 1 BUILDING.—The application of this paragraph to projects which consist of more than 1 building shall be made under regulations prescribed by the Secretary."

(2) CONFORMING AMENDMENT.—Subparagraph (C) of section 42(b)(3) is amended by striking "subsection (h)(6))" and inserting "subsection "(h)(7)".

(d) CREDIT FOR ACQUISITION OF EXISTING BUILDING TO APPLY ONLY IF BUILDING TO BE REHABILITATED; INCREASE IN REQUIRED REHABILITATION EXPENDITURES.—

(1) IN GENERAL.—Subparagraph (B) of section 42(d)(2) (relating to eligible basis of existing buildings) is amended by striking "and" at the end of clause (ii), by striking the period at the end of clause (iii) and inserting ", and", and by adding at the end thereof the following new clause:

"(iv) a credit is allowable under subsection (a) by reason of subsection (e) with respect to the building."

(2) CREDIT PERIOD FOR EXISTING BUILDINGS NOT TO BEGIN BEFORE REHABILITATION CREDIT ALLOWED.—Section 42(f) (relating to definition and special rules relating to credit period) is amended by adding at the end thereof the following new paragraph:

"(4) CREDIT PERIOD FOR EXISTING BUILDINGS NOT TO BEGIN BEFORE REHABILITATION CREDIT ALLOWED.—The credit period for an existing building (other than a federally-assisted building with respect to which a waiver is granted under subsection (d)((6)(C)) shall not begin before the 1st taxable year of the credit period for rehabilitation expenditures with respect to the building."

(3) INCREASE IN REQUIRED REHABILITATION EXPENDITURES.—Paragraph (3) of section 42(e) (relating to rehabilitation expenditures treated as separate new building) is amended—

(A) by striking "$2,000" in the text of subparagraph (A) and inserting "$3,000", and

(B) by striking "$2,000" in the heading and inserting "$3,000".

(e) RENT RESTRICTION DETERMINED ON BASIS OF NUMBER OF BEDROOMS, ETC.—

(1) Section 42(g)(2) is amended by redesignating subparagraph (C) as subparagraph (D) and by inserting after subparagraph (B) the following new subparagraph:

"(C) IMPUTED INCOME LIMITATION APPLICABLE TO UNIT.—For purposes of this paragraph, the imputed income limitation applicable to a unit is the income limitation which would apply under paragraph (1) to individuals occupying the unit if the number of individuals occupying the unit were as follows:

"(i) In the case of a unit which does not have a separate bedroom, 1 individual.

"(ii) In the case of a unit which has 1 or more separate bedrooms, 1.5 individuals for each separate bedroom.

In the case of a project with respect to which a credit is allowable by reason of this section and for which financing is provided by a bond described in section 142(a)(7), the imputed income limitation shall apply in lieu of the otherwise applicable income limitation for purposes of applying section 142(d)(4)(B)(ii)."

(B) Subparagraph (A) of section 42(g)(2), as amended by paragraph (1), is further amended by striking "the income limitation under paragraph (1) applicable to individuals occupying such unit" and inserting "the imputed income limitation applicable to such unit".

(f) ADDITIONAL BUILDINGS ELIGIBLE FOR WAIVER OF 10-YEAR PERIOD APPLICABLE TO ACQUISITIONS OF EXISTING BUILDINGS.—

(1) IN GENERAL.—Subparagraph (A) of section 42(d)(6) (relating to credit allowable for certain federally-assisted buildings acquired during 10-year period described in paragraph (2)(B)(ii)) is amended by striking "or" at the end of clause (i), by striking the period at the end of clause (ii) and inserting a comma and "or", and by adding at the end thereof the following new clause:

"(iii) to facilitate the sale of the building if—

"(I) the mortgage loan on the building is held by the Department of Housing and Urban Development,

"(II) the building is owned by such Department following its acquisition (by such Department or the mortgage loan lender) by foreclosure (or by instrument in lieu of foreclosure), or

"(III) the building is owned by the Farmers Home Administration."

(2) LOW-INCOME BUILDINGS WHERE MORTGAGE MAY BE PREPAID.—Section 42(d)(6) is amended by adding at the end thereof the following new subparagraphs:

"(C) LOW-INCOME BUILDINGS WHERE MORTGAGE MAY BE PREPAID.—A waiver may be granted under subparagraph (A) (without regard to any clause thereof) with respect to a federally-assisted building described in clause (ii) or (iii) of subparagraph (B) if—

"(i) at any time within 1 year after the date of the application by the taxpayer for such a waiver, the mortgage on such building is eligible for prepayment under subtitle B of the Emergency Low Income Housing Preservation Act of 1987 or under section 502(c) of the Housing Act of 1949, and

"(ii) the appropriate Federal official certifies to the Secretary that it is reasonable to expect that if the waiver is not granted such building will cease complying with its low-income occupancy requirements.

If a waiver is granted under subparagraph (A) with respect to such building, no person shall be eligible to prepay such mortgage without the approval of the appropriate Federal official."

"(D) BUILDINGS ACQUIRED FROM INSURED DEPOSITORY INSTITUTIONS IN DEFAULT.—A waiver may be granted under subparagraph (A) (without regard to any clause thereof) with respect to any building acquired from an insured depository institution in default (as defined in section 3 of the Federal Deposit Insurance Act) or from a receiver or conservator of such an institution."

(3) CERTAIN MULTI-FAMILY HOUSING.—Subparagraph (B) of section 42(d)(6) is amended by adding at the end thereof the following new sentence: "Such term also includes any building which has more than 4 residential rental units and the mortgage on which was originated by, or is insured or guaranteed by, the Federal Government."

(g) INCREASE IN CREDIT FOR BUILDINGS IN HIGH COST AREAS.—Paragraph (5) of section 42(d) (relating to eligible basis) is amended by adding at the end thereof the following new subparagraph:

"(D) INCREASE IN CREDIT FOR BUILDINGS IN HIGH COST AREAS.—

"(i) IN GENERAL.—In the case of any building located in a qualified census tract or difficult development area which is designated for purposes of this subparagraph—

"(I) in the case of a new building, the eligible basis of such building shall be 130 percent of such basis determined without regard to this subparagraph, and

"(II) in the case of an existing building, the rehabilitation expenditures taken into account under subsection (e) shall be 130 percent of such expenditures determined without regard to this subparagraph.

"(ii) QUALIFIED CENSUS TRACT.—

"(I) IN GENERAL.—The term 'qualified census tract' means any census tract in which 50 percent or more of the households have an income which is less than 60 percent of the area median gross income.

"(II) LIMIT ON MSA's DESIGNATED.—The portion of a metropolitan statistical area which may be designated for purposes of this subparagraph shall not exceed an area having 20 percent of the population of such metropolitan statistical area.

"(III) DETERMINATION OF AREAS.—For purposes of this clause, each metropolitan statistical area shall be treated as a separate area and all nonmetropolitan areas in a State shall be treated as one area.

"(iii) DIFFICULT DEVELOPMENT AREAS.—

"(I) IN GENERAL.—The term 'difficult development areas' means any area designated by the Secretary of Housing and Urban Development as an area which has high construction, land, and utility costs relative to area median gross income.

"(II) LIMIT ON AREAS DESIGNATED.—Only 20 percent of the metropolitan statistical areas in the United States may be designated for purposes of this subparagraph and only 20 percent of nonmetropolitan areas in the United States may be so designated.

"(iv) SPECIAL RULES AND DEFINITIONS.—For purposes of this subparagraph—

"(I) population shall be determined on the basis of the most recent decennial census for which data are available,

"(II) area median gross income shall be determined in accordance with subsection (g)(4),

"(III) the term 'metropolitan statistical area' has the same meaning as when used in section 143(k)(2)(B), and

"(IV) the term 'nonmetropolitan area' means any county (or portion thereof) which is not within a metropolitan statistical area."

(h) CHANGES IN RULES RELATING TO BUILDINGS FOR WHICH CREDIT MAY BE ALLOWED.—

(1) SINGLE-ROOM OCCUPANCY UNITS RENTED ON A MONTHLY BASIS.—Subparagraph (B) of section 42(i)(3) (relating to low income unit) is amended by adding at the end thereof the following new sentence: "For purposes of the preceding sentence, a single-room occupancy unit shall not be treated as used on a transient basis merely because it is rented on a month-by-month basis."

(2) SPECIAL NEEDS HOUSING.—

(A) CONSIDERATION OF REQUIRED FEES FOR SUPPORTIVE SERVICES IN CALCULATION OF GROSS RENT.—Subparagraph (B) of section 42(g)(2) (relating to gross rent) is amended—

(i) in clause (i), by striking "and" at the end,

(ii) in clause (ii), by striking the period at the end and inserting ", and", and

(iii) by adding at the end the following:

"(iii) includes any fee assessed for a supportive service (as defined in paragraph (8)) if payment of the fee is required as a condition of occupancy, unless the fee is paid to the owner of the unit by any governmental program of assistance in which the amount of assistance provided for rent is not separable from the amount of assistance provided for supportive services.

If the fee described in clause (iii) is included in gross rent, the gross rent limitation under subparagraph (A) shall be increased by 20 percent."

(B) ELIGIBILITY OF SPECIAL NEEDS HOUSING.—Section 42(g) (relating to qualified low-income housing project) is amended by adding at the end the following new paragraph:

"(8) ELIGIBILITY OF SPECIAL NEEDS HOUSING.—

"(A) IN GENERAL.—A residential rental property shall not be treated as failing to be a qualified low-income housing project for purposes of this section solely because individuals occupying residential units in the property are provided supportive services. The preceding sentence shall not apply if section 7872 does not apply to any individual occupying a residential unit in the property (or such individual spouse) by reason of subsection (g) thereof.

"(B) SUPPORTIVE SERVICE.—For purposes of this paragraph, the term 'supportive service' means any service provided under a planned program of services designed to enable residents of a residential rental property to remain independent and avoid placement in a hospital, nursing home, or intermediate care facility for the mentally or physically handicapped."

(3) SCATTERED SITE PROJECTS.—Section 42(g) (relating to qualified low-income housing project) is further amended by adding at the end thereof the following new paragraph:

"(9) SCATTERED SITE PROJECTS.—Buildings which would (but for their lack of proximity) be treated as a project for purposes of this section shall be so treated if all of the dwelling units in each of the buildings are rent-restricted (within the meaning of paragraph (2)) residential rental units."

(4) OWNER-OCCUPIED BUILDINGS HAVING 4 OR FEWER UNITS ELIGIBLE FOR CREDIT WHERE DEVELOPMENT PLAN.—Section 42(i)(3) (defining low-income unit) is amended by adding at the end thereof the following new subparagraph:

"(D) OWNER-OCCUPIED BUILDINGS HAVING 4 OR FEWER UNITS ELIGIBLE FOR CREDIT WHERE DEVELOPMENT PLAN.—

"(i) IN GENERAL.—Subparagraph (C) shall not apply to the acquisition or rehabilitation of a building pursuant to a development plan of action sponsored by a State or local government or a qualified nonprofit organization (as defined in subsection (h)(5)(C)).

"(ii) LIMITATION ON CREDIT.—In the case of a building to which clause (i) applies, the applicable fraction shall not exceed 80 percent of the unit fraction.

"(iii) CERTAIN UNRENTED UNITS TREATED AS OWNER-OCCUPIED.—In the case of a building to which clause (i) applies, any unit which is not rented for 90 days or more shall be treated as occupied by the owner of the building as of the 1st day it is not rented."

(5) BUILDINGS RECEIVING SECTION 8 MODERATE REHABILITATION ASSISTANCE OR SIMILAR ASSISTANCE NOT ELIGIBLE FOR CREDIT.—Section 42(b)(1) (relating to applicable percentage for buildings placed in service during 1987) is amended by adding at the end thereof the following new flush sentence:

"A building shall not be treated as described in subparagraph (B) if, at any time during the credit period, moderate rehabilitation assistance is provided with respect to such building under section 8(e)(2) of the United States Housing Act of 1937."

(i) ELIGIBLE BASIS FOR NEW BUILDINGS TO INCLUDE EXPENDITURES BEFORE CLOSE OF 1ST YEAR OF CREDIT PERIOD.—

(1) NEW BUILDINGS.—Paragraph (1) of section 42(d) (relating to eligible basis for new buildings) is amended by inserting before the period "as of the close of the 1st taxable year of the credit period".

(2) EXISTING BUILDINGS.—Subparagraph (A) of section 42(d)(2) (relating to eligible basis for existing buildings) is amended by striking "subparagraph (B)" and all that follows through the end of clause (i) and inserting "subparagraph (B), its adjusted basis as of the close of the 1st taxable year of the credit period, and".

(3) CONFORMING AMENDMENTS.—

(A) Subparagraph (C) of section 42(d)(2) is amended by striking "ACQUISITION COST" in the heading and inserting "ADJUSTED BASIS" and by striking "cost" in the text and inserting "adjusted basis".

(B) Paragraph (5) of section 42(d), as amended by subsection (g), is further amended by striking subparagraph (A), by redesignating subparagraphs (B), (C), and (D) as subparagraphs (A), (B), and (C), respectively, and by striking the paragraph heading and inserting the following:

"(5) SPECIAL RULES FOR DETERMINING ELIGIBLE BASIS.—".

(C) Paragraph (5) of section 42(e) is amended by striking "subsection (d)(2)(A)(i)(II)" and inserting "subsection (d)(2)(A)(i)".

(j) HOUSING CREDIT MAY BE ALLOCATED ON PROJECT BASIS.—

(1) IN GENERAL.—Section 42(h)(1) (relating to credit may not exceed credit amount allocated to building) is amended by adding at the end thereof the following new subparagraph:

"(F) ALLOCATION OF CREDIT ON A PROJECT BASIS.—

"(i) IN GENERAL.—In the case of a project which includes (or will include) more than 1 building, an allocation meets the requirements of this subparagraph if—

"(I) the allocation is made to the project for a calendar year during the project period,

"(II) the allocation only applies to buildings placed in service during or after the calendar year for which the allocation is made, and

"(III) the portion of such allocation which is allocated to any building in such project is specified not later than the close of the calendar year in which the building is placed in service.

"(ii) PROJECT PERIOD.—For purposes of clause (i), the term 'project period' means the period—

"(I) beginning with the 1st calendar year for which an allocation may be made for the 1st building placed in service as part of such project, and

"(II) ending with the calendar year the last building is placed in service as part of such project."

(2) CONFORMING AMENDMENT.—Subparagraph (B) of section 42(h)(1) is amended by striking "or (E)" and inserting "(E), or (F)".

(3) PROJECTS WITH MORE THAN 1 BUILDING MUST BE IDENTIFIED.—Section 42(g)(3) (relating to date for meeting requirements) is amended by adding at the end thereof the following new subparagraph:

"(D) PROJECTS WITH MORE THAN 1 BUILDING MUST BE IDENTIFIED.—For purposes of this section, a project shall be treated as consisting of only 1 building unless, before the close of the 1st calendar year in the project period (as defined in subsection (h)(1)(F)(ii)), each building which is (or will be) part of such project is identified in such form and manner as the Secretary may provide."

(k) CHANGES IN RULES RELATED TO DEEP RENT SKEWED PROJECTS.—

(1) Clause (iii) of section 142(d)(4)(B) (relating to deep rent skewed project) is amended by striking "⅓" and inserting "½".

(2) Section 42(g)(4) (relating to certain rules made applicable) is amended by striking "(other than section 142(d)(4)(B)(iii))".

(l) HOUSING CREDIT AGENCIES MUST ADOPT PLANS FOR ALLOCATION OF CREDIT AMONG PROJECTS.—Subsection (h) of section 42 (relating to limitation on aggregate credit allowable with respect to projects located in a State), as amended by subsection (c), is further amended by inserting after paragraph (7) the following new paragraph:

"(8) HOUSING CREDIT AGENCIES MUST ADOPT PLANS FOR ALLOCATION OF CREDIT AMONG PROJECTS.—

"(A) IN GENERAL.—Notwithstanding any other provision of this section, the housing credit dollar amount with respect to any building shall be zero unless such amount was allocated pursuant to a qualified allocation plan of the housing credit agency which is approved by the governmental unit (in accordance with rules similar to the rules of section 147(f)(2) (other than subparagraph (B)(ii) thereof)) of which such agency is a part.

"(B) QUALIFIED ALLOCATION PLAN.—For purposes of this paragraph, the term 'qualified allocation plan' means any plan—

"(i) which sets forth selection criteria to be used to determine housing priorities of the housing credit agency which are appropriate to local conditions, and

"(ii) which gives preference in allocating housing credit dollar amounts among selected projects to—

"(I) projects serving the lowest income tenants, and

"(II) projects obligated to serve qualified tenants for the longest periods.

"(C) CERTAIN SELECTION CRITERIA MUST BE USED.—The selection criteria set forth in a qualified allocation plan must include—

"(i) project location,

"(ii) housing needs characteristics,

"(iii) project characteristics,

"(iv) sponsor characteristics,

"(v) participation of local tax-exempt organizations,

"(vi) encouragement of mixed-use housing,

"(vii) tenant populations with special housing needs, and

"(viii) project financial feasibility and viability as described in paragraph (9).

"(D) APPLICATION TO BOND FINANCED PROJECTS.—Paragraph (4) shall not apply to any project unless the project satisfies the requirements for allocation of a housing credit dollar amount under the qualified allocation plan applicable to the area in which the project is located."

(m) CREDIT ALLOCATED NOT TO EXCEED AMOUNT NECESSARY TO ASSURE PROJECT FEASIBILITY.—Subsection (h) of section 42 is further amended by inserting after paragraph (8) the following new paragraph:

"(9) CREDIT ALLOCATED TO BUILDING NOT TO EXCEED AMOUNT NECESSARY TO ASSURE PROJECT FEASIBILITY.—

"(A) IN GENERAL.—The housing credit dollar amount allocated to a project shall not exceed the amount the housing credit agency determines and certifies is necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the compliance period or such longer period as such agency determines to be appropriate.

"(B) AGENCY EVALUATION.—In making the determination under subparagraph (A), the housing credit agency shall consider—

"(i) the sources and uses of funds and the total financing planned for the project, and

"(ii) any proceeds or receipts expected to be generated by reason of tax benefits.

Such a determination shall not be construed to be a representation or warranty as to the feasibility or viability of the project.

"(C) DETERMINATION MADE WHEN CREDIT AMOUNT APPLIED FOR AND WHEN BUILDING PLACED IN SERVICE.—

"(i) IN GENERAL.—A determination under subparagraph (A) shall be made as of each of the following times:

"(I) The application for the housing credit dollar amount.

"(II) The allocation of the housing credit dollar amount.

"(III) The date the building is placed in service.

"(ii) CERTIFICATION AS TO AMOUNT OF OTHER SUBSIDIES.—Prior to each determination under clause (i), the taxpayer shall certify to the housing credit agency the full extent of all Federal, State, and local subsidies which apply (or which the taxpayer expects to apply) with respect to the building.

"(D) APPLICATION TO BOND FINANCED PROJECTS.—Paragraph (4) shall not apply to any project unless the governmental unit which issued the bonds (or on behalf of which the bonds were issued) makes a determination under rules similar to the rules of subparagraphs (A) and (B)."

(n) APPLICATION OF AT-RISK RULES WITH RESPECT TO CERTAIN FINANCING PROVIDED BY QUALIFIED NONPROFIT ORGANIZATIONS.—Subparagraph (D) of section 42(k)(2) (relating to application of at-risk rules) is amended by adding at the end thereof the following new flush sentence:

"In the case of a qualified nonprofit organization which is not described in section 46(c)(8)(D)(iv)(II) with respect to a building, clause (ii) of this subparagraph shall be applied as if the date described therein were the 90th day after the earlier of the date the building ceases to be a qualified low-income building or the date which is 15 years after the close of a compliance period with respect thereto."

(o) TIME FOR CERTIFICATION.—Section 42(l)(1) (relating to certification with respect to 1st year of credit period) is amended—

(1) by striking "Not later than the 90th day following" and inserting "Following", and

(2) by inserting "at such time and" before "in such form".

(p) CERTAIN PURCHASE OPTIONS DISREGARDED.—Section 42(i) (relating to definitions and special rules) is amended by adding at the end thereof the following new paragraph:

"(7) CERTAIN PURCHASE OPTIONS DISREGARDED.—

"(A) IN GENERAL.—For purposes of this title, the determination of whether any qualified low-income building is owned by the taxpayer shall be made without regard to any qualified purchase option by a qualified nonprofit organization (as defined in subsection (h)(5)(C)) or a limited equity cooperative or resident management group recognized by the Department of Housing and Urban Development to acquire such building at less than fair market value after the close of the compliance period if no financing with respect to such building is provided during such period by such organization (or a related person (as defined in subsection (d)(2)(D)(iii)) to such organization) or such cooperative group.

"(B) QUALIFIED PURCHASE OPTION.—For purposes of subparagraph (A), the term 'qualified purchase option' means an option exercisable at the price which equals or exceeds an amount equal to the sum of—

"(i) the principal amount of outstanding indebtedness secured by the building (other than indebtedness incurred within the 5-year period ending on the date of the sale), and

"(ii) all Federal, State, and local taxes attributable to such sale.

Except in the case of Federal income taxes, there shall not be taken into account under clause (ii) any additional tax attributable to the application of clause (ii)."

(q) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to determinations under section 42 of the Internal Revenue Code of 1986 with respect to housing credit dollar amounts allocated from State housing credit ceilings for calendar years after 1989.

(2) BUILDINGS NOT SUBJECT TO ALLOCATION LIMITS.—Except as otherwise provided in this subsection, to the extent paragraph (1) of section 42(h) of such Code does not apply to any building by reason of paragraph (4) thereof, the amendments made by this section shall apply to buildings placed in service after December 31, 1989.

(3) 1-YEAR CARRYOVER OF UNUSED CREDIT AUTHORITY.—The amendments made by subsection (b) shall apply to calendar years after 1989, but clauses (ii), (iii), and (iv) of section 42(h)(3)(C) of such Code (as added by this section) shall not apply to unused allocations for 1989 or any preceding year.

(4) ADDITIONAL BUILDINGS ELIGIBLE FOR WAIVER OF 10-YEAR RULE.—The amendments made by subsection (f) shall take effect on the date of the enactment of this Act.

(5) CERTIFICATIONS WITH RESPECT TO 1ST YEAR OF CREDIT PERIOD.—The amendment made by subsection (o) shall apply to taxable years ending on or after December 31, 1989.

(6) CERTAIN RULES WHICH APPLY TO BONDS.—Paragraphs (8)(D) and (9)(D) of section 42(h) of such Code, as added by this section, shall apply to obligations issued December 31, 1989.

(7) CLARIFICATIONS.—The following amendments shall apply as if included in the amendments made by section 252 of the Tax Reform Act of 1986:

(A) Paragraph (1) of subsection (h) (relating to units rented on a monthly basis).

(B) Subsection (i) (relating to eligible basis for new buildings to include expenditures before close of 1st year of credit period).

(8) REGULATIONS ON DIFFICULT DEVELOPMENT AREAS.—Not later than 180 days after the date of the enactment of this Act, the Secretary of Housing and Urban Development shall prescribe initial regulations on the designation of difficult development areas under section 42(d)(5)(C) of such Code, as added by this section.

SEC. 6112. LOW-INCOME HOUSING CREDIT AND REHABILITATION CREDIT EXEMPT FROM INCOME PHASEOUT OF $25,000 EXEMPTION FROM PASSIVE LOSS RULES.

(a) IN GENERAL.—Subparagraph (B) of section 469(i)(3) (relating to phase-out of exemption) is amended to read as follows:

"(B) EXCEPTION FOR LOW-INCOME HOUSING AND REHABILITATION CREDITS.—Subparagraph (A) shall not apply to any portion of the passive activity credit for any taxable year which is attributable to any credit to which paragraph (6)(B) applies."

(b) CONFORMING AMENDMENT.—Subparagraph (A) of section 469(i)(5) is amended by striking clause (iii), by striking ", and" at the end of clause (ii) and inserting a period, and by adding "and" at the end of clause (i).

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to property placed in service after December 31, 1989, in taxable years ending after such date.

(2) SPECIAL RULE WHERE INTEREST HELD IN PASS-THRU ENTITY.—In the case of a taxpayer who holds an indirect interest in property described in paragraph (1), the amendments made by this section shall apply only if such interest is acquired after December 31, 1989.

SEC. 6113. RESEARCH CREDIT MADE PERMANENT; MODIFICATIONS TO CREDIT.

(a) CREDIT MADE PERMANENT.—

(1) IN GENERAL.—Section 41 is amended by striking subsection (i) (relating to termination).

(2) CONFORMING AMENDMENT.—Paragraph (1) of section 28(b) is amended by striking subparagraph (D).

(b) CHANGES IN COMPUTATION OF INCREMENTAL CREDIT.—

(1) IN GENERAL.—Subsection (c) of section 41 is amended to read as follows:

"(c) BASE AMOUNT.—

"(1) IN GENERAL.—The term 'base amount' means the product of—

"(A) the fixed-base percentage, and

"(B) the average annual gross receipts of the taxpayer for the 4 taxable years preceding the taxable year for which the credit is being determined (hereinafter in this subsection referred to as the 'credit year').

"(2) MINIMUM BASE AMOUNT.—In no event shall the base amount be less than the applicable percentage (determined in accordance with the following table) of the qualified research expenses for the credit year.

"If the credit year begins during—	The applicable percentage is—
1990	50
1991	55
1992	60
1993	65
1994	70
1995 or thereafter	75.

"(3) FIXED-BASE PERCENTAGE.—

"(A) IN GENERAL.—Except as otherwise provided in this paragraph, the fixed-base percentage is the percentage which the aggregate qualified research expenses of the taxpayer for taxable years beginning after December 31, 1983, and before January 1, 1989, is of the aggregate gross receipts of the taxpayer for such taxable years.

"(B) START-UP COMPANIES.—

"(i) TAXPAYERS TO WHICH SUBPARAGRAPH APPLIES.—The fixed-base percentage shall be determined under this subparagraph if there are fewer than 3 taxable years beginning after December 31, 1983, and before January 1, 1989, in which the taxpayer had both gross receipts and qualified research expenses.

"(ii) FIXED-BASE PERCENTAGE.—In a case to which this subparagraph applies, the fixed-base percentage is—

"(I) 3 percent for each of the taxpayer's 1st 5 taxable years beginning after December 31, 1989, for which the taxpayer has qualified research expenses,

"(II) in the case of the taxpayer's 6th such taxable year, 1/6 of the percentage which the aggregate qualified research expenses of the taxpayer for the 4th and 5th such taxable years is of the aggregate gross receipts of the taxpayer for such years,

"(III) in the case of the taxpayer's 7th such taxable year, 1/3 of the percentage which the aggregate qualified research expenses of the taxpayer for the 5th and 6th such taxable years is of the aggregate gross receipts of the taxpayer for such years,

"(IV) in the case of the taxpayer's 8th such taxable year, 1/2 of the percentage which the aggregate qualified research expenses of the taxpayer for the 5th, 6th, and 7th such taxable years is of the aggregate gross receipts of the taxpayer for such years,

"(V) in the case of the taxpayer's 9th such taxable year, 2/3 of the percentage which the aggregate qualified research expenses of the taxpayer for the 5th, 6th, 7th, and 8th such taxable years is of the aggregate gross receipts of the taxpayer for such years,

"(VI) in the case of the taxpayer's 10th such taxable year, 5/6 of the percentage which the aggregate qualified research expenses of the taxpayer for the 5th, 6th, 7th, 8th, and 9th such taxable years is of the aggregate gross receipts of the taxpayer for such years, and

"(VII) for taxable years thereafter, the percentage which the aggregate qualified research expenses for 5 taxable years selected by the taxpayer from the 5th through the 10th such taxable years is of the aggregate gross receipts of the taxpayer for such years.

"(iii) TREATMENT OF DE MINIMIS AMOUNTS OF GROSS RECEIPTS AND QUALIFIED RESEARCH EXPENSES.—The Secretary may prescribe regulations providing that de minimis amounts of gross receipts and qualified research expenses shall be disregarded under clauses (i) and (ii).

"(C) MAXIMUM FIXED-BASE PERCENTAGE.—In no event shall the fixed-base percentage exceed 16 percent.

"(D) ROUNDING.—The percentages determined under subparagraphs (A) and (B)(ii) shall be rounded to the nearest 1/100th of 1 percent.

"(4) CONSISTENT TREATMENT OF EXPENSES REQUIRED.—

"(A) IN GENERAL.—Notwithstanding whether the period for filing a claim for credit or refund has expired for any taxable year taken into account in determining the fixed-base percentage, the qualified research expenses taken into account in computing such percentage shall be determined on a basis consistent with the determination of qualified research expenses for the credit year.

"(B) PREVENTION OF DISTORTIONS.—The Secretary may prescribe regulations to prevent distortions in calculating a taxpayer's qualified research expenses or gross receipts caused by a change in accounting methods used by such taxpayer between the current year and a year taken into account in computing such taxpayer's fixed-base percentage.

"(5) GROSS RECEIPTS.—For purposes of this subsection, gross receipts for any taxable year shall be reduced by returns and allowances made during the taxable year. In the case of a foreign corporation, there shall be taken into account only gross receipts which are effectively connected with the conduct of a trade or business within the United States."

(2) CONFORMING AMENDMENTS.—

(A) Subparagraph (B) of section 41(a)(1) is amended to read as follows:

"(B) the base amount, and".

(B) Clause (ii) of section 41(e)(7)(C) is amended by striking "base period research expenses" and inserting "base amount".

(C) Paragraph (1) of section 41(f) (relating to aggregation of expenditures) is amended by striking "proportionate share of the increase in qualified research expenses" each place it appears and inserting "proportionate shares of the qualified research expenses and basic research payments".

(D) Subparagraph (A) of section 41(f)(3) is amended—

(i) by striking "June 30, 1980" and inserting "December 31, 1983", and

(ii) by inserting before the period ", and the gross receipts of the taxpayer for such periods shall be increased by so much of the gross receipts of such predecessor with respect to the acquired trade or business as is attributable to such portion".

(E) Subparagraph (B) of section 41(f)(3) is amended—

(i) by striking "June 30, 1980" and inserting "December 31, 1983", and

(ii) by inserting before the period ", and the gross receipts of the taxpayer for such periods shall be decreased by so much of the gross receipts as is attributable to such portion".

(F)(i) Subparagraph (C) of section 41(f)(3) is amended by striking "for the base period" and all that follows and inserting "for the taxable years taken into account in computing the fixed-base percentage shall be increased by the lesser of—

"(i) the amount of the decrease under subparagraph (B) which is allocable to taxable years so taken into account, or

"(ii) the product of the number of taxable years so taken into account, multiplied by the amount of the reimbursement described in this subparagraph."

(ii) The heading for such subparagraph (C) is amended to read as follows:

"(C) CERTAIN REIMBURSEMENTS TAKEN INTO ACCOUNT IN DETERMINING FIXED-BASE PERCENTAGE.—".

(G) Paragraph (4) of section 41(f) is amended by inserting "and gross receipts" after "qualified research expenses".

(b) TRADE OR BUSINESS REQUIREMENT DISREGARDED FOR IN-HOUSE RESEARCH EXPENSES OF CERTAIN STARTUP VENTURES.—Subsection (b) of section 41 (defining qualified research expenses) is amended by adding at the end thereof the following new paragraph:

"(4) TRADE OR BUSINESS REQUIREMENT DISREGARDED FOR IN-HOUSE RESEARCH EXPENSES OF CERTAIN STARTUP VENTURES.—In the case of in-house research expenses, a taxpayer shall be treated as meeting the trade or business requirement of paragraph (1) if, at the time such in-house research expenses are paid or incurred, the principal purpose of the taxpayer in making such expenditures is to use the results of the research in the active conduct of a future trade or business—

"(A) of the taxpayer, or

"(B) of 1 or more other persons who with the taxpayer are treated as a single taxpayer under subsection (f)(1)."

(c) FULL DISALLOWANCE OF DEDUCTION FOR QUALIFIED RESEARCH EXPENSES.—

(1) Subsection (c) of section 280C, as amended by subtitle H, is further amended by striking "50 percent of" each place it appears.

(2) Paragraph (2) of section 196(d) is amended by inserting before the period "for a taxable year beginning before January 1, 1990".

(d) ONLY REASONABLE RESEARCH EXPENDITURES ELIGIBLE FOR SECTION 174.—Section 174 is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) ONLY REASONABLE RESEARCH EXPENDITURES ELIGIBLE.—This section shall apply to a research or experimental expenditure only to the extent that the amount thereof is reasonable under the circumstances."

(e) EFFECTIVE DATE.—The amendments made by this section (other than subsection (a)) shall apply to taxable years beginning after December 31, 1989.

(f) TREASURY STUDY.—The Secretary of the Treasury or his delegate shall conduct a study with respect to the 5-year period beginning on January 1, 1990, and each 5-year period thereafter—

(1) comparing the projected revenue loss resulting from section 41 of the Internal Revenue Code of 1986 (relating to research credit) for the period and the actual revenue loss resulting from such section for the period,

(2) analyzing the effectiveness of such credit in promoting research during such period, and

(3) evaluating whether the rules for computing the fixed-base percentage for start-up firms are appropriate in view of actual trends in the qualified research expenditures and gross receipts of those firms.

The results of such study for each such period shall be submitted, not later than the close of such period, to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.

SEC. 6114. ENERGY INVESTMENT CREDIT FOR SOLAR, GEOTHERMAL, AND OCEAN THERMAL PROPERTY MADE PERMANENT.

The table contained in section 46(b)(2)(A) (relating to energy percentage) is amended by striking "Dec. 31, 1989" in clauses (viii), (ix), and (x).

SEC. 6115. QUALIFIED MORTGAGE BONDS MADE PERMANENT.

(a) IN GENERAL.—Paragraph (1) of section 143(a) (defining qualified mortgage bond) is amended to read as follows:

"(1) QUALIFIED MORTGAGE BOND DEFINED.—For purposes of this title, the term 'qualified mortgage bond' means a bond which is issued as part of a qualified mortgage issue."

(b) MORTGAGE CREDIT CERTIFICATES.—Section 25 is amended by striking subsection (h) and by redesignating subsection (i) as subsection (h).

(c) SUSPENSION OF MORTGAGE CREDIT CERTIFICATES TIME LIMIT.—With respect to bond authority exchanged before August 15, 1986, but not issued as of such date, the 2-year period under section 25(e)(3)(B) of the Internal Revenue Code of 1986 shall begin on the date of the enactment of this subsection.

Subtitle B—Corporate Provisions

SEC. 6201. DIVIDEND RECEIVED DEDUCTION NOT ALLOWED FOR DIVIDENDS ON PREFERRED STOCK OF CERTAIN SUBSIDIARIES.

(a) IN GENERAL.—Section 246 (relating to rules for applying deduction for dividends received) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) DEDUCTION DISALLOWED ON PREFERRED STOCK OF SUBSIDIARY TO EXTENT TAXABLE INCOME REDUCED BY LOSSES OF GROUP.—

"(1) GENERAL RULE.—No deduction shall be allowed under section 243, 244, or 245 in respect of the disallowed portion of any applicable dividend.

"(2) APPLICABLE DIVIDEND.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'applicable dividend' means any dividend—

"(i) on stock described in section 1504(a)(4) in any corporation which is a member of an affiliated group filing a consolidated return other than the common parent (hereinafter in this subsection referred to as the 'distributing corporation'), and

"(ii) paid out of the current earnings and profits of the distributing corporation for the taxable year (as determined under section 316(a)(2)).

"(B) LIMITATION BASED ON CONSOLIDATED LOSS OFFSET.—The aggregate amount of dividends treated as applicable dividends under subparagraph (A) shall not exceed the consolidated loss offset of the distributing corporation.

"(3) DISALLOWED PORTION.—For purposes of this subsection, the term 'disallowed portion' means the portion of an applicable dividend which bears the same ratio to such dividend as—

"(A) the consolidated loss offset, bears to

"(B) the separately computed taxable income of the distributing corporation.

"(4) CONSOLIDATED LOSS OFFSET.—For purposes of this subsection, the term 'consolidated loss offset' means, with respect to any distributing corporation, any of the following items of any other member of the same affiliated group as such corporation which are treated as used to offset the separately computed taxable income of such corporation:

"(A) Any net operating loss or any net operating loss carryover under section 172.

"(B) Any loss from the sale or exchange of any capital asset or any capital loss carryover under section 1212.

"(C) The deduction equivalent (determined in the same manner as under section 383) of any excess credit or any excess credit carryover (determined under section 383 without regard to any foreign tax credit allowed under section 27(a)).

"(5) SEPARATELY COMPUTED TAXABLE INCOME.—The term 'separately computed taxable income' means the taxable income of a distributing corporation computed as if it were not a member of an affiliated group.

"(6) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the provisions of this subsection, including regulations—

"(A) preventing the avoidance of this subsection through the transfer of assets with built-in losses to the distributing corporation, through delaying dividend payments, or through the use of tiered entities; and

"(B) exempting dividends from the application of this subsection if the taxpayer can establish such dividends were paid from previously taxed income."

(b) REPORTING REQUIREMENTS FOR DIVIDENDS.—Section 6042(a) (relating to returns regarding payments of dividends and corporate earnings and profits) is amended by inserting "or" at the end of subparagraph (B) and by adding after subparagraph (B) the following new subparagraph:

"(C) who makes payments of applicable dividends (within the meaning of section 246(f)(2)) to any corporation a portion of which is not allowable as a deduction under section 243 or 245 by reason of section 246(f),".

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendment made by this section shall apply to distributions after October 2, 1989, in respect of stock issued after such date.

(2) BINDING CONTRACT EXCEPTION.—The amendment made by this section shall not apply to distributions after October 2, 1989, in respect to stock issued after such date pursuant to a written binding contract in effect on October 2, 1989, and at all times thereafter before such issuance.

(3) SPECIAL RULE WHEN SUBSIDIARY LEAVES GROUP.—If, by reason of a transaction after October 2, 1989, a corporation ceases to be, or becomes, a member of an affiliated group, the amendment made by this section shall apply to any distribution in respect of the stock in such corporation after the date of such cessation or commencement, unless such transaction is of a kind which would not result in the recognition of any deferred intercompany gain under the consolidated return regulations by reason of the acquisition of the entire group.

(4) RETIRED STOCK.—The amendments made by this section shall apply to distributions in respect of stock described in paragraph (1) or (2) if such stock is retired (or acquired) by the corporation or another member of the same affiliated group, unless such retirement is pursuant to an obligation to reissue under a binding written contract in effect on October 1, 1989, and at all times thereafter.

(5) SPECIAL RATE FOR AUCTION RATE REFERRED.—For purposes of this subsection, auction rate preferred stock shall be treated as issued when the contract requiring the auction became binding.

SEC. 6202. DEFERRAL OF INTEREST DEDUCTIONS ON CERTAIN HIGH YIELD ORIGINAL ISSUE DISCOUNT OBLIGATIONS.

(a) GENERAL RULE.—Subsection (e) of section 163 (relating to interest deductions on original issue discount obligations) is amended by redesignating paragraph (5) as paragraph (6) and by inserting after paragraph (4) the following new paragraph:

"(5) SPECIAL RULE FOR ORIGINAL ISSUE DISCOUNT ON CERTAIN HIGH YIELD OBLIGATIONS.—Any portion of any original issue discount on an applicable high yield discount obligation (as defined in subsection (i)) otherwise deductible by a C corporation shall not be allowable as a deduction until paid. For purposes of the preceding sentence, rules similar to the rules of subsection (i)(3)(B) shall apply in determining the time when original issue discount is paid."

(b) APPLICABLE HIGH YIELD DISCOUNT OBLIGATION.—Section 163 is amended by redesignating subsection (i) as subsection (j) and by inserting after subsection (h) the following new subsection:

"(i) APPLICABLE HIGH YIELD DISCOUNT OBLIGATION.—

"(1) IN GENERAL.—For purposes of this section, the term 'applicable high yield discount obligation' means any debt instrument if—

"(A) the maturity date of such instrument is more than 5 years from the date of issue, "(B) the yield to maturity on such instrument equals or exceeds the sum of—

"(i) the applicable Federal rate in effect under section 1274(d) for the calendar month in which the obligation is issued, plus

"(ii) 5 percentage points, and

"(C) such instrument has significant original issue discount.

For purposes of subparagraph (B)(i), the Secretary may by regulation permit a rate to be used with respect to any debt instrument which is higher than the applicable Federal rate if the taxpayer establishes to the satisfaction of the Secretary that such higher rate is based on the same principles as the applicable Federal rate and is appropriate for the term of the instrument.

"(2) SIGNIFICANT ORIGINAL ISSUE DISCOUNT.—For purposes of paragraph (1)(C), a debt instrument shall be treated as having significant original issue discount if—

"(A) the aggregate amount which would be includible in gross income with respect to such instrument for periods before the close of any accrual period (as defined in section 1272(a)(5)) ending after the date 5 years after the date of issue, exceeds—

"(B) the sum of—

"(i) the aggregate amount of interest to be paid under the instrument before the close of such accrual period, and

"(ii) the product of the issue price of such instrument (as defined in section 1273(b)) and its yield to maturity.

"(3) SPECIAL RULES.—For purposes of determining whether a debt instrument is an applicable high yield discount obligation—

"(A) any payment under the instrument shall be assumed to be made on the last day permitted under the instrument, and

"(B) any payment to be made in the form of another obligation (or stock) of the issuer (or a related person within the meaning of section 453(f)(1)) shall be assumed to be made when such obligation (or stock) is required to be paid in cash or in property other than such obligation (or stock).

"(4) DEBT INSTRUMENT.—For purposes of this subsection, the term 'debt instrument' means any instrument which, without regard to this section, is a debt instrument as defined in section 1275(a).

"(5) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection, including—

"(A) regulations providing for modifications to the provisions of this subsection in the case of varying rates of interest, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments, conversion rights, or other circumstances where such modifications are appropriate to carry out the purposes of this subsection, and

"(B) regulations to prevent avoidance of the purposes of this subsection through the use of issuers other than C corporations, agreements to borrow amounts due under the debt instrument, or other arrangements."

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to instruments issued after July 10, 1989.

(2) EXCEPTIONS.—

(A) The amendments made by this section shall not apply to any instrument if—

(i) such instrument is issued in connection with an acquisition—

(I) which is made on or before July 10, 1989,

(II) for which there was a written binding contract in effect on July 10, 1989, and at all times thereafter before such acquisition, or

(III) for which a tender offer was filed with the Securities and Exchange Commission on or before July 10, 1989,

(ii) the term of such instrument is not greater than—

(I) the term specified in the written documents described in clause (iii), or

(II) if no term is determined under subclause (I), 10 years, and

(iii) the use of such instrument in connection with such acquisition (and the maximum amount of proceeds from such instrument) was determined on or before July 10, 1989, and such determination is evidenced by written documents—

(I) which were transmitted on or before July 10, 1989 between the issuer and any governmental regulatory bodies or prospective parties to the issuance or acquisition, and

(II) which are customarily used for the type of acquisition or financing involved.

(B) The amendments made by this section shall not apply to any instrument issued pursuant to the terms of a debt instrument issued on or before July 10, 1989, or described in subparagraph (A) or (D).

(C) The amendments made by this section shall not apply to any instrument issued to refinance an original issue discount debt instrument to which the amendments made by this section do not apply if—

(i) the maturity date of the refinancing instrument is not later than the maturity date of the refinanced instrument,

(ii) the issue price of the refinancing instrument does not exceed the adjusted issue price of the refinanced instrument,

(iii) the stated redemption price at maturity of the refinancing instrument is not greater than the stated redemption price at maturity of the refinanced instrument, and

(iv) the interest payments required under the refinancing instrument before maturity are not less than (and are paid not later than) the interest payments required under the refinanced instrument.

(D) The amendments made by this section shall not apply to instruments issued after July 10, 1989, pursuant to a reorganization plan in a title 11 or similar case (as defined in section 368(a)(3) of the Internal Revenue Code of 1986) if the amount of proceeds of such instruments, and the maturities of such instruments, do not exceed the amount or maturities specified in the last reorganization plan filed in such case on or before July 10, 1989.

SEC. 6203. SECTION 351 MADE INAPPLICABLE TO CERTAIN TRANSFERS OF SECURITIES.

(a) GENERAL RULE.—Section 351(a) (relating to nonrecognition in cases of transfers to corporations controlled by transferor) is amended by striking "or securities".

(b) EXCEPTIONS FOR CERTAIN EXCHANGES.—Section 351 is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) CERTAIN TRANSFERORS PERMITTED TO RECEIVE SECURITIES WITHOUT RECOGNITION OF GAIN OR LOSS.—

"(1) IN GENERAL.—In the case of the following exchanges, subsections (a), (b), (d), and (e) shall be applied by substituting 'stock or securities' for 'stock':

"(A) Any exchange in pursuance of a plan of reorganization.

"(B) Any exchange where the stock or securities received in the exchange are distributed in a transaction to which section 355 (or so much of section 356 as relates to section 355) applies."

(c) CONFORMING AMENDMENTS.—Subsections (b), (d), and (e)(2) of section 351 are each amended by striking "or securities".

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in this subsection, the amendments made by this section shall apply to transfers after October 2, 1989, in taxable years ending after such date.

(2) BINDING CONTRACT.—The amendments made by this section shall not apply to any transfer pursuant to a written binding contract in effect on October 2, 1989, and at all times thereafter before such transfer.

(3) CORPORATE TRANSFERS.—In the case of property transferred (directly or indirectly through a partnership or otherwise) by a corporation, paragraphs (1) and (2) shall be applied by substituting "July 11, 1989" for "October 2, 1989". The preceding sentence shall not apply where the corporation meets the requirements of section 1504(a)(2) of the Internal Revenue Code of 1986 with respect to the transferee corporation (and where the transfer is not part of a plan pursuant to which the transferor subsequently fails to meet such requirements.)

SEC. 6204. PROVISIONS RELATED TO REGULATED INVESTMENT COMPANIES.

(a) REQUIREMENT TO DISTRIBUTE 98 PERCENT OF ORDINARY INCOME.—

(1) IN GENERAL.—Subparagraph (A) of section 4982(b)(1) (defining required distribution) is amended by striking "97 percent" and inserting "98 percent".

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to calendar years ending after July 10, 1989.

(b) TREATMENT OF CERTAIN MUTUAL FUND LOAD CHARGES.—

(1) IN GENERAL.—Section 852 (relating to taxation of regulated investment companies and their shareholders) is amended by adding at the end thereof the following new subsection:

"(f) TREATMENT OF CERTAIN LOAD CHARGES.—

"(1) IN GENERAL.—If—

"(A) the taxpayer incurs a load charge in acquiring stock in a regulated investment company and, by reason of incurring such charge or making such acquisition, the taxpayer acquires a reinvestment right,

"(B) such stock is disposed of within 6 months of the date on which such stock was acquired, and

"(C) the taxpayer subsequently acquires stock in such regulated investment company or in another regulated investment company and the otherwise applicable load charge is reduced by reason of the reinvestment right,

the load charge referred to in subparagraph (A) (to the extent it does not exceed the reduction referred to in subparagraph (C)) shall not be taken into account for purposes of determining the amount of gain or loss on the disposition referred to in subparagraph (B). To the extent such charge is not taken into account in determining the amount of such gain or loss, such charge shall be treated as incurred in connection with the acquisition referred to in subparagraph (C) (including for purposes of reapplying this paragraph).

"(2) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

"(A) LOAD CHARGE.—The term 'load charge' means any sales or similar charge incurred by a person in acquiring stock of a regulated investment company. Such term does not include any charge incurred by reason of the reinvestment of a dividend.

"(B) REINVESTMENT RIGHT.—The term 'reinvestment right' means any right to acquire stock of 1 or more other regulated investment companies without the payment of a load charge or with the payment of a reduced charge.

"(C) NONRECOGNITION TRANSACTIONS.—If the taxpayer acquires stock in a regulated investment company from another person in a transaction in which gain or loss is not recognized, the taxpayer shall succeed to the treatment of such other person under this subsection."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to charges incurred after October 3, 1989, in taxable years ending after such date.

(c) REGULATED INVESTMENT COMPANIES REQUIRED TO ACCRUE DIVIDENDS ON THE EX-DIVIDEND DATE.—

(1) IN GENERAL.—Subsection (b) of section 852 (relating to treatment of companies and shareholders) is amended by adding at the end thereof the following new paragraph:

"(9) DIVIDENDS TREATED AS RECEIVED BY COMPANY ON EX-DIVIDEND DATE.—For purposes of this title, any dividend received by a regulated investment company with respect to any share of stock shall be treated as received by such company on the later of—

"(A) the date such share became ex-dividend with respect to such dividend, or

"(B) the date such company acquired such share."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to dividends in cases where the stock becomes ex-dividend after the date of the enactment of this Act.

SEC. 6205. LIMITATION ON THRESHOLD REQUIREMENT UNDER SECTION 382 BUILT-IN GAIN AND LOSS PROVISIONS.

(a) GENERAL RULE.—Clause (i) of section 382(h)(3)(B) (relating to threshold requirement) is amended to read as follows:

"(i) IN GENERAL.—If the amount of the net unrealized built-in gain or net unrealized built-in loss (determined without regard to this subparagraph) of any old loss corporation is not greater than the lesser of—

"(I) 15 percent of the amount determined for purposes of subparagraph (A)(i)(I), or

"(II) $25,000,000,

the net unrealized built-in gain or net unrealized built-in loss shall be zero."

(b) CONFORMING AMENDMENT TO ADJUSTED CURRENT EARNINGS PREFERENCE.—Subparagraph (H) of section 56(g)(4) (relating to treatment of certain ownership changes) is amended by striking clause (ii) and all that follows and inserting the following:

"(ii) there is a net unrealized built-in loss (within the meaning of section 382(h)) with respect to such corporation,

then the adjusted basis of each asset of such corporation (immediately after the ownership change) shall be its proportionate share (determined on the basis of respective fair market values) of the fair market value of the assets of such corporation (determined under section 382(h)) immediately before the ownership change."

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to ownership changes and acquisitions after October 2, 1989, in taxable years ending after such date.

(2) BINDING CONTRACT.—The amendments made by this section shall not apply to any ownership change or acquisition pursuant to a written binding contract in effect on October 2, 1989, and at all times thereafter before such change or acquisition.

(3) BANKRUPTCY PROCEEDINGS.—In the case of a reorganization described in section 368(a)(1)(G) of the Internal Revenue Code of 1986, or an exchange of debt for stock in a title 11 or similar case (as defined in section 368(a)(3) of such Code), the amendments made by this section shall not apply to any ownership change resulting from such a reorganization or proceeding if a petition in such case was filed with the court before October 3, 1989.

SEC. 6206. DISTRIBUTIONS ON CERTAIN PREFERRED STOCK TREATED AS EXTRAORDINARY DIVIDENDS.

(a) GENERAL RULE.—Section 1059 (relating to corporate shareholder's basis in stock reduced by nontaxed portion of extraordinary dividends) is amended by striking subsection (f) and inserting the following:

"(f) TREATMENT OF DIVIDENDS ON CERTAIN PREFERRED STOCK.—

"(1) IN GENERAL.—Any dividend with respect to disqualified preferred stock shall be treated as an extraordinary dividend to which paragraphs (1) and (2) of subsection (a) apply without regard to the period the taxpayer held the stock.

"(2) DISQUALIFIED PREFERRED STOCK.—For purposes of this subsection, the term 'disqualified preferred stock' means any stock which is preferred as to dividends if—

"(A) when issued, such stock has a dividend rate which declines (or can reasonably be expected to decline) in the future,

"(B) the issue price of such stock exceeds its liquidation rights or its stated redemption price, or

"(C) such stock is otherwise structured—

"(i) to avoid the other provisions of this section, and

"(ii) to enable corporate shareholders to reduce tax through a combination of dividend received deductions and loss on the disposition of the stock.

"(g) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including regulations—

"(1) providing for the application of this section in the case of stock dividends, stock splits, reorganizations, and other similar transactions and in the case of stock held by pass-thru entities, and

"(2) providing that the rules of subsection (f) shall apply in the case of stock which is not preferred as to dividends in cases where stock is structured to avoid the purposes of this section."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendment made by subsection (a) shall apply to stock issued after July 10, 1989, in taxable years ending after such date.

(2) BINDING CONTRACT.—The amendment made by subsection (a) shall not apply to any stock issued pursuant to a written binding contract in effect on July 10, 1989, and at all times thereafter before the stock is issued.

SEC. 6207. REPEAL OF ELECTION TO REDUCE EXCESS LOSS ACCOUNT RECAPTURE BY REDUCING BASIS OF INDEBTEDNESS.

(a) GENERAL RULE.—Subsection (e) of section 1503 (relating to special rule for determining adjustment to basis) is amended by adding at the end thereof the following new paragraph:

"(4) ELIMINATION OF ELECTION TO REDUCE BASIS OF INDEBTEDNESS.—Nothing in the regulations prescribed under section 1502 shall permit any reduction in the amount otherwise included in gross income by reason of an excess loss account if such reduction is on account of a reduction in the basis of indebtedness."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendment made by subsection (a) shall apply to dispositions after July 10, 1989, in taxable years ending after such date.

(2) BINDING CONTRACT.—The amendment made by subsection (a) shall not apply to any disposition pursuant to a written binding contract in effect on July 10, 1989, and at all times thereafter before such disposition.

SEC. 6208. OTHER PROVISIONS RELATING TO TREATMENT OF STOCK AND DEBT; ETC.

(a) CLARIFICATION OF REGULATORY AUTHORITY UNDER SECTION 385.—

(1) IN GENERAL.—Subsection (a) of section 385 (relating to treatment of certain interests in corporations as stock or indebtedness) is amended by inserting "(or as in part stock and in part indebtedness)" before the period at the end thereof.

(2) REGULATIONS NOT TO BE APPLIED RETROACTIVELY.—Any regulations issued pursuant to the authority granted by the amendment made by paragraph (1) shall only apply with respect to instruments issued after the date on which the Secretary of the Treasury or his delegate provides public guidance as to the characterization of such instruments whether by regulation, ruling, or otherwise.

(b) REPORTING OF CERTAIN ACQUISITIONS OR RECAPITALIZATIONS.—

(1) IN GENERAL.—Section 6043 is amended by striking subsection (c) and inserting the following new subsections:

"(c) CHANGES IN CONTROL AND RECAPITALIZATIONS.—If—

"(1) control (as defined in section 304(c)(1)) of a corporation is acquired by any person (or group of persons) in a transaction (or series of related transactions), or

"(2) there is a recapitalization of a corporation or other substantial change in the capital structure of a corporation,

when required by the Secretary, such corporation shall make a return (at such time and in such manner as the Secretary may prescribe) setting forth the identity of the parties to the transaction, the fees involved, the changes in the capital structure involved, and such other information as the Secretary may require with respect to such transaction.

"(d) CROSS REFERENCES.—

"For provisions relating to penalties for failure to file—

"(1) a return under subsection (b), see section 6652(c), or

"(2) a return under subsection (c), see section 6652(l)."

(2) PENALTY.—Section 6652 is amended by redesignating subsection (l) as subsection (m) and by inserting after subsection (k) the following new subsection:

"(l) FAILURE TO FILE RETURN WITH RESPECT TO CERTAIN CORPORATE TRANSACTIONS.—In the case of any failure to make a return required under section 6043(c) containing the information required by such section on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause, there shall be paid (on notice and demand by the Secretary and in the same manner as tax) by the person failing to file such return, an amount equal to $500 for each day during which such failure continues, but the total amount imposed under this subsection with respect to any return shall not exceed $100,000."

(3) CONFORMING AMENDMENTS.—

(A) The subsection heading for subsection (a) of section 6043 is amended by striking "CORPORATIONS" and inserting "CORPORATE LIQUIDATING, ETC., TRANSACTIONS".

(B) The section heading for section 6043 is amended to read as follows:

"SEC. 6043. LIQUIDATING; ETC., TRANSACTIONS."

(C) The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by striking the item relating to section 6043 and inserting the following:

"Sec. 6043. Liquidating; etc., transactions."

(4) EFFECTIVE DATE.—The amendments made by this subsection shall apply to transactions after March 31, 1990.

(c) STUDY.—

(1) IN GENERAL.—The Secretary of the Treasury or his delegate shall conduct a study of—

(A) whether the present law distinctions between debt and equity are meaningful and whether there are cases in which it is appropriate to limit interest deductions,

(B) the policy and revenue implications of proposals to integrate the corporate and individual income tax systems, and

(C) the policy and revenue implications of the tax treatment of corporate distributions with respect to debt and equity held by tax-exempt entities and foreign persons.

(2) REPORT.—Not later than the date 1 year after the date of the enactment of this Act, the Secretary of the Treasury or his delegate shall submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report on the study conducted under paragraph (1), together with such recommendations as he may deem advisable.

SEC. 6209. ESTIMATED TAX PAYMENTS REQUIRED FOR S CORPORATIONS.

(a) IN GENERAL.—Subsection (g) of section 6655 (relating to failure by corporation to pay estimated income tax) is amended by adding at the end thereof the following new paragraph:

"(4) APPLICATION OF SECTION TO CERTAIN TAXES IMPOSED ON S CORPORATIONS.—In the case of an S corporation, for purposes of this section—

"(A) The following taxes shall be treated as imposed by section 11:

"(i) The tax imposed by section 1374(a) (or the corresponding provisions of prior law).

"(ii) The tax imposed by section 1375(a).

"(iii) Any tax for which the S corporation is liable by reason of section 1371(d)(2).

"(B) Paragraph (2) of subsection (d) shall not apply.

"(C) Clause (ii) of subsection (d)(1)(B) shall be applied as if it read as follows:

"'(ii) the sum of—

"'(I) the amount determined under clause (i) by only taking into account the taxes referred to in clauses (i) and (iii) of subsection (g)(4)(A), and

"'(II) 100 percent of the tax imposed by section 1375(a) which was shown on the return of the corporation for the preceding taxable year.'

"(D) The requirement in the last sentence of subsection (d)(1)(B) that the return for the preceding taxable year show a liability for tax shall not apply.

"(E) Any reference in subsection (e) to taxable income shall be treated as including a reference to the net recognized built-in gain or the excess passive income (as the case may be)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1989.

SEC. 6210. LIMITATIONS ON REFUNDS DUE TO NET OPERATING LOSS CARRYBACKS OR EXCESS INTEREST ALLOCABLE TO CORPORATE EQUITY REDUCTION TRANSACTIONS.

(a) IN GENERAL.—Paragraph (1) of section 172(b) (relating to which loss may be carried) is amended by adding at the end thereof the following new subparagraph:

"(M) EXCESS INTEREST LOSS.—

"(i) IN GENERAL.—If—

"(I) there is a corporate equity reduction transaction, and

"(II) an applicable corporation has a corporate equity reduction interest loss for any loss limitation year ending after August 2, 1989,

then the corporate equity reduction interest loss shall be a net operating loss carryback and carryover to the taxable years described in subparagraphs (A) and (B), except that such loss shall not be carried back to a taxable year preceding the taxable year in which the corporate equity reduction transaction occurs.

"(ii) LOSS LIMITATION YEAR.—For purposes of clause (i) and subsection (m), the term 'loss limitation year' means, with respect to any corporate equity reduction transaction, the taxable year in which such transaction occurs and each of the 2 succeeding taxable years.

"(iii) APPLICABLE CORPORATION.—For purposes of clause (i), the term 'applicable corporation' means—

"(I) a C corporation which acquires stock, or the stock of which is acquired, in a major stock acquisition,

"(II) a C corporation which makes distributions with respect to, or redeems, its stock in connection with an excess distribution, or

"(III) any C corporation which is a successor corporation of a corporation described in subclause (I) or (II).

"(iv) OTHER DEFINITIONS.—For definitions of terms used in this subparagraph, see subsection (m)."

(b) CORPORATE EQUITY REDUCTION INTEREST LOANS AND CORPORATE EQUITY REDUCTION TRANSACTION DEFINED.—Section 172 is amended by redesignating subsection (m) as subsection (n) and by inserting after subsection (l) the following new subsection:

"(m) CORPORATE EQUITY REDUCTION INTEREST LOSSES.—For purposes of this section—

"(1) IN GENERAL.—The term 'corporate equity reduction interest loss' means, with respect to any loss limitation year, the excess (if any) of—

"(A) the net operating loss for such taxable year, over

"(B) the net operating loss for such taxable year determined without regard to any allocable interest deductions otherwise taken into account in computing such loss.

"(2) ALLOCABLE INTEREST DEDUCTIONS.—

"(A) IN GENERAL.—The term 'allocable interest deductions' means deductions allowed under this chapter for interest on the portion of any indebtedness allocable to a corporate equity reduction transaction.

"(B) METHOD OF ALLOCATION.—Except as provided in regulations and subparagraph (E), indebtedness shall be allocated to a corporate equity reduction transaction in the manner prescribed under clause (ii) of section 263A(f)(2)(A) (without regard to clause (i) thereof).

"(C) ALLOCABLE DEDUCTIONS NOT TO EXCEED INTEREST INCREASES.—Allocable interest deductions for any loss limitation year shall not exceed the excess (if any) of—

"(i) the amount allowable as a deduction for interest paid or accrued by the taxpayer during the loss limitation year, over

"(ii) the average of such amounts for the 3 taxable years preceding the taxable year in which the corporate equity reduction transaction occurred.

"(D) DE MINIMIS RULE.—A taxpayer shall be treated as having no allocable interest deductions for any taxable year if the amount of such deductions (without regard to this subparagraph) is less than $1,000,000.

"(E) SPECIAL RULE FOR CERTAIN UNFORESEEABLE EVENTS.—If an unforeseeable extraordinary adverse event occurs during a loss limitation year but after the corporate equity reduction transaction—

"(i) indebtedness shall be allocated in the manner described in subparagraph (B) to unreimbursed costs paid or incurred in connection with such event before being allocated to the corporate equity reduction transaction, and

"(ii) the amount determined under subparagraph (C)(i) shall be reduced by the amount of interest on indebtedness described in clause (i).

"(F) TRANSITION RULE.—If any of the 3 taxable years described in subparagraph (C)(ii) end on or before August 2, 1989, the taxpayer may substitute for the amount determined under such subparagraph an amount equal to the interest paid or accrued (determined on an annualized basis) during the taxpayer's taxable year which includes August 3, 1989, on indebtedness of the taxpayer outstanding on August 2, 1989.

"(3) CORPORATE EQUITY REDUCTION TRANSACTION.—

"(A) IN GENERAL.—The term 'corporate equity reduction transaction' means—

"(i) a major stock acquisition, or

"(ii) an excess distribution.

"(B) MAJOR STOCK ACQUISITION.—

"(i) IN GENERAL.—The term 'major stock acquisition' means the acquisition by a corporation pursuant to a plan of such corporation (or any group of persons acting in concert with such corporation) of stock in another corporation representing 50 percent or more (by vote or value) of the stock in such other corporation,

"(ii) EXCEPTIONS.—The term 'major stock acquisition' shall not include—

"(I) a qualified stock purchase (within the meaning of section 338) to which an election under section 338 applies, or

"(II) except as provided in regulations, an acquisition in which a corporation acquires stock of another corporation which, immediately before the acquisition, was a member of an affiliated group (within the meaning of section 1504(a)) other than the common parent of such group.

"(C) EXCESS DISTRIBUTION.—The term 'excess distribution' means the excess (if any) of—

"(i) the aggregate distributions (including redemptions) made during a taxable year by a corporation with respect to its stock, over

"(ii) the greater of—

"(I) 150 percent of the average of such distributions during the 3 taxable years immediately preceding such taxable year, or

"(II) 10 percent of the fair market value of the stock of such corporation as of the beginning of such taxable year.

"(D) RULES FOR APPLYING SUBPARAGRAPH (B).—For purposes of subparagraph (B)—

"(i) PLANS TO ACQUIRE STOCK.—All plans referred to in subparagraph (B) by any corporation (or group of persons acting in concert with such corporation) with respect to another corporation shall be treated as 1 plan.

"(ii) ACQUISITIONS DURING 24-MONTH PERIOD.—All acquisitions during any 24-month period shall be treated as pursuant to 1 plan.

"(E) RULES FOR APPLYING SUBPARAGRAPH (C).—For purposes of subparagraph (C)—

"(i) CERTAIN PREFERRED STOCK DISREGARDED.—Stock described in section 1504(a)(4), and distributions (including redemptions) with respect to such stock, shall be disregarded.

"(ii) ISSUANCE OF STOCK.—The amounts determined under clauses (i) and (ii)(I) of subparagraph (C) shall be reduced by the aggregate amount of stock issued by the corporation during the applicable period in exchange for money or property other than stock in the corporation.

"(4) OTHER RULES.—

"(A) ORDERING RULE.—For purposes of paragraph (1), in determining the allocable interest deductions taken into account in computing the net operating loss for any taxable year, taxable income for such taxable year shall be treated as having been computed by taking allocable interest deductions into account after all other deductions.

"(B) COORDINATION WITH SUBSECTION (B)(2).—In applying paragraph (2) of subsection (b), the corporate equity reduction interest loss shall be treated in a manner similar to the manner in which a foreign expropriation loss is treated.

"(C) MEMBERS OF AFFILIATED GROUPS.—Except as provided by regulations, all members of an affiliated group filing a consolidated return under section 1501 shall be treated as 1 taxpayer for purposes of this subsection and subsection (b)(1)(M).

"(5) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including regulations—

"(A) for applying this subsection to successor corporations and in cases where a taxpayer becomes, or ceases to be, a member of an affiliated group filing a consolidated return under section 1501,

"(B) to prevent the avoidance of this subsection through related parties, pass-through entities, and intermediaries, and

"(C) for applying this subsection where more than 1 corporation is involved in a corporate equity reduction transaction.

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in this subsection, the amendments made by this section shall apply to corporate equity reduction transactions occurring after August 2, 1989, in taxable years ending after August 2, 1989.

(2) EXCEPTIONS.—In determining whether a corporate equity reduction transaction has occurred after August 2, 1989, there shall not be taken into account—

(A) acquisitions or redemptions of stock, or distributions with respect to stock, occurring on or before August 2, 1989,

(B) acquisitions or redemptions of stock after August 2, 1989, pursuant to a binding written contract (or tender offer filed with the Securities and Exchange Commission) in effect on August 2, 1989, and at all times thereafter before such acquisition or redemption, or

(C) any distribution with respect to stock after August 2, 1989, which was declared on or before August 2, 1989.

Any distribution to which the preceding sentence applies shall be taken into account under section 172(m)(3)(C)(ii)(I) of the Internal Revenue Code of 1986 (relating to base period for distributions).

SEC. 6211. SMALL CORPORATION EXCEPTION TO GAIN RECOGNITION ON CERTAIN DISTRIBUTIONS IN COMPLETE LIQUIDATION.

(a) GENERAL RULE.—Section 336 (relating to gain or loss recognized on property distributed in complete liquidation) is amended by adding at the end thereof the following new subsection:

"(f) EXCEPTION FOR LIQUIDATIONS OF SMALL CORPORATIONS.—

"(1) GENERAL RULE.—In the case of any distribution in complete liquidation of a qualified asset by a qualified corporation, in determining whether the applicable percentage of gain or loss on such qualified asset is recognized, the following provisions shall be applied as in effect on the day before the date of the enactment of the Tax Reform Act of 1986:

"(A) Section 311.

"(B) Section 333.

"(C) Section 336.

"(D) Section 337.

"(E) Section 338.

"(F) Section 341.

"(G) Section 1374.

"(H) Any other provision of this title relating to the preceding provisions.

"(2) QUALIFIED ASSET.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'qualified asset' means any asset the gain or loss on which, in the hands of the qualified corporation, is treated as long-term capital gain or long-term capital loss (determined without regard to section 1239).

"(B) CERTAIN ASSETS EXCLUDED.—The term 'qualified asset' shall not include an asset acquired by the qualified corporation if—

"(i) the basis of such asset in the hands of the qualified corporation is determined (in whole or in part) by reference to the basis of such asset in the hands of the person from whom acquired, and

"(ii) a principal purpose for the transfer of such asset to the qualified corporation was to secure the benefits of this subsection.

"(3) APPLICABLE PERCENTAGE.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'applicable percentage' means 100 percent reduced (but not below zero) by an amount which bears the same ratio to 100 percent as—

"(i) the excess of the applicable value of the corporation over $5,000,000, bears to

"(ii) $5,000,000.

"(B) APPLICABLE VALUE.—The term 'applicable value' means the fair market value of all of the stock of the corporation on the plan adoption date.

"(4) QUALIFIED CORPORATION.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'qualified corporation' means any corporation 50 percent or more (by value) of the stock in which on the plan adoption date is qualified stock.

"(B) QUALIFIED STOCK.—The term 'qualified stock' means stock held by a group of 10 or fewer qualified persons each of whom owned (or are treated as owning under paragraph (5)) the stock held by such person on the plan adoption date at all times during the 5-year period ending on such date (or, if shorter, the period ending on such date during which such corporation or any predecessor was in existence).

"(C) QUALIFIED PERSON.—The term 'qualified person' means—

"(i) an individual,

"(ii) an estate, or

"(iii) any trust described in clause (i) or (iii) of section 1361(c)(2)(A).

"(5) ATTRIBUTION RULES.—For purposes of this subsection—

"(A) IN GENERAL.—Any stock owned by a corporation, trust (other than a trust referred to in paragraph (4)(C)(iii)), or partnership shall be treated as owned proportionately by its shareholders, beneficiaries, or partners, and shall not be treated as owned by such corporation, trust, or partnership. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person.

"(B) FAMILY MEMBERS.—Stock owned (or treated as owned) by members of the same family (within the meaning of section 318(a)(1)) shall be treated as owned by 1 person, and shall be treated as owned by such 1 person for any period during which it was owned (or treated as owned) by any such member.

"(C) TREATMENT OF CERTAIN TRUSTS.—Stock owned (or treated as owned) by the estate of any decedent or by any trust referred to in paragraph (4)(C)(iii) with respect to such decedent shall be treated as owned by 1 person and shall be treated as owned by such 1 person for the period during which it was owned (or treated as owned) by such estate or any such trust or by the decedent.

"(D) SPECIAL HOLDING PERIOD RULES.—Any property acquired by reason of the death of an individual shall be treated as owned at all times during which such property was owned (or treated as owned) by the decedent.

"(E) CONTROLLED GROUP OF CORPORATIONS.—All members of the same controlled group (as defined in section 267(f)(1)) shall be treated as 1 corporation for purposes of determining the applicable percentage with respect to any of such corporations. For purposes of the preceding sentence, an S corporation shall not be treated as a member of a controlled group unless such corporation was a C corporation during any taxable year ending during the 5-year period described in paragraph (4)(B), or it was not described for any such taxable year in paragraph (1) or (2) of section 1374(c) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986).

"(6) APPLICATION TO OTHER DISTRIBUTIONS.—Rules similar to the rules of this subsection shall apply—

"(A) to any distribution (not in complete liquidation) made by a qualified corporation,

"(B) to a transaction described in section 338, and

"(C) for purposes of applying section 1374 in the case of a qualifying corporation which makes an election to become an S corporation.

"(7) PLAN ADOPTION DATE.—For purposes of this subsection, the term 'plan adoption date' means the date of adoption of the plan of complete liquidation.

"(8) REGULATIONS.—The Secretary shall precribe such regulations as are necessary to carry out the provisions of this subsection, including regulations providing for the increase in the value of the stock of a corporation on the plan adoption date to reflect any decrease in such value by reason of redemptions, contractions, and extraordinary distributions during the 5-year period ending on such date."

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendment made by this section shall apply to distributions—

(A) pursuant to a complete liquidation occurring after December 31, 1988,

(B) pursuant to a transaction described in section 338 of the Internal Revenue Code of 1986 where the acquisition date occurs after December 31, 1988, and

(C) made by a corporation after December 31, 1988, without regard to whether the corporation is completely liquidated.

(2) S corporations.—The amendments made by this section shall apply for purposes of applying section 1374 of such Code in the case of a corporation which makes an election to be an S corporation under section 1362 of such Code after December 31, 1988.

SEC. 6212. TREATMENT OF CERTAIN LEASES BY RURAL ELECTRIC COOPERATIVES.

In the case of a rural electric cooperative described in section 1381(a)(2)(C) of the Internal Revenue Code of 1986, any interest income in connection with a transaction involving qualified leased property which was treated as a lease under section 168(i) of the Internal Revenue Code of 1954 (as in effect before the amendments made by the Tax Reform Act of 1986) or any corresponding prior provision of law shall be offset by any rental expense in connection with such transaction before allocation of such income or expense to members and nonmembers of such cooperative for purposes of such Code.

Subtitle C—Employee Benefit Provisions

PART I—REPEAL OF SECTION 89 NONDISCRIMINATION RULES

SEC. 6301. REPEAL OF SECTION 89.

(a) IN GENERAL.—Section 89 (relating to benefits provided under certain discriminatory employee benefit plans) is hereby repealed.

(b) CLERICAL AMENDMENT.—The table of sections for part II of subchapter B of chapter 1 is amended by striking the item relating to section 89.

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect as if included in section 1151 of the Tax Reform Act of 1986.

SEC. 6302. REINSTATEMENT OF PRE-1986 ACT NONDISCRIMINATION RULES.

(a) IN GENERAL.—

(1) Each provision of law amended by subsection (b), (c), (d)(1), or (g) of section 1151 of the Tax Reform Act of 1986 is amended to read as if the amendments made by such subsection had not been enacted.

(2) Each provision of law amended by paragraph (22), (27), or (31) of section 1011B(a) of the Technical and Miscellaneous Revenue Act of 1988 is amended to read as if the amendments made by such paragraph had not been enacted.

(3) Subparagraph (A) of section 125(g)(3) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) is amended by striking "subparagraph (B) of section 410(b)(1)" and inserting "section 410(b)(2)(A)(i)".

(4) Section 162(l)(2) is amended by striking subparagraph (B) and redesignating subparagraph (C) as subparagraph (B).

(5) Subparagraph (C) of section 401(a)(9) is amended—

(A) by striking "(as defined in section 89(i)(4))", and

(B) by adding at the end the following: "For purposes of this subparagraph, the term 'church plan' means a plan maintained by a church for church employees, and the term 'church' means any church (as defined in section 3121(w)(3)(A)) or qualified church-controlled organization (as defined in section 3121(w)(3)(B))."

(6)(A) Subparagraph (C) of section 414(n)(3) is amended by striking "89,".

(B) Paragraph (1) of section 414(r) is amended by striking "sections 89 and" and inserting "section".

(C) Paragraph (2) of section 414(t) is amended by striking "89,".

(7) Sections 3021(c) and 6070 of the Technical and Miscellaneous Revenue Act of 1988 are hereby repealed.

(b) EXCEPTIONS.—

(1)(A) Paragraph (7) of section 79(d) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) is amended to read as follows:

"(7) EXEMPTION FOR CHURCH PLANS.—

"(A) IN GENERAL.—This subsection shall not apply to a church plan maintained for church employees.

"(B) DEFINITIONS.—For purposes of subparagraph (A), the terms 'church employee' and 'church plan' have the meaning given such terms by paragraphs (3)(B) and (1) of section 414(e), respectively, except that—

"(i) section 414(e) shall be applied by substituting 'section 501(c)(3)' for 'section 501' each place it appears, and

"(ii) the term 'church employee' shall not include an employee of—

"(I) an organization described in section 170(b)(1)(A)(ii) above the secondary school level (other than a school for religious training),

"(II) an organization described in section 170(b)(1)(A)(iii), and

"(III) an organization described in section 501(c)(3), the basis of the exemption for which is substantially similar to the basis for exemption of an organization described in subclause (II)."

(2) Paragraph (2) of section 125(d) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) is amended to read as follows:

"(2) DEFERRED COMPENSATION PLANS EXCLUDED.—

"(A) IN GENERAL.—The term 'cafeteria plan' does not include any plan which provides for deferred compensation.

"(B) EXCEPTION FOR CASH AND DEFERRED ARRANGEMENTS.—Subparagraph (A) shall not apply to a profit-sharing or stock bonus plan or rural cooperative plan (within the meaning of section 401(k)(7)) which includes a qualified cash or deferred arrangement (as defined in section 401(k)(2)) to the extent of amounts which a covered employee may elect to have the employer pay as contributions to a trust under such plan on behalf of the employee.

"(C) EXCEPTION FOR CERTAIN PLANS MAINTAINED BY EDUCATIONAL INSTITUTIONS.—Subparagraph (A) shall not apply to a plan maintained by an educational organization described in section 170(b)(1)(A)(ii) to the extent of amounts which a covered employee may elect to have the employer pay as contributions for post-retirement group life insurance if—

"(i) all contributions for such insurance must be made before retirement, and

"(ii) such life insurance does not have a cash surrender value at any time.

For purposes of section 79, any life insurance described in the preceding sentence shall be treated as group-term life insurance."

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect as if included in section 1151 of the Tax Reform Act of 1986.

SEC. 6303. OTHER PROVISIONS RELATING TO NONTAXABLE BENEFITS.

(a) TREATMENT OF LEASED EMPLOYEES.—

(1) REPLACEMENT OF HISTORICAL TEST WITH CONTROL TEST.—Subparagraph (C) of section 414(n)(2) is amended to read as follows:

"(C) such services are performed by such person under the control of the recipient."

(2) SERVICES INCIDENTAL TO SALES OR CONSTRUCTION DISREGARDED.—Paragraph (2) of section 414(n) is amended by adding at the end thereof the following new flush sentence:

"The term 'leased employee' shall not include an individual solely because such individual is performing services incidental to the sale of goods or equipment or incidental to the construction of a facility. Such term shall include the support staff of professional service organizations."

(b) DEPENDENT CARE ASSISTANCE.—

(1) INCLUSION IN INCOME OF EXCESS BENEFITS.—Paragraph (7) of section 129(d) is amended by adding at the end thereof the following new paragraph:

"(C) FAILURE TO MEET REQUIREMENTS.—

"(i) IN GENERAL.—If a plan fails to meet the requirements of this paragraph for any plan year—

"(I) such plan shall be treated as a plan which is a dependent care assistance program to which subsection (a) applies, but

"(II) there shall be included in the gross income of each highly compensated employee for the taxable year of such employee with or within which the plan year ends an amount equal to such employee's excess benefit.

"(ii) EXCESS BENEFIT.—For purposes of this subparagraph, the excess benefit of any employee is the excess of the employee's employer-provided benefit under the plan over the highest permitted benefit.

"(iii) HIGHEST PERMITTED BENEFIT.—For purposes of clause (ii), the highest permitted benefit under any plan shall be determined by reducing the nontaxable benefits of highly compensated employees (beginning with employees with the greatest nontaxable benefits) until such plan would be treated as meeting the requirements of subparagraph (A) if such reduced benefits were taken into account."

(2) INFORMATION REPORTING.—Paragraph (9) of section 6051(a) of such Code is amended by inserting "and the amount of such assistance required to be included in gross income by reason of section 129(d)(7)(C)" after "section 129(d)".

(c) LINE OF BUSINESS TEST.—

(1) APPLICATION OF LINE OF BUSINESS TEST FOR PERIOD BEFORE GUIDELINES ISSUED.—In the case of any plan year beginning on or before the date the Secretary of the Treasury or his delegate issues guidelines and begins issuing determinations under section 414(r)(2)(C) of the Internal Revenue Code of 1986, an employer shall be treated as operating separate lines of business if the employer reasonably determines that it meets the requirements of section 414(r) (other than paragraph (2)(C) thereof) of such Code.

(2) DEPENDENT CARE.—Paragraph (1) of section 414(r) is amended by striking "section 410(b)" and inserting "sections 129(d)(7) and 410(b)".

(d) EFFECTIVE DATES.—

(1) The amendments made by subsection (a) shall apply to years beginning after December 31, 1983.

(2) The amendments made by subsections (b) and (c)(2) shall apply to years beginning after December 31, 1988.

(3) The provisions of subsection (c)(1) shall apply to years beginning after December 31, 1986.

PART II—EMPLOYEE STOCK OWNERSHIP PLANS

SEC. 6311. LIMITATIONS ON PARTIAL EXCLUSION OF INTEREST ON LOANS USED TO ACQUIRE EMPLOYER SECURITIES.

(a) EXCLUSION AVAILABLE ONLY WHERE EMPLOYEES RECEIVE SIGNIFICANT OWNERSHIP INTEREST.—Subsection (b) of section 133 (defining securities acquisition loans) is amended by adding at the end thereof the following new paragraph:

"(6) PLAN MUST HOLD 30 PERCENT OF STOCK AFTER ACQUISITION OR TRANSFER.—

"(A) IN GENERAL.—A loan shall not be treated as a securities acquisition loan for purposes of this section unless, immediately after the acquisition or transfer referred to in subparagraph (A) or (B) of paragraph (1), respectively, the employee stock ownership plan owns (after application of section 318(a)(4)) at least 30 percent of—

"(i) each class of outstanding stock of the corporation issuing the employer securities, or

"(ii) the total value of all outstanding stock of the corporation.

"(B) STOCK.—For purposes of subparagraph (A)—

"(i) IN GENERAL.—The term 'stock' means stock other than stock described in section 1504(a)(4).

"(ii) TREATMENT OF CERTAIN RIGHTS.—The Secretary may provide that warrants, options, contracts to acquire stock, convertible debt interests and other similar interests be treated as stock for 1 or more purposes under subparagraph (A).".

(b) TERM OF LOAN MAY NOT EXCEED 15 YEARS.—Paragraph (1) of section 133(b) is amended by adding at the end thereof the following new sentence: "The term 'securities acquisition loan' shall not include a loan with a term greater than 15 years."

(c) VOTING RIGHTS.—Subsection (b) of section 133, as amended by subsection (a), is amended by adding at the end thereof the following new paragraph:

"(7) VOTING RIGHTS OF EMPLOYER SECURITIES.—A loan shall not be treated as a securities acquisition loan for purposes of this section unless—

"(A) the employee stock ownership plan meets the requirements of section 409(e)(2) with respect to all employer securities acquired by, or transferred to, the plan in connection with such loan (without regard to whether or not the employer has a registration-type class of securities), and

"(B) no stock described in section 409(l)(3) is acquired by, or transferred to, the plan in connection with such loan unless—

"(i) such stock has voting rights equivalent to the stock to which it may be converted, and

"(ii) the requirements of subparagraph (A) are met with respect to such voting rights.".

(d) TAX ON DISPOSITION OF SECURITIES BY EMPLOYEE STOCK OWNERSHIP PLANS.—

(1) IN GENERAL.—Chapter 43 is amended by inserting after section 4978A the following new section:

"SEC. 4978B. TAX ON DISPOSITION OF EMPLOYER SECURITIES TO WHICH SECTION 133 APPLIED.

"(a) IMPOSITION OF TAX.—In the case of an employee stock ownership plan which has acquired section 133 securities, there is hereby imposed a tax on each taxable event in an amount equal to the amount determined under subsection (b).

"(b) AMOUNT OF TAX.—

"(1) IN GENERAL.—The amount of the tax imposed by subsection (a) shall be equal to 10 percent of the amount realized on the disposition to the extent allocable to section 133 securities under section 4978A(d).

"(2) DISPOSITIONS OTHER THAN SALES OR EXCHANGES.—For purposes of paragraph (1), in the case of a disposition of employer securities which is not a sale or exchange, the amount realized on such disposition shall be the fair market value of such securities at the time of disposition.

"(c) TAXABLE EVENT.—For purposes of this section, the term 'taxable event' means any of the following dispositions:

"(1) DISPOSITIONS WITHIN 3 YEARS.—Any disposition of any employer securities by an employee stock ownership plan within 3 years after such plan acquired section 133 securities if—

"(A) the total number of employer securities held by such plan after such disposition is less than the total number of employer securities held after such acquisition, or

"(B) except to the extent provided in regulations, the value of employer securities held by such plan after the disposition is less than 30 percent of the total value of all employer securities as of the time of the disposition.

"(2) STOCK DISPOSED OF BEFORE ALLOCATION.—Any disposition of section 133 securities to which paragraph (1) does not apply if—

"(A) such disposition occurs before such securities are allocated to accounts of participants or their beneficiaries, and

"(B) the proceeds from such disposition are not so allocated.

"(d) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) EXCEPTIONS.—Rules similar to the rules of section 4978A(e) shall apply.

"(2) LIABILITY FOR PAYMENT OF TAXES.—The tax imposed by this section shall be paid by the employer.

"(3) SECTION 133 SECURITIES.—The term 'section 133 securities' means employer securities acquired by an employee stock ownership plan in a transaction to which section 133 applied, except that such term shall not include—

"(A) qualified securities (as defined in section 4978(e)(2)), or

"(B) qualified employer securities (as defined in section 4978A(f)(2)).

"(4) DISPOSITION.—The term 'disposition' includes any distribution.

"(5) ORDERING RULES.—For ordering rules for dispositions of employer securities, see section 4978A(d)."

(2) CONFORMING AMENDMENTS.—

(A) Section 4978A(d) is amended by redesignating paragraphs (3) and (4) as paragraphs (5) and (6) and by inserting after paragraph (2) the following new paragraphs:

"(3) Third, from section 133 securities (as defined in section 4978B(d)(3)) acquired during the 3-year period ending on the date of such disposition, beginning with the securities first so acquired.

"(4) Fourth, from section 133 securities (as so defined) acquired before such 3-year period unless such securities (or proceeds from the disposition) have been allocated to accounts of participants or beneficiaries."

(B) Section 4978A(d)(5), as redesignated by clause (i), is amended by striking "Third" and inserting "Fifth".

(C) The table of sections for chapter 43 is amended by inserting after the item relating to section 4978A the following new item:

"Sec. 4978B. Tax on disposition of employer securities to which section 133 applied.".

(e) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in this subsection, the amendments made by this section shall apply to loans made after June 6, 1989.

(2) BINDING COMMITMENT EXCEPTION.—The amendments made by this section shall not apply to any loan—

(A) which is made pursuant to a binding written commitment in effect on June 6, 1989, and at all times thereafter before such loan is made, or

(B) to the extent that the proceeds of such loan are used to acquire employer securities pursuant to a written binding contract (or tender offer registered with the Securities and Exchange Commission) in effect on June 6, 1989, and at all times thereafter before such securities are acquired.

(3) REFINANCINGS.—The amendments made by this section shall not apply to loans made after June 6, 1989, to refinance securities acquisition loans (determined without regard to section 133(b)(2) of the Internal Revenue Code of 1986) made on or before such date or to refinance loans described in this paragraph or paragraph (2), (4), or (5) if—

(A) such refinancing loans meet the requirements of such section 133 of such Code (as in effect before such amendments) applicable to such loans,

(B) immediately after the refinancing the principal amount of the loan resulting from the refinancing does not exceed the principal amount of the refinanced loan (immediately before the refinancing), and

(C) the term of such refinancing loan does not extend beyond the later of—

(i) the last day of the term of the original securities acquisition loan, or

(ii) the last day of the 7-year period beginning on the date the original securities acquisition loan was made.

For purposes of this paragraph, the term "securities acquisition loan" shall include a loan from a corporation to an employee stock ownership plan described in section 133(b)(3) of such Code.

(4) COLLECTIVE BARGAINING AGREEMENTS.—The amendments made by this section shall not apply to any loan used to acquire employer securities pursuant to a collective bargaining agreement setting forth the material terms of such acquisition which was agreed to on or before June 6, 1989, by an employer and employee representatives (and ratified on or before such date or within a reasonable period thereafter).

(5) FILINGS WITH UNITED STATES.—The amendments made by this section shall not apply to any loan the aggregate principal amount of which was specified in a filing with an agency of the United States on or before June 6, 1989, if—

(A) such filing specifies such loan is to be a securities acquisition loan for purposes of section 133 of the Internal Revenue Code of 1986 and such filing is for the registration required to permit the offering of such loan, or

(B) such filing is for the approval required in order for the employee stock ownership plan to acquire more than a certain percentage of the stock of the employer.

PART III—TAX TREATMENT OF RETIREE HEALTH ACCOUNTS

Subpart A—General Rules

SEC. 6321. TRANSFER OF EXCESS PENSION ASSETS TO RETIREE HEALTH ACCOUNTS.

(a) IN GENERAL.—Part I of subchapter D of chapter 1 (relating to pension, profit-sharing, and stock bonus plans) is amended by adding at the end thereof the following new subpart:

"Subpart E—Treatment of Transfers to Retiree Health Accounts

"Sec. 420. Transfers of excess pension assets to retiree health accounts.

"SEC. 420. TRANSFERS OF EXCESS PENSION ASSETS TO RETIREE HEALTH ACCOUNTS.

"(a) GENERAL RULE.—If there is a qualified transfer of any excess pension assets of a defined benefit plan to a health benefits account which is part of such plan—

"(1) a trust which is part of such plan shall not be treated as failing to meet the requirements of subsection (a) or (h) of section 401 solely by reason of such transfer (or any other action authorized under this section),

"(2) no amount shall be includible in the gross income of the employer maintaining the plan solely by reason of such transfer, and such transfer shall not be treated as an employer reversion for purposes of section 4980, and

"(3) the limitations of subsection (d) shall apply to such employer.

"(b) QUALIFIED TRANSFER.—For purposes of this section—

"(1) IN GENERAL.—The term 'qualified transfer' means a transfer of excess pension assets by a defined benefit plan to a health benefits account in a taxable year beginning after December 31, 1989, with respect to which the plan meets—

"(A) the use requirements of subsection (c)(1),

"(B) the vesting requirements of subsection (c)(2), and

"(C) the minimum benefit requirements of subsection (c)(3).

"(2) ONLY 1 TRANSFER PER YEAR.—

"(A) IN GENERAL.—No more than 1 transfer with respect to any plan during a taxable year may be treated as a qualified transfer for purposes of this section.

"(B) EXCEPTION.—A transfer described in paragraph (4) shall not be taken into account for purposes of subparagraph (A).

"(3) LIMITATION ON AMOUNT TRANSFERRED.—The amount of excess pension assets which may be transferred in a qualified transfer shall not exceed the amount which is reasonably estimated to be the amount the employer maintaining the plan will pay out of such account under such plan during the taxable year of the transfer for qualified current retiree health liabilities.

"(4) SPECIAL RULE FOR 1989.—

"(A) IN GENERAL.—Subject to the provisions of subsection (c), a transfer shall be treated as a qualified transfer if such transfer—

"(i) is made after the close of the taxable year preceding the employer's first taxable year beginning after December 31, 1989, and before the due date (including extensions) for the filing of the return of tax for such preceding taxable year, and

"(ii) does not exceed the expenditures of the employer for qualified current retiree health liabilities for such preceding year.

"(B) INCLUSION WITH 1990 TRANSFER.—An employer may elect to include the transfer described in subparagraph (A) as part of the qualified transfer for the employer's first taxable year beginning after December 31, 1989. If an election is made under this subparagraph, the limitation under paragraph (3) for the taxable year shall be increased by the amount determined under subparagraph (A)(ii).

"(C) COORDINATION WITH REDUCTION RULE.—Subsection (e)(1)(B) shall not apply to a transfer described in subparagraph (A) with respect to contributions to a welfare benefit fund.

"(5) TERMINATION.—No transfer in any taxable year beginning after December 31, 1994, shall be treated as a qualified transfer.

"(c) REQUIREMENTS OF PLANS TRANSFERRING ASSETS.—

"(1) USE OF TRANSFERRED ASSETS.—

"(A) IN GENERAL.—Any assets transferred to a health benefits account in a qualified transfer (and any income allocable thereto) shall be used only to pay qualified current retiree health liabilities (whether directly or through reimbursement).

"(B) AMOUNTS NOT USED TO PAY FOR HEALTH BENEFITS.—Any assets transferred to a health benefits account in a qualified transfer (and any income allocable thereto) which are not used as provided in subparagraph (A) for the taxable year of such transfer—

"(i) shall be transferred out of the account to the transferor plan, but

"(ii) shall not be includible in the gross income of the employer for such taxable year, and shall not be treated, for purposes of section 4980, as an employer reversion.

"(2) REQUIREMENTS RELATING TO PENSION BENEFITS ACCRUING BEFORE TRANSFER.—

"(A) IN GENERAL.—The requirements of this paragraph are met if the accrued pension benefits of any participant or beneficiary under the plan become nonforfeitable in the same manner which would be required if the plan had terminated immediately before the qualified transfer (or in the case of a participant who separated during the year before the transfer, immediately before such separation).

"(B) SPECIAL RULE FOR 1989.—In the case of a qualified transfer described in subsection (b)(4), the requirements of this paragraph are met with respect to any participant who separated from service during 1989 by recomputing such participant's benefits as if subparagraph (A) had applied immediately before such separation.

"(3) MINIMUM BENEFIT REQUIREMENTS.—

"(A) IN GENERAL.—The requirements of this paragraph are met if the applicable employer cost for each year during the benefit maintenance period is not less than the highest applicable employer cost for the 2 taxable years immediately preceding the taxable year of the qualified transfer.

"(B) APPLICABLE EMPLOYER COST.—For purposes of this paragraph—

"(i) IN GENERAL.—The term 'applicable employer cost' means the average employer cost per covered employee in providing applicable health benefits to covered employees.

"(ii) COVERED EMPLOYEE.—The term 'covered employee' means any employee who is taken into account in determining the qualified current retiree health liabilities with respect to any qualified transfer.

"(C) BENEFIT MAINTENANCE PERIOD.—For purposes of this paragraph, the term 'benefit maintenance period' means the 5-taxable-year period beginning with the taxable year in which the qualified transfer occurs. If there is more than 1 qualified transfer applicable to any taxable year, this paragraph shall be applied by taking into account the highest applicable employer cost.

"(D) MULTIPLE PLANS.—If applicable health benefits are provided through more than 1 plan, such plans shall be treated as 1 plan for determining the applicable employer cost.

"(d) LIMITATIONS ON EMPLOYER.—For purposes of this title—

"(1) DEDUCTION LIMITATIONS.—No deduction shall be allowed—

"(A) for the transfer of any amount to a health benefits account in a qualified transfer (or any retransfer to the plan under subsection (c)(1)(B)),

"(B) for qualified current retiree health liabilities paid out of the assets (and income) described in subsection (c)(1), or

"(C) for any amounts to which subparagraph (B) does not apply and which are paid for qualified current retiree health liabilities for the taxable year to the extent such amounts are not greater than the excess (if any) of—

"(i) the amount determined under subparagraph (A) (and income allocable thereto), over

"(ii) the amount determined under subparagraph (B).

"(2) NO CONTRIBUTIONS ALLOWED.—An employer may not contribute after December 31, 1989, any amount to a health benefits account or welfare benefit fund (as defined in section 419(e)(1)) with respect to qualified current retiree health liabilities for which transferred assets are required to be used under subsection (c)(1).

"(e) DEFINITION AND SPECIAL RULES.—For purposes of this section—

"(1) QUALIFIED CURRENT RETIREE HEALTH LIABILITIES.—For purposes of this section—

(A) IN GENERAL.—The term "qualified current retiree health liabilities" means, with respect to any taxable year, the aggregate amounts (including administrative expenses) which would have been allowable as a deduction to the employer for such taxable year with respect to applicable health benefits provided during such taxable year if—

"(i) such benefits were provided directly by the employer, and

"(ii) the employer used the cash receipts and disbursements method of accounting.

For purposes of the preceding sentence, the rule of section 419(c)(3)(B) of such Code shall apply.

"(B) REDUCTIONS FOR AMOUNTS PREVIOUSLY SET ASIDE.—The amount determined under subparagraph (A) shall be reduced by any amount previously contributed to a health benefits account or welfare benefit fund (as defined in section 419(e)(1)) to pay for the qualified current retiree health liabilities.

"(C) APPLICABLE HEALTH BENEFITS.—The term 'applicable health benefits' means health benefits which are provided through the health benefits account maintained by the employer to employees of such employer who—

"(i) are eligible for pension benefits under the defined benefit plan maintaining the health benefits account, and

"(ii) have retired on or before the date of the qualified transfer.

"(D) KEY EMPLOYEES EXCLUDED.—If an employee is a key employee (within the meaning of section 416(i)(1)) with respect to any plan year ending in a taxable year, such employee shall not be taken into account in computing qualified current retiree health liabilities for such taxable year.

"(2) EXCESS PENSION ASSETS.—The term "excess pension assets" means the excess (if any) of—

"(A) the amount determined under section 412(c)(7)(A)(ii), over

"(B) the amount determined under section 412(c)(7)(A)(i).

"(3) HEALTH BENEFITS ACCOUNT.—The term "health benefits account" means an account established and maintained under section 401(h).

"(4) COORDINATION WITH FULL-FUNDING LIMITATION.—For purposes of determining the full-funding limitation of any plan under paragraph (7) or (12) of section 412(c), the assets transferred to a health benefits account in a qualified transfer (and any income allocable thereto) shall be treated as assets of such plan."

(b) CONFORMING AMENDMENT.—Section 401(h) is amended by inserting ", and subject to the provisions of section 420" after "Secretary".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1989.

SEC. 6322. LIMITATION ON CONTRIBUTIONS TO SECTION 401(h) ACCOUNTS.

(a) IN GENERAL.—Section 401(h) is amended by adding at the end thereof the following new sentence: "In no event shall the requirements of paragraph (1) be treated as met if the aggregate actual contributions for medical benefits, when added to actual contributions for life insurance protection under the plan, exceed 25 percent of the total actual contributions to the plan (other than contributions to fund past service credits) after the date on which the account is established."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to contributions after October 3, 1989.

Subpart B—Coal Industry Plans

SEC. 6323. SHORT TITLE.

This subpart may be cited as the "Coal Industry Health Benefit Stabilization Act of 1989".

SEC. 6324. AUTHORIZATION OF TRANSFER OF SURPLUS ASSETS FROM COAL PENSION PLAN TO COAL HEALTH PLANS.

(a) IN GENERAL.—Notwithstanding any other provision of law, a plan described in subsection (c) shall transfer surplus assets to a plan described in subsection (d) whenever—

(1) the actuary for a plan described in subsection (c) notifies the joint board of trustees of the plan and the settlors in writing that the plan contains surplus assets;

(2) the actuary's determination is accepted by the trustees; and

(3) both settlors direct the board of trustees to transfer all (or any portion of) such surplus assets from a plan described in subsection (c) to a plan described in subsection (d).

(b) TAX TREATMENT OF TRANSFER.—

(1) DEDUCTIBILITY OF CONTRIBUTIONS.—No deduction shall be allowed under the Internal Revenue Code of 1986 with respect to a transfer of surplus assets pursuant to subsection (a), but such transfer shall not adversely affect the deductibility (under applicable provisions of such Code) of contributions previously made by employers or amounts hereafter contributed by employers to a plan described in subsection (c) or (d).

(2) EMPLOYER TREATMENT.—A transfer of surplus assets pursuant to subsection (a)—

(A) shall not be treated as an employer reversion from a qualified plan for purposes of section 4980 of the Internal Revenue Code of 1986, and

(B) shall not be includible in the gross income of any employer maintaining a plan described in subsection (c).

(c) PLAN FROM WHICH ASSETS TRANSFERRED.—A plan is described in this subsection if—

(1) it is a plan described in section 404(c) of the Internal Revenue Code of 1986 or a continuation thereof; and

(2) participation in the plan is substantially limited to individuals who retired prior to January 1, 1976.

(d) PLANS TO WHICH ASSETS TRANSFERRED.—A plan is described in this subsection if—

(1) it is a plan described in section 404(c) of the Internal Revenue Code of 1986 or a continuation thereof, and

(2) it provides health benefits to retirees and beneficiaries of the industry which maintained the plan described in subsection (c).

SEC. 6325. CONTINUING OBLIGATION TO CONTRIBUTE TO MULTIEMPLOYER PLANS.

(a) IN GENERAL.—Any employer that had an obligation to contribute to a plan described in section 6324(d) on January 1, 1988 (including a contingent obligation to contribute), shall have a continuing obligation to contribute to the plan in the amount and form determined in subsection (b). This obligation to contribute shall only continue for any period during which there exists a collective bargaining agreement between the settlors which establishes a contribution rate for the plan. Any continuation of the obligation to contribute under this section shall be effective with respect to the first month for which contributions to the plan are required under the new collective bargaining agreement between the settlors.

(b) AMOUNT OF OBLIGATION.—

(1) IN GENERAL.—An employer's continuing obligation shall be determined under the following subparagraphs:

(A) An employer subject to this section shall be liable to a plan described in section 6324(d) for hourly contributions based on all hours worked by its employees engaged in the production of coal. Contributions shall be paid to the plan by the 10th day of each month for all hours worked during the preceding month. The hourly contribution rate applicable under this paragraph shall be identical to the rate established for the plan in the collective bargaining agreement then in effect between the settlors, and shall increase or decrease at any time, and to the same extent, that the rate established pursuant to the collective bargaining agreement increases or decreases.

(B) If an employer subject to this section would make no contributions to a plan described in section 6324(d) pursuant to subparagraph (A) for any month, or if, for any month, such employer's contributions required pursuant to subparagraph (A) would not at least equal 70 percent of the product of the hourly contribution rate applicable under subparagraph (A) and the employer's highest average monthly reported hours, then the employer shall be required to contribute to the plan for that month contributions equal to 70 percent of the product of the hourly contribution rate applicable under subparagraph (A) and the employer's highest average monthly reported hours. The employer's highest average monthly reported hours is the average number of hours reported monthly by the employer to any plan described in section 6324(d) or, if higher, to any related pension plan, for the 60 consecutive months for which the employer's reported hours were the highest within the 120 months immediately preceding the application of this section.

(C)(i) With respect to a plan described in section 6324(d), participation in which is substantially limited to individuals who retired on or after January 1, 1976, an employer's continuing obligation under subparagraphs (A) and (B) shall be increased in the amount determined by the joint board of trustees of the plan under clauses (ii) and (iii), for each month during which any participant or beneficiary described in clause (iii)(II) is eligible for health benefits from the plan.

(ii) The board of trustees shall once during each plan year set a monthly premium rate which shall be equal to a reasonable estimate of the full cost to the plan of providing benefits coverage during the plan year for one participant or beneficiary.

(iii) The board of trustees shall increase an employer's continuing obligation each month by an amount equal to the product of—

(I) the premium rate set under clause (ii); and

(II) the total number of participants and beneficiaries eligible for benefits from the plan during that month who were previously eligible for health benefits under a welfare plan (other than a multiemployer plan) maintained by the employer, or who would have been eligible for such health benefits if the employer had continued to maintain its welfare plan for the same categories of participants and beneficiaries as were originally covered thereunder.

(2) CHANGES IN METHOD OF FUNDING.—In the event that the cents per hour method of funding of a plan is converted to a different method of funding, an employer's continuing obligation as determined under subparagraphs (A) and (B) of paragraph (1) shall be converted to an equivalent contribution obligation determined pursuant to the revised method of funding.

(c) CERTAIN EMPLOYERS EXCLUDED.—With respect to any plan described in section 6324(d), this section shall not apply to any employer so long as the employer is bound by and in compliance with either—

(1) all of the terms and conditions (relating to the plan) of the collective bargaining agreement then in effect between the settlors; or

(2) all of the terms and conditions (relating to the plan) of any other collective bargaining agreement entered into prior to September 29, 1989 (but excluding any renewal, extension or modification of such collective bargaining agreement entered into after September 29, 1989), between the employer and the labor organization which is a settlor of the plan.

(d) TREATMENT OF EMPLOYERS IN PARTIAL COMPLIANCE.—Except as provided in subsection (c)(2), with respect to any plan described in section 6324(d), this section shall apply to any employer which contributes to the plan, but not in accordance with all of the terms and conditions (relating to the plan) of the collective bargaining agreement then in effect between the settlors. However, such employer shall be credited with the amount of any contributions made to the plan pursuant to any other collective bargaining agreement entered into by the employer and the labor organization which is a settlor of the plan, to the extent that such contributions are based on the same hours or other equivalent for which contributions are required under subsection (b)(1).

(e) LIABILITY FOR PAYMENT.—Persons responsible for paying to a plan described in section 6324(d) the amount of an employer's continuing obligation determined under this section shall include the employer and, only to the extent provided in this subsection, all trades or businesses (whether or not incorporated) which—

(1) are under common control with such employer; and

(2) are or were at any time on or after January 1, 1988, obligated to contribute to the plan (including a contingent obligation to contribute) under a collective bargaining agreement with the labor organization which is a settlor of the plan.

A plan may initiate legal action against such trade or business simultaneously with its pursuit of any remedy against the employer, but collection must first be pursued against the employer. The determination of whether such trades or businesses are under common control with an employer shall be made by the joint board of trustees of the plan, under rules which are consistent and coextensive with regulations prescribed by the Secretary of the Treasury or his delegate under section 414(c) of the Internal Revenue Code of 1986.

(f) SALES OF ASSETS.—An employer shall not be liable for a continuing obligation under this section with respect to operations sold to an unrelated party (hereinafter referred to as the "purchaser") in a bona fide, arms-length sale of assets, provided that the terms and conditions of subsections (a) and (d) of section 4204 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1384 (a) and (d)) have been met, treating a continuing obligation to a plan under this Act as if it were withdrawal liability within the meaning of section 4201 of such Act (29 U.S.C. 1381). In such event, the employer shall be subject only to secondary liability for a continuing obligation with respect to the operations purchased, under the terms referred to in subsection (a)(1)(C) of section 4204 of such Act (29 U.S.C. 1384(a)(1)(C)), and the purchaser shall, for all purposes under this Act, be treated as if it had made all contributions and reported all hours as were made or reported by the employer with respect to the operations purchased.

(g) RECORDS.—An employer that has a continuing obligation to contribute to a plan described in section 6324(d) shall keep such records and render such statements as the joint board of trustees of the plan may from time to time prescribe. The board of trustees shall have the right to audit the books and records of the employer for the purpose of enforcing the provisions of this section. In connection with any such audit, the board of trustees (or its duly designated employee or representative) shall, at all reasonable times, upon request, have access to, and be permitted to copy, all books, papers, and other documents of the employer which are necessary to verify the accuracy of payments made under this Act. In any case in which an audit establishes that an employer has not paid to a plan described in section 6324(d) the full amount of the continuing obligation determined pursuant to subsection (b), the employer, at the discretion of the board of trustees, shall be liable to the plan for the full cost of the audit, in addition to any amounts owed under subsection (b).

(h) ACTIONS OF TRUSTEES.—The joint board of trustees of any plan described in section 6324(d) shall determine an employer's continuing obligation under this section, notify the employer of such determination, and collect the continuing obligation of the employer. The continuing obligation (including arrearages which arose prior to the assessment of the obligation) shall be payable beginning no later than 60 days after the date of the notification to the employer of the determination of the board of trustees, notwithstanding the pendency of any proceeding to contest the assessment of liability. Such past arrearages may be amortized over 12 equal monthly payments. Any dispute between an employer and a board of trustees concerning a determination shall be resolved through arbitration. The provisions of sections 4221 and 4301 (a) through (f) of the Employee Retirement Income Security Act of 1974 (29 U.S.C 1401 and 1451(a)-(f)) shall be applicable to this section, treating an employer's continuing obligation to a plan as if it were withdrawal liability within the meaning of section 4201 of such Act (29 U.S.C. 1381).

SEC. 6326. DEFINITIONS.

(a) For purposes of this subpart, the term—

(1) "employee engaged in the production of coal" means any individual employed by an employer in a job classification at any operation which is or was at any time on or after January 1, 1988, covered by a collective bargaining agreement with the United Mine Workers of America (or a local affiliate thereof) requiring contributions to a plan described in section 6324(d);

(2) "employer" means a person which is or was required to make contributions to a plan described in section 6324(d) on behalf of employees engaged in the production of coal;

(3) "plan year" means with respect to a plan described in section 6324(d), the calendar year or fiscal year on which the records of the plan are kept;

(4) "related pension plan" means any pension plan described in section 404(c) of the Internal Revenue Code of 1986 or a continuation thereof;

(5) "settlors" means the United Mine Workers of America (hereinafter referred to as the "UMWA") and the Bituminous Coal Operators' Association, Inc. (hereinafter referred to as the "BCOA"), except that if the BCOA ceases to exist, members of the BCOA representing more than 50 percent of the tonnage membership of BCOA on the date of enactment of this subpart shall collectively be considered a settlor, and in such event, the uniform contribution rate, terms and conditions relating to a plan described in section 6324(d), which are set forth in collective bargaining agreements then in effect between such members and the UMWA shall constitute the rate, terms, and conditions of the collective bargaining agreement between the settlors for purposes of this Act; and

(6) "surplus assets" means the excess of the current value of plan assets (as defined in section 3(26) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(26))) over the actuarial present value of all benefits for all plan participants, determined as of the first day of the plan year in accordance with actuarial assumptions and methods which reflect the actuary's best estimate of anticipated experience under the plan.

SEC. 6327. RELATIONSHIP TO COLLECTIVE BARGAINING AGREEMENTS.

Nothing in this subpart is intended to diminish or adversely affect in any manner any cause of action of a plan described in section ______(d), or of its board of trustees, against an employer for contributions based on a collective bargaining agreement between the employer and a labor organization which is a settlor of the plan.

SEC. 6328. REPORT.

The settlors shall prepare a report on or before February 1, 1994, analyzing the effect of this subpart on the delivery of retiree health benefits in the bituminous coal industry.

SEC. 6329. SEVERABILITY.

If any provision of this subpart is declared invalid, all other provisions of this subpart shall remain in full force and effect.

SEC. 6330. EFFECTIVE DATES.

(a) IN GENERAL.—Except as provided in subsection (b), this subpart shall take effect on the date of enactment.

(b) OBLIGATION TO CONTRIBUTE.—The provisions of this subpart relating to an employer's continuing obligation to contribute to multiemployer plans shall take effect on January 1, 1988.

PART IV—ALTERNATIVE FULL-FUNDING LIMITATION

SEC. 6331. ALTERNATIVE FULL-FUNDING LIMITATION.

(a) IN GENERAL.—Subsection (c) of section 412 (relating to minimum funding standards) is amended by adding at the end thereof the following new paragraph:

"(12) ALTERNATIVE FULL-FUNDING LIMITATION.—

"(A) GENERAL RULE.—An employer may elect the full-funding limitation under this paragraph with respect to any defined benefit plan of the employer in lieu of the full-funding limitation determined under paragraph (7) if the requirements of subparagraphs (C) and (D) are met.

"(B) ALTERNATIVE FULL-FUNDING LIMITATION.—The full-funding limitation under this paragraph is the full-funding limitation determined under paragraph (7) without regard to 'the lesser of (I) 150 percent of current liability, or (II)'.

"(C) REQUIREMENTS RELATING TO PLAN ELIGIBILITY.—

"(i) IN GENERAL.—The requirements of this subparagraph are met with respect to a defined benefit plan if—

"(I) as of the 1st day of the election period, the accrued liability of participants accruing benefits under the plan is at least 90 percent of the plan's total accrued liability,

"(II) the plan is not a top-heavy plan (as defined in section 416(g)) for the 1st plan year of the election period or either of the 2 preceding plan years,

"(III) the plan is described in section 404(a)(1)(D) for the plan year and 2 preceding plan years, and

"(IV) each defined benefit plan of the employer (and each defined benefit plan of each employer who is a member of any controlled group which includes such employer) meets the requirements of subclauses (I), (II), and (III).

"(ii) FAILURE TO CONTINUE TO MEET REQUIREMENTS.—

"(I) If any plan fails to meet the requirement of clause (i)(I) for any plan year during an election period, the benefits of the election under this paragraph shall be phased out under regulations prescribed by the Secretary.

"(II) If any plan fails to meet the requirement of clause (i) (II) or (III) for any plan year during an election period, such plan shall be treated as not meeting the requirements of clause (i) for the remainder of the election period.

If there is a failure described in subclause (I), (II), or (III) with respect to any plan, such plan (and each plan described in clause (i)(IV) with respect to such plan) shall be treated as not meeting the requirements of clause (i) for any of the 10 plan years beginning after the election period.

"(D) REQUIREMENTS RELATING TO ELECTION.—The requirements of this subparagraph are met if—

"(i) FILING DATE.—Notice of such election is filed with the Secretary (in such form and manner and containing such information as the Secretary may provide) at least 425 days before the 1st day of the election period.

"(ii) CONSISTENT ELECTION.—Such an election is made for all defined benefit plans maintained by the employer or by any member of a controlled group which includes the employer.

"(E) TERM OF ELECTION.—Any election made under this paragraph shall apply for the election period.

"(F) OTHER CONSEQUENCES OF ELECTION.—

"(i) NO FUNDING WAIVERS.—In the case of a plan with respect to which an election is made under this paragraph, no waiver may be granted under subsection (d) for any plan year beginning after the date the election was made and ending at the close of the election period with respect thereto.

"(ii) FAILURE TO MAKE SUCCESSIVE ELECTIONS.—If an election is made under this paragraph with respect to any plan and such an election does not apply for each successive plan year of such plan, such plan shall be treated as not meeting the requirements of subparagraph (C) for the period of 10 plan years beginning after the close of the last election period for such plan.

"(G) DEFINITIONS.—For purposes of this paragraph—

"(i) ELECTION PERIOD.—The term 'election period' means the period of 5 consecutive plan years beginning with the 1st plan year for which the election is effective.

"(ii) CONTROLLED GROUP.—The term 'controlled group' means all persons who are treated as a single employer under subsection (b), (c), (m), or (o) of section 414.

"(H) PROCEDURES IF ALTERNATIVE FUNDING LIMITATION REDUCES NET FEDERAL REVENUES.—

"(i) IN GENERAL.—At least once with respect to each fiscal year, the Secretary shall estimate whether the application of this paragraph will result in a net reduction in Federal revenues for such fiscal year.

"(ii) ADJUSTMENT OF FULL-FUNDING LIMITATION IF REVENUE SHORTFALL.—If the Secretary estimates that the application of this paragraph will result in a more than insubstantial net reduction in Federal revenues for any fiscal year, the Secretary—

"(I) shall make the adjustment described in clause (iii), and

"(II) to the extent such adjustment is not sufficient to reduce such reduction to an insubstantial amount, shall make the adjustment described in clause (iv).

Such adjustments shall apply only to defined benefit plans with respect to which an election under this paragraph is not in effect.

"(iii) REDUCTION IN LIMITATION BASED ON 150 PERCENT OF CURRENT LIABILITY.—The adjustment described in this clause is an adjustment which—

"(I) applies paragraph (7) separately with respect to participants who are not accruing benefits under the plan and to participants who are so accruing, and

"(II) reduces the percentage described in paragraph (7)(A)(i)(I) (not below 140 percent) with respect to such participants who are not so accruing.

"(iv) REDUCTION IN LIMITATION BASED ON ACCRUED LIABILITY.—The adjustment described in this clause is an adjustment which reduces the percentage of accrued liability taken into account under paragraph (7)(A)(i)(II). In no event may the amount of accrued liability taken into account under such paragraph after the adjustment be less than current liability under paragraph (7)(A)(i)(I) (determined by substituting '140' for '150')."

(b) REPEAL OF DISCRETIONARY REGULATORY AUTHORITY.—Section 412(c)(7) is amended by striking subparagraph (D).

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

PART V—OTHER PROVISIONS

SEC. 6341. TAX-EXEMPT ORGANIZATIONS ELIGIBLE FOR SECTION 401(k) PLANS.

(a) IN GENERAL.—Subparagraph (B) of section 401(k)(4) is amended to read as follows:

"(B) STATE AND LOCAL GOVERNMENTS NOT ELIGIBLE.—A cash or deferred arrangement shall not be treated as a qualified cash or deferred arrangement if it is a part of a plan maintained by a State or local government, or political subdivision thereof, or any agency or instrumentality thereof. This subparagraph shall not apply to a rural cooperative plan."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to years beginning after December 31, 1989.

SEC. 6342. VOLUNTARY EMPLOYEES' BENEFICIARY ASSOCIATIONS.

(a) IN GENERAL.—Paragraph (9) of section 501(c) is amended by inserting "and if the members of such association have an employment-related common bond" after "individual".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to years beginning after October 3, 1989.

SEC. 6343. INCREASE IN EMPLOYER REVERSION TAX.

(a) IN GENERAL.—Section 4980(a) is amended by striking "15 percent" and inserting "20 percent".

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply to reversions occurring after October 3, 1989.

(2) EXCEPTIONS.—The amendment made by subsection (a) shall not apply to any reversion after October 3, 1989, pursuant to a plan termination if—

(A) with respect to plans subject to title IV of the Employee Retirement Income Security Act of 1974, a notice of intent to terminate required under such title was provided to participants (or if no participants, to the Pension Benefit Guaranty Corporation) before October 4, 1989, or

(B) with respect to plans subject to title I of such Act, a notice of intent to reduce future accruals required under section 204(h) of such Act was provided to participants in connection with the termination before October 4, 1989.

SEC. 6344. QUALIFIED TRANSPORTATION FRINGE BENEFIT.

(a) EXCLUSION.—Section 132(a) is amended by striking "or" at the end of paragraph (3), by striking the comma at the end of paragraph (4) and inserting ", or", and by adding at the end thereof the following new paragraph:

"(5) qualified transportation fringe."

(b) QUALIFIED TRANSPORTATION FRINGE.—Section 132 is amended by adding at the end thereof the following new subsection:

"(i) QUALIFIED TRANSPORTATION FRINGE.—

"(1) IN GENERAL.—For purposes of this section, the term 'qualified transportation fringe' means—

"(A) transportation in a commuter highway vehicle between the employee's residence and place of employment, and

"(B) any transit pass.

"(2) Limitation on exclusion for transit passes.—In the case of a qualified transportation fringe described in paragraph (1)(B), the amount excluded from gross income under subsection (a)(5) shall not exceed $15 per month.

"(3) Additional requirements.—Paragraph (1) shall not apply to any qualified transportation fringe unless—

"(A) such benefit is provided under a separate written plan of the employer, and

"(B) the plan provides that such benefit is provided in addition to (and not in lieu of) any compensation otherwise payable to the employee.

"(4) Definitions.—For purposes of this subsection—

"(A) Transit pass.—The term 'transit pass' means any pass, token, farecard, voucher, or similar item entitling a person to transportation on mass transit facilities (whether or not publicly owned).

"(B) Commuter highway vehicle.—The term 'commuter highway vehicle' means any highway vehicle—

"(i) the seating capacity of which is at least seven adults (not including the driver), and

"(ii) at least 80 percent of the mileage use of which can reasonably be expected to be—

"(I) for purposes of transporting employees between their residences and their place of employment, and

"(II) on trips during which the number of employees transported for such purposes is at least ½ of the adult seating capacity of such vehicle (not including the driver).

"(C) Transportation provided by employer.—Transportation referred to in paragraph (1)(A) shall be considered to be provided by an employer if such transportation is furnished in a commuter highway vehicle operated by or for the employer.

"(D) Employee.—The term 'employee' does not include an individual who is an employee within the meaning of section 401(c)(1).".

(c) Conforming Amendment.—Section 132(h)(1) is amended by striking "and (2)" and inserting ", (2), and (5)".

(d) Effective Date.—The amendments made by this section shall apply to taxable years beginning after December 31, 1989.

SEC. 6345. PERSONAL USE OF AIRPLANES.

In applying Treasury Regulation § 1.61-21(g)(12) for taxable years beginning after December 31, 1989, the determination of the value of a flight by an individual who is not flying primarily for an employer's business shall be determined on the basis of the percentage of occupied seats (other than crew) which are occupied by individuals whose flights are primarily for the employer's business rather than the percentage of seating capacity.

Subtitle D—Foreign Provisions

SEC. 6401. TAXABLE YEAR OF CERTAIN FOREIGN CORPORATIONS.

(a) General Rule.—Subpart D of part II of subchapter N of chapter 1 (relating to miscellaneous provisions) is amended by adding at the end thereof the following new section:

"SEC. 898. TAXABLE YEAR OF CERTAIN FOREIGN CORPORATIONS.

"(a) General Rule.—For purposes of this title, the taxable year of any specified foreign corporation shall be the required year determined under subsection (c).

"(b) Specified Foreign Corporation.—For purposes of this section—

"(1) In general.—The term 'specified foreign corporation' means any foreign corporation—

"(A) which is—

"(i) treated as a controlled foreign corporation for any purpose under subpart F of part III of this subchapter, or

"(ii) a foreign personal holding company (as defined in section 552), and

"(B) with respect to which the ownership requirements of paragraph (2) are met.

"(2) Ownership requirements.—

"(A) IN GENERAL.—The ownership requirements of this paragraph are met with respect to any foreign corporation if a United States shareholder owns, on each testing day, more than 50 percent of—

"(i) the total voting power of all classes of stock of such corporation entitled to vote, or

"(ii) the total value of all classes of stock of such corporation.

"(B) OWNERSHIP.—For purposes of subparagraph (A), the rules of subsections (a) and (b) of section 958 and sections 551(f) and 554, whichever are applicable, shall apply in determining ownership.

"(3) UNITED STATES SHAREHOLDER.—

"(A) IN GENERAL.—The term 'United States shareholder' has the meaning given to such term by section 951(b), except that, in the case of a foreign corporation having related person insurance income (as defined in section 953(c)(2)), the Secretary may treat any person as a United States shareholder for purposes of this section if such person is treated as a United States shareholder under section 953(c)(1).

"(B) FOREIGN PERSONAL HOLDING COMPANIES.—In the case of any foreign personal holding company (as defined in section 552) which is not a specified foreign corporation by reason of paragraph (1)(A)(i), the term 'United States shareholder' means any person who is treated as a United States shareholder under section 551.

"(c) DETERMINATION OF REQUIRED YEAR.—

"(1) CONTROLLED FOREIGN CORPORATIONS.—

"(A) IN GENERAL.—In the case of a specified foreign corporation described in subsection (b)(1)(A)(i), the required year is—

"(i) the majority U.S. shareholder year, or

"(ii) if there is no majority U.S. shareholder year, the taxable year prescribed under regulations.

"(B) 1-MONTH DEFERRAL ALLOWED.—Except as provided in paragraph (2), a specified foreign corporation may elect, in lieu of the taxable year under subparagraph (A)(i), a taxable year beginning 1 month earlier than the majority U.S. shareholder year.

"(C) MAJORITY U.S. SHAREHOLDER YEAR.—

"(i) IN GENERAL.—For purposes of this subsection, the term 'majority U.S. shareholder year' means the taxable year (if any) which, on each testing day, constituted the taxable year of—

"(I) each United States shareholder described in subsection (b)(2)(A), and

"(II) each United States shareholder not described in subclause (I) whose stock was treated as owned under subsection (b)(2)(B) by any shareholder described in such subclause.

"(ii) TESTING DAY.—The testing days shall be—

"(I) the first day of the corporation's taxable year (determined without regard to this section), or

"(II) the days during such representative period as the Secretary may prescribe.

"(2) FOREIGN PERSONAL HOLDING COMPANIES.—In the case of a foreign personal holding company described in subsection (b)(3)(B), the required year shall be determined under paragraph (1), except that subparagraph (B) of paragraph (1) shall not apply."

(b) TREATMENT OF DIVIDENDS PAID AFTER CLOSE OF TAXABLE YEAR.—

(1) IN GENERAL.—Section 563 is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) FOREIGN PERSONAL HOLDING COMPANY TAX.—

"(1) IN GENERAL.—In the determination of the dividends paid deduction for purposes of part III, a dividend paid after the close of any taxable year and on or before the 15th day of the 3rd month following the close of such taxable year shall, to the extent the company designates such dividend as being taken into account under this subsection, be considered as paid during such taxable year. The amount allowed as a deduction by reason of the application of this subsection with respect to any taxable year shall not exceed the undistributed foreign personal holding company income of the corporation for the taxable year computed without regard to this subsection.

"(2) SPECIAL RULES.—In the case of any distribution referred to in paragraph (1)—

"(A) paragraph (1) shall apply only if such distribution is to the person who was the shareholder of record (as of the last day of the taxable year of the foreign personal holding company) with respect to the stock for which such distribution is made,

"(B) the determination of the person required to include such distribution in gross income shall be made under the principles of section 551(f), and

"(C) any person required to include such distribution in gross or distributable net income shall include such distribution in income for such person's taxable year in which the taxable year of the foreign personal holding company ends."

(2) CONFORMING AMENDMENT.—Subsection (d) of section 563 (as redesignated by paragraph (1)) is amended by striking "subsection (a) or (b)" and inserting "subsection (a), (b), or (c)".

(c) CLERICAL AMENDMENT.—The table of sections for subpart D of part II of subchapter N of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 898. Taxable year of certain foreign corporations."

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to taxable years of foreign corporations beginning after July 10, 1989.

(2) SPECIAL RULES.—If any foreign corporation is required by the amendments made by this section to change its taxable year for its first taxable year beginning after July 10, 1989—

(A) such change shall be treated as initiated by the taxpayer,

(B) such change shall be treated as having been made with the consent of the Secretary of the Treasury or his delegate, and

(C) if, by reason of such change, any United States person is required to include in gross income for 1 taxable year amounts attributable to 2 taxable years of such foreign corporation, the amount which would otherwise be required to be included in gross income for such 1 taxable year by reason of the short taxable year of the foreign corporation resulting from such change shall be included in gross income ratably over the 4-taxable-year period beginning with such 1 taxable year.

SEC. 6402. LIMITATION ON USE OF DECONSOLIDATION TO AVOID FOREIGN TAX CREDIT LIMITATIONS.

(a) GENERAL RULE.—Section 904 (relating to limitations on foreign tax credit) is amended by redesignating subsection (i) as subsection (j) and by inserting after subsection (h) the following new subsection:

"(i) LIMITATION ON USE OF DECONSOLIDATION TO AVOID FOREIGN TAX CREDIT LIMITATIONS.—If 2 or more domestic corporations would be members of the same affiliated group if—

"(1) section 1504(b) were applied without regard to the exceptions contained therein, and

"(2) the constructive ownership rules of section 1563(e) applied for purposes of section 1504(a),

the Secretary may by regulations provide for resourcing the income of any of such corporations or for modifications to the consolidated return regulations to the extent that such resourcing or modifications are necessary to prevent the avoidance of the provisions of this subpart."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after July 10, 1989.

SEC. 6403. INFORMATION WITH RESPECT TO CERTAIN FOREIGN-OWNED CORPORATIONS.

(a) 25-PERCENT FOREIGN-OWNED CORPORATIONS REQUIRED TO REPORT.—

(1) Paragraph (2) of section 6038A(a) is amended to read as follows:

"(2) is 25-percent foreign-owned,".

(2) Subsection (c) of section 6038A is amended to read as follows:

"(c) DEFINITIONS.—For purposes of this section—

"(1) 25-PERCENT FOREIGN-OWNED.—A corporation is 25-percent foreign-owned if at least 25 percent of—

"(A) the total voting power of all classes of stock of such corporation entitled to vote, or

"(B) the total value of all classes of stock of such corporation,

is owned at any time during the taxable year by 1 foreign person (hereinafter in this section referred to as a '25-percent foreign shareholder').

"(2) RELATED PARTY.—The term 'related party' means—

"(A) any 25-percent foreign shareholder of the reporting corporation, "(B) any person who is related (within the meaning of section 267(b) or 707(b)(1)) to the reporting corporation or to a 25-percent foreign shareholder of the reporting corporation, and

"(C) any other person who is related (within the meaning of section 482) to the reporting corporation.

"(4) FOREIGN PERSON.—The term 'foreign person' means any person who is not a United States person. For purposes of the preceding sentence, the term 'United States person' has the meaning given to such term by section 7701(a)(30), except that any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States shall not be treated as a United States person.

"(5) RECORDS.—The term 'records' includes any books, papers, or other data.

"(6) SECTION 318 TO APPLY.—Section 318 shall apply for purposes of paragraphs (1) and (2), except that—

"(A) '10 percent' shall be substituted for '50 percent' in section 318(a)(2)(C), and

"(B) subparagraphs (A), (B), and (C) of section 318(a)(3) shall not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person."

(b) U.S. RECORDKEEPING REQUIREMENTS.—Subsection (a) of section 6038A is amended by inserting before the period at the end thereof the following: "and such corporation shall maintain (in the location, in the manner, and to the extent prescribed in regulations) such records as may be appropriate to determine the correct treatment of transactions with related parties as the Secretary shall by regulations prescribe (or shall cause another person to so maintain such records)".

(c) INCREASE IN PENALTY.—Subsection (d) of section 6038A is amended to read as follows:

"(d) PENALTY FOR FAILURE TO FURNISH INFORMATION OR MAINTAIN RECORDS.—

"(1) IN GENERAL.—If a reporting corporation—

"(A) fails to furnish (within the time prescribed by regulations) any information described in subsection (b), or

"(B) fails to maintain (or cause another to maintain) records as required by subsection (a),

such corporation shall pay a penalty of $10,000 for each taxable year with respect to which such failure occurs.

"(2) INCREASE IN PENALTY WHERE FAILURE CONTINUES AFTER NOTIFICATION.—If any failure described in paragraph (1) continues for more than 90 days after the day on which the Secretary mails notice of such failure to the reporting corporation, such corporation shall pay a penalty (in addition to the amount required under paragraph (1)) of $10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of such 90-day period.

"(3) REASONABLE CAUSE.—For purposes of this subsection, the time prescribed by regulations to furnish information or maintain records (and the beginning of the 90-day period after notice by the Secretary) shall be treated as not earlier than the last day on which (as shown to the satisfaction of the Secretary) reasonable cause existed for failure to furnish the information or maintain the records."

(d) ENFORCEMENT OF INFORMATION REQUESTS.—Section 6038A is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) ENFORCEMENT OF REQUESTS FOR CERTAIN RECORDS.—

"(1) AGREEMENT TO TREAT CORPORATION AS AGENT.—The rules of paragraph (3) shall apply to any transaction between the reporting corporation and any related party who is a foreign person unless such related party agrees (in such manner and at such time as the Secretary shall prescribe) to authorize the reporting corporation to act as such related party's agent solely for purposes of applying sections 7602, 7603, and 7604 with respect to any request to examine records or produce testimony related to any such transaction or with respect to any summons for such records or testimony.

"(2) RULES WHERE INFORMATION NOT FURNISHED.—If—

"(A) for purposes of determining the correct treatment of any transaction between the reporting corporation and a related party who is a foreign person, the Secretary issues a summons to such corporation to produce (either directly or as agent for such related party) any records or testimony,

"(B) such summons is not quashed in a proceeding begun under paragraph (4) and is not determined to be invalid in a proceeding begun under section 7604(b) to enforce such summons, and

"(C) the reporting corporation does not substantially comply in a timely manner with such summons,

the Secretary may apply the rules of paragraph (3) with respect to such transaction (whether or not the Secretary begins a proceeding to enforce such summons). If the reporting corporation fails to maintain (or cause another to maintain) records as required by subsection (a), and by reason of that failure, the summons is quashed in a proceeding described in subparagraph (B) or the reporting corporation is not able to provide the records requested in the summons, the Secretary may apply the rules of paragraph (3) with respect to any transaction to which the records relate.

"(3) APPLICABLE RULES IN CASES OF NONCOMPLIANCE.—If the rules of this paragraph apply to any transaction—

"(A) the amount of the deduction allowed under subtitle A for any amount paid or incurred by the reporting corporation to the related party in connection with such transaction, and

"(B) the cost to the reporting corporation of any property acquired in such transaction from the related party (or transferred by such corporation in such transaction to the related party),

shall be the amount determined by the Secretary in the Secretary's sole discretion from the Secretary's own knowledge or from such information as the Secretary may obtain through testimony or otherwise.

"(4) PROCEEDING TO QUASH.—

"(A) IN GENERAL.—Notwithstanding any law or rule of law, any reporting corporation to which the Secretary issues a summons referred to in paragraph (2)(A) shall have the right to begin a proceeding to quash such summons not later than the 90th day after such summons was issued. In any such proceeding, the Secretary may seek to compel compliance with such summons.

"(B) JURISDICTION.—The United States district court for the district in which the person (to whom the summons is issued) resides or is found shall have jurisdiction to hear any proceeding brought under subparagraph (A). An order denying the petition shall be treated as a final order which may be appealed.

"(C) SUSPENSION OF STATUTE OF LIMITATIONS.—If the reporting corporation brings an action under subparagraph (A) to quash the summons referred to in paragraph (2)(A), the running of any period of limitations under section 6501 (relating to assessment and collection of tax) or under section 6531 (relating to criminal prosecutions) with respect to any transaction to which the summons relates shall be suspended for the period during which such proceeding, and appeals therein, are pending. In no event shall any such period expire before the 90th day after the day on which there is a final determination in such proceeding."

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after July 10, 1989.

SEC. 6404. TREATMENT OF NONRESIDENT ALIENS RECEIVING CERTAIN EDUCATIONAL AND TRAINING GRANTS.

(a) GENERAL RULE.—Section 873 (relating to definitions) is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) TREATMENT OF NONRESIDENT ALIENS RECEIVING CERTAIN SCHOLARSHIP OR FELLOWSHIP GRANTS.—

"(1) IN GENERAL.—In the case of a qualified nonresident alien individual—

"(A) section 63(c)(6)(B) (relating to disallowance of standard deduction) shall not apply,

"(B) notwithstanding subsection (b)(3), the deduction for personal exemptions allowed by section 151 shall not be limited to 1 exemption,

"(C) section 152(b)(3) shall not exclude from the definition of 'dependent' any individual who is a member of the taxpayer's household in the United States, and

"(D) no exemption shall be allowed under section 151(b) for the spouse of the taxpayer unless such spouse is a member of the taxpayer's household in the United States.

Any deduction allowed by reason of the preceding sentence shall be allowed whether or not such deduction is connected with income which is effectively connected with the conduct of a trade or business within the United States.

"(2) LIMITATION.—The amount allowed as a deduction by reason of paragraph (1) for any taxable year shall not exceed the amount of the qualified scholarship or fellowship grants includible in gross income for such taxable year.

"(3) DEFINITIONS.—For purposes of this subsection—

"(A) QUALIFIED NONRESIDENT ALIEN INDIVIDUAL.—The term 'qualified nonresident alien individual' means any individual—

"(i) who is temporarily present in the United States as a nonimmigrant under subparagraph (F), (J), or (M) of section 101(a)(15) of the Immigration and Nationality Act, and

"(ii) who receives or accrues any qualified scholarship or fellowship grant during the taxable year.

"(B) QUALIFIED SCHOLARSHIP OR FELLOWSHIP GRANT.—The term 'qualified scholarship or fellowship grant' means any amount—

"(i) which is includible in the gross income of the nonresident alien for the taxable year, and

"(ii) which is granted (directly or indirectly) by—

"(I) the United States (or an agency or instrumentality thereof),

"(II) a State, a possession of the United States, or any political subdivision of a State or a possession, or

"(III) any organization created or organized in the United States which is described in section 501(c)(3) and exempt from tax under section 501(a),

as a scholarship or fellowship for study, training, teaching, research, or career development in the United States.

"(4) REDUCTION IN WITHHOLDING.—The Secretary may by regulations provide for a reduction in the amount required to be deducted and withheld under section 1441 from any qualified scholarship or fellowship grant to take into account the provisions of this subsection."

(b) CONFORMING AMENDMENT.—Subsection (a) of section 873 is amended by striking "subsection (b)" and inserting "subsections (b) and (c)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1989.

SEC. 6405. MISCELLANEOUS FOREIGN PROVISIONS.

(a) TREATMENT OF EXPORT TRADE CORPORATIONS UNDER PASSIVE FOREIGN INVESTMENT COMPANY RULES.—

(1) IN GENERAL.—Subsection (b) of section 1296 (defining passive income) is amended by adding at the end thereof the following new paragraph:

"(3) TREATMENT OF EXPORT TRADE CORPORATIONS.—

"(A) IN GENERAL.—In the case of an export trade corporation (as defined in section 971), the term 'passive income' does not include any export trade income (as defined in section 971(b)).

"(B) LIMITATION.—The amount treated as not being passive income by reason of subparagraph (A) for any taxable year shall not exceed the excess (if any) of—

"(i) the reduction in the subpart F income of the export trade corporation under section 970(a), over

"(ii) the amount which would have been such reduction if any export trade income which would (but for this paragraph) be passive income were not taken into account under section 970(a)."

(2) CONFORMING AMENDMENT.—Paragraph (1) of section 1296(b) is amended by striking "paragraph (2)" and inserting "paragraphs (2) and (3)".

(3) EFFECTIVE DATE.—

(A) IN GENERAL.—The amendments made by this subsection shall apply to taxable years of foreign corporations beginning after December 31, 1988.

(B) EXTENSION OF TIME FOR MAKING CERTAIN ELECTIONS.—In the case of any export trade corporation which was a passive foreign investment company for any taxable year beginning after December 31, 1986, and before January 1, 1989, the time for making an election under section 1294 or 1295 of the Internal Revenue Code of 1986 with respect to any such taxable year for which it was a passive foreign investment company shall not expire before the date 60 days after the date of the enactment of this Act. The period for assessing or collecting any underpayment of tax resulting from such an election shall in no event expire before the day 3 years after the date on which such election is made.

(b) TREATMENT OF CERTAIN LEASED PROPERTY UNDER PASSIVE FOREIGN INVESTMENT COMPANY RULES.—

(1) IN GENERAL.—Section 1296 (defining passive foreign investment company) is amended by adding at the end thereof the following new subsection:

"(e) TREATMENT OF CERTAIN LEASED PROPERTY.—

"(1) IN GENERAL.—For purposes of subsection (a)(2), any computer or peripheral equipment with respect to which the foreign corporation is the lessee under a lease with a term of at least 6 months shall be treated as an asset actually held by such corporation.

"(2) COMPUTER OR PERIPHERAL EQUIPMENT.—The term 'computer or peripheral equipment' has the meaning given to such term by section 168(i)(2)(B).

"(3) EXCEPTIONS.—This subsection shall not apply in any case where—

"(A) the lessor is a related person (as defined in the last sentence of subsection (b)(2)) with respect to the foreign corporation,

"(B) the foreign corporation is a sublessor of the property, or

"(C) a principal purpose of leasing the equipment was to avoid the provisions of this part."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to taxable years of foreign corporations beginning after December 31, 1988.

(c) TREATMENT OF CERTAIN HOLDINGS OF CONTROLLED FOREIGN CORPORATIONS.—

(1) IN GENERAL.—Section 958 is amended by adding at the end thereof the following new subsection:

"(c) CERTAIN HOLDINGS DISREGARDED.—Solely for purposes of this subpart, the Secretary may by regulations provide that the stock of an investment company shall not be treated as owned by a controlled foreign corporation to the extent such stock is held solely for the benefit of foreign persons that are the owners of variable contracts issued by such controlled foreign corporation."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to taxable years of foreign corporations beginning after December 31, 1989.

SEC. 6406. EXCLUSION FOR CERTAIN OVERSEAS ALLOWANCES RECEIVED BY PERSONNEL OF DEPARTMENT OF DEFENSE.

(a) IN GENERAL.—Paragraph (1) of section 912 (relating to foreign area allowances) is amended by striking "or" at the end of subparagraph (C), by striking the period at the end of subparagraph (D) and inserting a comma, and by adding at the end the following new subparagraphs:

"(E) section 9(b) of the National Security Agency Act of 1959, if the amount would be excluded from gross income if received under a law referred to in subparagraph (A) or (B) of this paragraph, or

"(F) section 1605(a) of title 10, United States Code, if the amount would be excluded from gross income if received under the law referred to in subparagraph (A) of this paragraph."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to allowances received after December 31, 1988, in taxable years ending after such date.

Subtitle E—Excise Tax Provisions

SEC. 6501. REPEAL OF AUTOMATIC REDUCTION IN AVIATION-RELATED TAXES.

(a) IN GENERAL.—Section 4283 (relating to reduction in aviation-related taxes in certain cases) is repealed.

(b) CONFORMING AMENDMENTS.—

(1) Section 6427 is amended—

(A) by striking subsection (q) and redesignating subsection (r) as subsection (q),

(B) by striking "(l), or (p)" in subsection (i)(1) and inserting "and (l)", and

(C) by striking "(h), and (p)" in subsection (i)(2)(A)(i) and inserting "and (h)".

(2) Section 4041(c) is amended by striking paragraph (6).

(c) EFFECTIVE DATE.—The repeal and amendments made by this section shall be effective after December 31, 1989.

SEC. 6502. INCREASE IN INTERNATIONAL AIR PASSENGER DEPARTURE TAX.

(a) IN GENERAL.—Section 4261(c) (relating to tax on use of international travel facilities) is amended by striking "$3" and inserting "$6".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to transportation beginning after December 31, 1989.

SEC. 6503. SHIP PASSENGERS INTERNATIONAL DEPARTURE TAX.

(a) IN GENERAL.—Chapter 36 (relating to certain other excise taxes) is amended by inserting after subchapter A the following new subchapter:

"Subchapter B—Transportation by Water

"Sec. 4471. Imposition of tax.
"Sec. 4472. Definitions and special rules.

"SEC. 4471. IMPOSITION OF TAX.

"(a) IN GENERAL.—There is hereby imposed a tax of $3 per passenger on a covered voyage.

"(b) BY WHOM PAID.—The tax imposed by this section shall be paid by the person providing the covered voyage.

"(c) TIME OF IMPOSITION.—The tax imposed by this section shall be imposed only once for each passenger on a covered voyage, either at the time of first embarkation or disembarkation in the United States.

"SEC. 4472. DEFINITIONS.

"For purposes of this subchapter—

"(1) COVERED VOYAGE.—

"(A) IN GENERAL.—The term 'covered voyage' means a voyage of—

"(i) a commercial passenger vessel which extends over 1 or more nights, or

"(ii) a commercial vessel transporting passengers engaged in gambling aboard the vessel beyond the territorial waters of the United States,

during which passengers embark or disembark the vessel in the United States. Such term shall not include any voyage on any vessel owned or operated by the United States, a State, or any agency or subdivision thereof.

"(B) EXCEPTION FOR CERTAIN VOYAGES ON PASSENGER VESSELS.—The term 'covered voyage' shall not include a voyage of a passenger vessel of less than 12 hours between 2 ports in the United States.

"(2) PASSENGER VESSEL.—The term 'passenger vessel' means any vessel having berth or stateroom accommodations for more than 16 passengers."

(b) CLERICAL AMENDMENTS.—The table of subchapters for chapter 36 is amended by inserting after the item relating to subchapter A the following new item:

"SUBCHAPTER B. Transportation by water."

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to voyages beginning after December 31, 1989.

(2) NO DEPOSITS REQUIRED BEFORE APRIL 1, 1990.—No deposit of any tax imposed by subchapter B of chapter 36 of the Internal Revenue Code of 1986, as added by this section, shall be required to be made before April 1, 1990.

SEC. 6504. ACCELERATION OF DEPOSIT REQUIREMENTS FOR TELEPHONE EXCISE TAX AND AIRLINE TICKET TAX; TELEPHONE EXCISE TAX EXEMPTION CERTIFICATES.

(a) ACCELERATION OF DEPOSIT REQUIREMENTS.—

(1) IN GENERAL.—Section 6302 (relating to mode or time of collection) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) TIME FOR DEPOSIT OF TAXES ON COMMUNICATIONS SERVICES AND AIRLINE TICKETS.—If, under regulations prescribed by the Secretary, a person is required to make deposits of any tax imposed by section 4251 or subsection (a) or (b) of section 4261 with respect to amounts considered collected by such person during any semimonthly period, such deposits shall be made not later than the 3rd day (not including Saturdays, Sundays, or legal holidays) after the close of the 1st week of the 2nd semimonthly period following the period to which such amounts relate.".

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to payments of taxes considered collected for semimonthly periods beginning after June 30, 1990.

(b) ONE-TIME FILING OF TELEPHONE EXCISE TAX EXEMPTION CERTIFICATES.—

(1) IN GENERAL.—Section 4253 is amended by adding at the end thereof the following new subsection:

"(k) FILING OF EXEMPTION CERTIFICATES.—

"(1) IN GENERAL.—In order to claim an exemption under subsection (c), (h), (i), or (j), a person shall provide to the provider of communications services a statement (in such form and manner as the Secretary may provide) certifying that such person is entitled to such exemption.

"(2) DURATION OF CERTIFICATE.—Any statement provided under paragraph (1) shall remain in effect until—

"(A) the provider of communications services has actual knowledge that the information provided in such statement is false, or

"(B) such provider is notified by the Secretary that the provider of the statement is no longer entitled to an exemption described in paragraph (1).

If any information provided in such statement is no longer accurate, the person providing such statement shall inform the provider of communications services within 30 days of any change of information."

(2) EFFECTIVE DATE.—

(A) IN GENERAL.—The amendment made by paragraph (1) shall apply to any claim for exemption made after the date of the enactment of this Act.

(B) DURATION OF EXISTING CERTIFICATES.—Any annual certificate of exemption effective on the date of the enactment of this Act shall remain effective until the end of the annual period.

SEC. 6505. TELEPHONE EXCISE TAX MADE PERMANENT.

(a) IN GENERAL.—Paragraph (1) of section 4251(a) (relating to imposition of tax) is amended by striking "the applicable percentage" and inserting "3 percent".

(b) CONFORMING AMENDMENT.—Subsection (b) of section 4251 is amended to read as follows:

"(b) COMMUNICATIONS SERVICES.—For purposes of subsection (a), the term 'communications services' means—

"(1) local telephone service,

"(2) toll telephone service, and

"(3) teletypewriter exchange service."

SEC. 6506. OIL SPILL LIABILITY TRUST FUND TAX TO TAKE EFFECT ON JANUARY 1, 1990.

(a) TAX TO TAKE EFFECT ON JANUARY 1, 1990.—

(1) IN GENERAL.—Subsection (f) of section 4611 (relating to application of Oil Spill Liability Trust Fund financing rate) is amended by striking paragraphs (1) and (2) and by inserting the following:

"(1) IN GENERAL.—Except as provided in paragraph (2), the Oil Spill Liability Trust Fund financing rate under subsection (c) shall apply after December 31, 1989, and before January 1, 1992."

(2) CONFORMING AMENDMENT.—Paragraph (3) of section 4611(f) is redesignated as paragraph (2) and is amended by striking "the commencement date" in subparagraph (A) and inserting "January 1, 1990,".

(b) 3 CENT RATE OF TAX.—Subparagraph (B) of section 4611(c)(2) is amended by striking "1.3 cents" and inserting "3 cents".

(c) OIL SPILL LIABILITY TRUST FUND TO BE OPERATING FUND.—

(1) IN GENERAL.—For purposes of sections 8032(d) and 8033(c) of the Omnibus Budget Reconciliation Act of 1986, the commencement date is January 1, 1990.

(2) CONFORMING AMENDMENTS.—

(A) Section 9509 (relating to Oil Spill Liability Trust Fund) is amended by adding at the end thereof the following new subsection:

"(f) REFERENCES TO COMPREHENSIVE OIL POLLUTION LIABILITY AND COMPENSATION ACT.—For purposes of this section, references to the Comprehensive Oil Pollution Liability and Compensation Act shall be treated as references to any law enacted before December 31, 1990, which is substantially identical to subtitle E of title VI, or subtitle D of title VIII, of H.R. 5300 of the 99th Congress as passed by the House of Representatives or the Oil Pollution Liability and Compensation Act of 1989, S. 686 of the 101st Congress as passed by the Senate."

(B) Paragraph (3) of section 9509(b) is amended by striking "(on the 1st day the Oil Spill Liability Trust Fund financing rate under section 4611(c) applies)" and inserting "(on January 1, 1990)".

(C) Paragraph (1)(A) of section 9509(c) is amended by striking the last sentence.

SEC. 6507. EXCISE TAX ON SALE OF CHEMICALS WHICH DEPLETE THE OZONE LAYER AND OF PRODUCTS CONTAINING SUCH CHEMICALS.

(a) IN GENERAL.—Chapter 38 (relating to environmental taxes) is amended by adding at the end thereof the following new subchapter:

"Subchapter D—Ozone-Depleting Chemicals, Etc.

"Sec. 4681. Imposition of tax.

"Sec. 4682. Definitions and special rules.

"SEC. 4681. IMPOSITION OF TAX.

"(a) GENERAL RULE.—There is hereby imposed a tax on—

"(1) any ozone-depleting chemical sold or used by the manufacturer, producer, or importer thereof, and

"(2) any imported taxable product sold or used by the importer thereof.

"(b) AMOUNT OF TAX.—

"(1) OZONE-DEPLETING CHEMICALS.—

"(A) IN GENERAL.—The amount of the tax imposed by subsection (a) on each pound of ozone-depleting chemical shall be an amount equal to—

"(i) the base tax amount, multiplied by

"(ii) the ozone-depletion factor for such chemical.

"(B) BASE TAX AMOUNT.—The base tax amount for purposes of subparagraph (A) with respect to any sale or use during a calendar year is the amount determined under the following table for such calendar year:

"Calendar year:	Base tax amount:
1990	$1.07
1991	1.12
1992	1.67
1993	3.15
1994 or thereafter	3.15.

"(2) IMPORTED TAXABLE PRODUCT.—

"(A) IN GENERAL.—The amount of the tax imposed by subsection (a) on any imported taxable product shall be the amount of tax which would have been imposed by subsection (a) on the ozone-depleting chemicals used as materials in the manufacture or production of such product if such ozone-depleting chemicals had been sold in the United States on the date of the sale of such imported taxable product.

"(B) CERTAIN RULES TO APPLY.—Rules similar to the rules of paragraphs (2) and (3) of section 4671(b) shall apply.

"SEC. 4682. DEFINITIONS AND SPECIAL RULES.

"(a) OZONE-DEPLETING CHEMICAL.—For purposes of this subchapter—

"(1) IN GENERAL.—The term 'ozone-depleting chemical' means any substance—

"(A) which, at the time of the sale or use by the manufacturer, producer, or importer, is listed as an ozone-depleting chemical in the table contained in paragraph (2), and

"(B) which is manufactured or produced in the United States or entered into the United States for consumption, use, or warehousing.

"(2) OZONE-DEPLETING CHEMICALS.—

"Common name:	Chemical nomenclature:
CFC-11	trichlorofluoromethane
CFC-12	dichlorodifluoromethane
CFC-113	trichlorotrifluoroethane
CFC-114	1,2-dichloro-1,1,2,2-tetrafluoroethane
CFC-115	chloropentafluoroethane
Halon-1211	bromochlorodifluoromethane
Halon-1301	bromotrifluoromethane
Halon-2402	dibromotetrafluoroethane.

"(b) OZONE-DEPLETION FACTOR.—For purposes of this subchapter, the term 'ozone-depletion factor' means, with respect to an ozone-depleting chemical, the factor assigned to such chemical under the following table:

"Ozone-depleting chemical:	Ozone-depletion factor:
CFC-11	1.0
CFC-12	1.0
CFC-113	0.8
CFC-114	1.0
CFC-115	0.6
Halon-1211	3.0
Halon-1301	10.0
Halon-2402	6.0.

"(c) IMPORTED TAXABLE PRODUCT.—For purposes of this subchapter—

"(1) IN GENERAL.—The term 'imported taxable product' means any product (other than an ozone-depleting chemical) entered into the United States for consumption, use, or warehousing if any ozone-depleting chemical was used as material in the manufacture or production of such product.

"(2) DE MINIMIS EXCEPTION.—The term 'imported taxable product' shall not include any product specified in regulations prescribed by the Secretary as using a de minimis amount of ozone-depleting chemicals as materials in the manufacture or production thereof. The preceding sentence shall not apply to any product in which any ozone-depleting chemical is used for purposes of refrigeration or air conditioning, creating an aerosol or foam, or manufacturing electronic components.

"(d) EXCEPTIONS.—

"(1) RECYCLING.—No tax shall be imposed by section 4681 on any ozone-depleting chemical which is diverted or recovered in the United States as part of a recycling process (and not as part of the original manufacturing or production process).

"(2) USE IN FURTHER MANUFACTURE.—

"(A) IN GENERAL.—No tax shall be imposed by section 4681 on any ozone-depleting chemical which is used (and entirely consumed) by the manufacturer, producer, or importer thereof in the manufacture or production of any other chemical.

"(B) CREDIT OR REFUND.—Under regulations prescribed by the Secretary, if—

"(i) a tax under this subchapter was paid with respect to any ozone-depleting chemical, and

"(ii) such chemical was used (and entirely consumed) by any person in the manufacture or production of any other chemical,

then an amount equal to the tax so paid shall be allowed as a credit or refund (without interest) to such person in the same manner as if it were an overpayment of tax imposed by section 4681.

"(3) EXPORTS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), rules similar to the rules of section 4662(e) (other than section 4662(e)(2)(A)(ii)(II)) shall apply for purposes of this subchapter.

"(B) LIMIT ON BENEFIT.—

"(i) IN GENERAL.—The aggregate tax benefit allowable under subparagraph (A) with respect to ozone-depleting chemicals manufactured or produced by any person during a calendar year shall not exceed the sum of—

"(I) the amount equal to the 1986 export percentage of the aggregate tax imposed by this subchapter with respect to ozone-depleting chemicals manufactured or produced by such person during such calendar year (other than chemicals with respect to which subclause (II) applies), and

"(II) the aggregate tax imposed by this subchapter with respect to any additional production allowance granted to such person with respect to ozone-depleting chemicals manufactured or produced by such person during such calendar year by the Environmental Protection Agency under 40 CFR Part 82 (as in effect on September 14, 1989).

"(ii) 1986 EXPORT PERCENTAGE.—A person's 1986 export percentage is the percentage equal to the ozone-depletion factor adjusted pounds of ozone-depleting chemicals manufactured or produced by such person during 1986 which were exported during 1986, divided by the ozone-depletion factor adjusted pounds of all ozone-depleting chemicals manufactured or produced by such person during 1986. The percentage determined under the preceding sentence shall be based on data published by the Environmental Protection Agency.

"(e) OTHER DEFINITIONS.—For purposes of this subchapter—

"(1) IMPORTER.—The term 'importer' means the person entering the article for consumption, use, or warehousing.

"(2) UNITED STATES.—The term 'United States' has the meaning given such term by section 4612(a)(4).

"(f) SPECIAL RULES.—

"(1) FRACTIONAL PARTS OF A POUND.—In the case of a fraction of a pound, the tax imposed by this subchapter shall be the same fraction of the amount of such tax imposed on a whole pound.

"(2) DISPOSITION OF REVENUES FROM PUERTO RICO AND THE VIRGIN ISLANDS.—The provisions of subsections (a)(3) and (b)(3) of section 7652 shall not apply to any tax imposed by this subchapter.

"(g) PHASE-IN OF TAX ON CERTAIN SUBSTANCES.—

"(1) TREATMENT FOR 1990.—

"(A) HALONS.—The term 'ozone-depleting chemical' shall not include halon-1211, halon-1301, or halon-2402 with respect to any sale or use during 1990.

"(B) CHEMICALS USED IN RIGID FOAM INSULATION.—No tax shall be imposed by section 4681—

"(i) on the use during 1990 of any substance in the manufacture of rigid foam insulation,

"(ii) on the sale during 1990 by the manufacturer, producer, or importer of any substance—

"(I) for use by the purchaser in the manufacture of rigid foam insulation, or

"(II) for resale by the purchaser to a second purchaser for such use by the second purchaser, or

"(iii) on the sale or use during 1990 by the importer of any rigid foam insulation.

Clause (ii) shall apply only if the manufacturer, producer, and importer, and the 1st and 2d purchasers (if any) meet such registration requirements as may be prescribed by the Secretary.

"(2) TREATMENT FOR 1991, 1992, AND 1993.—

"(A) HALONS.—The tax imposed by section 4681 during 1991, 1992, or 1993 by reason of the treatment of halon-1211, halon-1301, and halon-2402 as ozone-depleting chemicals shall be the applicable percentage (determined under the following table) of the amount of such tax which would (but for this subparagraph) be imposed.

"In the case of:	The applicable percentage is:		
	For sales or use during 1991	For sales or use during 1992	For sales or use during 1993
Halon-1211	7	5	3
Halon-1301	2	1	1
Halon-2402	4	2	1.

"(B) CHEMICALS USED IN RIGID FOAM INSULATION.—In the case of a sale or use during 1991, 1992, or 1993 on which no tax would have been imposed by reason of paragraph (1)(B) had such sale or use occurred during 1990, the tax imposed by section 4681 shall be the applicable percentage (determined in accordance with the following table) of the amount of such tax which would (but for this subparagraph) be imposed.

"In the case of sales or use during:	The applicable percentage is:
1991	23
1992	16
1993	8.

"(3) OVERPAYMENTS WITH RESPECT TO CHEMICALS USED IN RIGID FOAM INSULATION.—If any substance on which tax was paid under this subchapter is used during 1990, 1991, 1992, or 1993 by any person in the manufacture of rigid foam insulation, credit or refund (without interest) shall be allowed to such person an amount equal to the excess of—

"(A) the tax paid under this subchapter on such substance, over

"(B) the tax (if any) which would be imposed by section 4681 if such substance were used for such use by the manufacturer, producer, or importer thereof on the date of its use by such person.

"(h) IMPOSITION OF FLOOR STOCKS TAXES.—

"(1) JANUARY 1, 1990, TAX.—On any ozone-depleting chemical which on January 1, 1990, is held by any person (other than the manufacturer, producer, or importer thereof) for sale or for use in further manufacture, there is hereby imposed a floor stocks tax in an amount equal to the tax which would be imposed by section 4681 on such chemical if the sale of such chemical by the manufacturer, producer, or importer thereof had occurred during 1990.

"(2) OTHER TAX-INCREASE DATES.—

"(A) IN GENERAL.—If, on any tax-increase date, any ozone-depleting chemical is held by any person (other than the manufacturer, producer, or importer thereof) for sale or for use in further manufacture, there is hereby imposed a floor stocks tax.

"(B) AMOUNT OF TAX.—The amount of the tax imposed by subparagraph (A) shall be the excess (if any) of—

"(i) the tax which would be imposed under section 4681 on such substance if the sale of such chemical by the manufacturer, producer, or importer thereof had occurred on the tax-increase date, over

"(ii) the prior tax (if any) imposed by this subchapter on such substance.

"(C) TAX-INCREASE DATE.—For purposes of this paragraph, the term 'tax-increase date' means January 1 of 1991, 1992, 1993, and 1994.

"(3) DUE DATE.—The taxes imposed by this subsection on January 1 of any calendar year shall be paid on or before April 1 of such year.

"(4) APPLICATION OF OTHER LAWS.—All other provisions of law, including penalties, applicable with respect to the taxes imposed by section 4681 shall apply to the floor stocks taxes imposed by this subsection."

(b) CLERICAL AMENDMENT.—The table of subchapters for chapter 38 is amended by adding at the end thereof the following new item:

"SUBCHAPTER D. Ozone-depleting chemicals, etc."

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall take effect on January 1, 1990.

(2) NO DEPOSITS REQUIRED BEFORE APRIL 1, 1990.—No deposit of any tax imposed by subchapter D of chapter 38 of the Internal Revenue Code of 1986, as added by this section, shall be required to be made before April 1, 1990.

SEC. 6508. EXCISE TAX FOR WETLANDS TRUST FUND.

(a) IN GENERAL.—Chapter 38 (relating to environmental taxes), as amended by section 6507, is further amended by adding at the end thereof the following new subchapter:

"Subchapter E—Offshore Oil and Natural Gas

"SEC. 4691. IMPOSITION OF TAX.

"(a) IN GENERAL.—There is hereby imposed a tax at the rate specified in subsection (b) on—

"(1) offshore oil, and

"(2) offshore natural gas.

"(b) RATE OF TAX.—The rate of tax imposed by—

"(1) subsection (a)(1) is 3 cents a barrel, and

"(2) subsection (a)(2) is 2 cents per thousand cubic feet.

"(c) PAID BY WHOM.—The tax imposed by this section shall be paid by the person who owns the offshore oil or offshore natural gas when such oil or natural gas is produced.

"(d) APPLICATION OF TAX.—The tax imposed by this section shall apply after December 31, 1989, and before January 1, 1995.

"SEC. 4692. DEFINITIONS.

"For purposes of this subchapter—

"(1) OFFSHORE OIL.—The term 'offshore oil' means crude oil (as defined in section 4612(a)(1)) produced from the outer Continental Shelf.

"(2) OFFSHORE NATURAL GAS.—The term 'offshore natural gas' means natural gas produced from the outer Continental Shelf.

"(3) OUTER CONTINENTAL SHELF.—The term 'outer Continental Shelf' has the meaning given such term by section 2(a) of the Outer Continental Shelf Lands Act (43 U.S.C. 1331(a)).

"(4) BARREL.—The term 'barrel' means 42 United States gallons.

"(5) FRACTIONAL PART OF BARREL; CUBIC FOOT.—In the case of a fraction of a barrel or cubic foot, the tax imposed by section 4691 shall be the same fraction of the amount of such tax imposed on a whole barrel or cubic foot."

(b) WETLANDS TRUST FUND CREATED.—Subchapter A of chapter 98 (relating to trust fund code) is amended by adding at the end thereof the following new section:

"SEC. 9511. WETLANDS TRUST FUND.

"(a) CREATION OF TRUST FUND.—There is hereby established in the Treasury of the United States a trust fund to be known as the 'Wetlands Trust Fund', consisting of such amounts as may be appropriated or credited to such Trust Fund as provided in this section or section 9602(b).

"(b) TRANSFER TO TRUST FUND.—There are hereby appropriated to the Wetlands Trust Fund amounts equivalent to the taxes received in the Treasury under section 4691 (relating to offshore oil and natural gas tax).

"(c) EXPENDITURES FROM TRUST FUND.—Amounts in the Wetlands Trust Fund shall be available for making expenditures to carry out the creation, restoration, protection, enhancement, and conservation of wetlands upon enactment of and as provided in qualified authorizing legislation substantially similar to S. 1731 of the 101st Congress, as introduced in the Senate, and, if necessary, any appropriations Acts."

(c) CLERICAL AMENDMENTS.—

(1) The table of subchapters for chapter 38, as amended by section 6507(b), is further amended by adding at the end thereof the following new item.

"SUBCHAPTER E. Offshore oil and natural gas."

(2) The table of sections for subchapter A of chapter 98 is amended by adding at the end thereof the following new item:

"Sec. 9511. Wetlands Trust Fund."

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall take effect on January 1, 1990.

(2) NO DEPOSITS REQUIRED BEFORE APRIL 1, 1990.—No deposit of any tax imposed by subchapter E of chapter 38 of the Internal Revenue Code of 1986, as added by this section, shall be required to be made before April 1, 1990.

SEC. 6509. ACCELERATION OF DEPOSIT REQUIREMENTS FOR GASOLINE EXCISE TAX.

(a) IN GENERAL.—Section 6302 (relating to mode or time of collection), as amended by section 6504, is further amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) FREQUENCY AND TIME FOR DEPOSIT OF TAXES ON GASOLINE.—

"(1) GENERAL RULE.—Any person whose liability for tax under section 4081 exceeds $100 in any month of a calendar quarter shall make deposits of such tax with respect to tax periods in any month in the succeeding quarter as determined under paragraph (2).

"(2) TIME OF DEPOSIT.—

"(A) IN GENERAL.—Any deposit of tax required with respect to any tax period under paragraph (1) shall be payable on or before—

"(i) the 9th day after the close of the tax period, or

"(ii) if such deposit is made by wire transfer to any government depository authorized under section 6302, the 14th day after the close of the tax period.

"(B) TAX PERIODS.—Each month shall include 4 tax periods ending on the 7th, 14th, 21st, and last days of such month.

"(3) SPECIAL RULE WHERE 9TH OR 14TH DAY FALLS ON SATURDAY, SUNDAY, OR HOLIDAY.—If, but for this paragraph, the due date under paragraph (2) would fall on a Saturday, Sunday, or holiday in the District of Columbia, such due date shall be deemed to be the immediately preceding day which is not a Saturday, Sunday, or such a holiday."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to payments of taxes for tax periods beginning after December 31, 1989.

SEC. 6510. APPLICATION OF SECTION 4091 OF THE 1986 CODE TO CERTAIN DISTRIBUTORS OF DIESEL AND AVIATION FUEL.

(a) IN GENERAL.—The tax under section 4091 of the Internal Revenue Code of 1986 shall not be imposed on the sale by a producer (as defined in section 4092(b)(1)(A)) of taxable fuel (as defined in section 4092(a)(1)) to a qualified person.

(b) TAXABLE SALES BY QUALIFIED PERSONS.—The tax under section 4091 of such Code shall be imposed on sales by a qualified person of taxable fuel (as so defined) for uses not described in section 4093(c) of such Code (as if such section was in effect on April 1, 1988) and section 4093(d) of such Code.

(c) QUALIFIED PERSON.—The term 'qualified person' means any person who—

(1) elects the provisions of this section,

(2) is not subject to the requirements of section 4101 of the Internal Revenue Code of 1986, and

(3) meets the definition of wholesale distributor for purposes of section 4092(b)(2) of such Code as in effect on January 1, 1989.

SEC. 6511. REDUCTION IN OCCUPATIONAL TAX ON SMALL RETAIL ALCOHOLIC BEVERAGE DISTRIBUTORS.

(a) IN GENERAL.—Section 5121 (imposing occupational tax on retail dealers) is amended by adding at the end thereof the following new subsection:

"(c) SPECIAL RULE FOR SMALL RETAIL DEALERS.—In the case of a small retail dealers, subsections (a) and (b) shall be applied by substituting '$150' for '$250'."

(b) SMALL RETAIL DEALERS DEFINED.—Section 5122 (relating to definitions) is amended by adding at the end thereof the following new subsection:

"(d) SMALL RETAIL DEALERS.—For purposes of this chapter—

"(1) IN GENERAL.—The term 'small retail dealer' means a retail dealer in liquors or beer who had gross receipts from retail sales of distilled spirits, wine, and beer of less than $250,000 for the preceding taxable period and derived at at least ⅓rd of such gross receipts from such sales which were consumed on the premises of such dealer.

"(2) AGGREGATION RULES.—All persons treated as 1 person under section 5061(e)(3) shall be treated as 1 person for purposes of paragraph (1)."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable periods beginning after December 31, 1989.

SEC. 6512. PROHIBITION ON ASSESSMENTS OR COLLECTIONS OF OCCUPATIONAL TAX FOR PERIODS BEGINNING BEFORE JULY 1, 1985.

(a) IN GENERAL.—Notwithstanding any other provision of law—

(1) the amount of any tax imposed by section 5121 of the Internal Revenue Code of 1986 (or any corresponding provision of prior law) for any taxable period beginning before July 1, 1985, and any interest or penalty thereon, shall not be assessed at any time after the date of the enactment of this Act;

(2) no proceeding in court without assessment for the collection of such tax (and any interest or penalty thereon) for such period shall be begun or continued after such date;

(3) if such tax for such period (and any interest or penalty thereon) was assessed after June 30, 1988, and on or before such date of enactment, such assessment shall be abated; and

(4) if such tax for such period (and any interest or penalty thereon) was collected after June 30, 1988, and on or before such date of enactment, the amount so collected shall be credited or refunded (without interest) as an overpayment of tax.

(b) EXCEPTION FOR WILLFUL FAILURE TO PAY TAX.—Subsection (a) shall not apply to any tax which the taxpayer willfully fails to pay without reasonable cause.

SEC. 6513. EXPENDITURES FROM THE AIRPORT AND AIRWAY TRUST FUND FOR ESSENTIAL AIR SERVICES.

(a) IN GENERAL.—Section 9502(d)(1) (relating to expenditures from airport and airway trust fund) is amended—

(1) by striking "or" at the end of subparagraph (B),

(2) by redesignating subparagraph (C) as subparagraph (D),

(3) by inserting after subparagraph (B) the following new subparagraph:

"(C) incurred for the essential air services program authorized under section 419 of the Federal Aviation Act of 1958, as amended (49 U.S.C. 1389); or", and

(4) by striking "subparagraph (A) or (B)" in subparagraph (D) (as so redesignated) and inserting "subparagraph (A), (B), or (C)".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to obligations of the United States incurred in fiscal years beginning after September 30, 1989.

SEC. 6514. PROVIDING TOLERANCE LIMITS FOR BLENDING OF GASOHOL.

(a) IN GENERAL.—Paragraph (1) of section 4081(c) (relating to gasoline mixed with alcohol at refinery, etc.) is amended by adding at the end thereof the following new sentence: "For purposes of the preceding sentence, the requirement of a 10 percent mixture shall be considered satisfied by applying a tolerance of plus or minus $\frac{1}{10}$th of 1 percent in the case of any person who establishes to the satisfaction of the Secretary an average 10 percent mixture in all gasohol produced over a reasonable period of time."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on and after January 1, 1990.

SEC. 6515. GASOLINE USED ON FARMS BY CROPDUSTERS.

(a) IN GENERAL.—Section 6420(c)(4)(B) (relating to gasoline used on farms) is amended to read as follows:

"(B) if the person so using the gasoline is an aerial or other applicator of fertilizers or other substances and is the ultimate purchaser of the gasoline, then subparagraph (A) of this paragraph shall not apply and the aerial or other applicator shall be treated as having used such gasoline on a farm for farming purposes."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to gasoline purchased after December 31, 1989.

SEC. 6516. ALCOHOL FUELS CREDIT EXTENDED TO PRODUCTION OF ETBE.

(a) IN GENERAL.—Subparagraph (A) of section 40(b)(2) (relating to alcohol credit) is amended—

(1) by striking out "or" at the end of clause (i),

(2) by striking out the period at the end of clause (ii) and inserting in lieu thereof ", or", and

(3) by adding at the end thereof the following new clause:

"(iii) is used to produce ethyl tertiary butyl ether (ETBE).".

(b) ETBE NOT CONSIDERED AN ALCOHOL.—Subparagraph (A) of section 40(d)(1) (defining alcohol) is amended—

(1) by striking out "or" at the end of clause (i),

(2) by striking out the period at the end of clause (ii) and inserting in lieu thereof ", or", and

(3) by adding at the end thereof the following new clause:

"(iii) ethyl tertiary butyl ether (ETBE).".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1989.

SEC. 6517. AMENDMENTS RELATED TO EXCISE TAX ON VACCINES AND VACCINE INJURY COMPENSATION TRUST FUND.

(a) INACTIVATED POLIO VIRUS VACCINE EXEMPT FROM TAX.—Paragraph (5) of section 4132(a) (defining polio vaccine) is amended by adding at the end thereof the following new sentence: "Such term shall not include any inactivated polio vaccine sold by the manufacturer, producer, or importer after the last day on which any injury or death resulting from the administration of such vaccine on such day is eligible for compensation from the Vaccine Injury Compensation Trust Fund."

(b) AUTHORITY TO PAY ADMINISTRATIVE EXPENSES FROM TRUST FUND.—

(1) IN GENERAL.—Paragraph (1) of section 9510(c) (relating to expenditures from Vaccine Injury Compensation Trust Fund) is amended by inserting before the period at the end thereof the following: ", or for the payment of all expenses of administration (but not in excess of $6,000,000 for any fiscal year) incurred by the Federal Government in administering such subtitle".

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to fiscal years beginning after September 30, 1989.

Subtitle F—Miscellaneous Provisions

PART I—LIKE KIND EXCHANGES BETWEEN RELATED PERSONS

SEC. 6601. LIKE KIND EXCHANGES BETWEEN RELATED PERSONS.

(a) SPECIAL RULES FOR EXCHANGES BETWEEN RELATED PERSONS, ETC.—Section 1031 (relating to exchange of property held for productive use or investment) is amended by adding at the end thereof the following new subsections:

"(f) SPECIAL RULES FOR EXCHANGES BETWEEN RELATED PERSONS.—

"(1) IN GENERAL.—If—

"(A) a taxpayer exchanges property with a related person,

"(B) there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection), and

"(C) before the date 2 years after the date of the last transfer which was part of such exchange—

"(i) the related person disposes of such property, or

"(ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer,

there shall be no nonrecognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which the disposition referred to in subparagraph (C) occurs.

"(2) CERTAIN DISPOSITIONS NOT TAKEN INTO ACCOUNT.—For purposes of paragraph (1)(C), there shall not be taken into account any disposition—

"(A) by reason of the death of the taxpayer,

"(B) in a compulsory or involuntary convention (within the meaning of section 1033) if the exchange occurred before the threat or imminence of such conversion, or

"(C) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.

"(3) RELATED PERSON.—For purposes of this subsection, the term 'related person' means any person bearing a relationship to the taxpayer described in section 267(b).

"(4) TREATMENT OF CERTAIN TRANSACTIONS.—This section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection.

"(g) SPECIAL RULE WHERE SUBSTANTIAL DIMINUTION OF RISK.—

"(1) IN GENERAL.—If paragraph (2) applies to any property for any period, the running of the period set forth in subsection (f)(1)(C) with respect to such property shall be suspended during such period.

"(2) PROPERTY TO WHICH SUBSECTION APPLIES.—This paragraph shall apply to any property for any period during which the holder's risk of loss with respect to the property is substantially diminished by—

"(A) the holding of a put with respect to such property,

"(B) the holding by another person of a right to acquire such property, or

"(C) a short sale or any other transaction.

"(h) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including such regulations as may be necessary to prevent the avoidance of the purposes of this section."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to transfers after July 10, 1989, in taxable years ending after such date.

(2) BINDING CONTRACT.—The amendments made by this section shall not apply to any transfer pursuant to a written binding contract in effect on July 10, 1989, and at all times thereafter before the transfer.

PART II—MINIMUM TAX PROVISIONS

SEC. 6411. MODIFICATIONS OF MINIMUM TAX.

(a) TREATMENT OF CERTAIN DIVIDENDS.—

(1) IN GENERAL.—Clause (ii) of section 56(g)(4)(C) is amended to read as follows:

"(ii) SPECIAL RULE FOR CERTAIN DIVIDENDS.—

"(I) IN GENERAL.—Clause (i) shall not apply to any deduction allowable under section 243 or 245 for any dividend which is a 100-percent dividend or which is received from a 20-percent owned corporation (as defined in section 243(c)(2)), but only to the extent such dividend is attributable to income of the paying corporation which is subject to tax under this chapter (determined after the application of sections 936 and 921).

"(II) EXCEPTION.—Subclause (I) shall not apply to any 100-percent dividend if the corporation paying such dividend and the corporation receiving such dividend are members of an affiliated group of corporations which may file a consolidated return but does not.

"(III) 100-PERCENT DIVIDEND.—For purposes of the subclause (I), the term '100 percent dividend' means any dividend if the percentage used for purposes of determining the amount allowable as a deduction under section 243 or 245 with respect to such dividend is 100 percent."

(2) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 1989.

(b) MODIFICATION TO CORPORATE MINIMUM TAX CREDIT.—

(1) IN GENERAL.—Subparagraph (B) of section 53(d)(1) (relating to credit not allowed for exclusion preferences) is amended by adding at the end thereof the following new clause:

"(iv) CREDIT ALLOWABLE FOR EXCLUSION PREFERENCES OF CORPORATIONS.—In the case of a corporation—

"(I) the preceding provisions of this subparagraph shall not apply, and

"(II) the adjusted net minimum tax for any taxable year is the amount of the net minimum tax for such year increased by the amount of any credit not allowed under section 29 solely by reason of the application of section 29(b)(5)(B)."

(2) CONFORMING AMENDMENT.—Clause (ii) of section 53(d)(1)(B) is amended—

(A) by striking "subsections (b)(1) and (c)(3)" and inserting "subsection (b)(1)", and

(B) by striking the last sentence.

(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply for purposes of determining the adjusted net minimum tax for taxable years beginning after December 31, 1989.

(c) INSTALLMENT SALES.—

(1) IN GENERAL.—Section 56(g)(4)(D) is amended by adding at the end thereof the following new clause:

"(iii) INSTALLMENT SALES ON WHICH INTEREST CHARGED.—Subclause (III) of clause (i) shall not apply to the applicable percentage (as defined in section 453A(c)(4)) of the gain from any installment sale with respect to which section 453A(a)(1) applies."

(2) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 1989.

(d) APPRECIATED PROPERTY CHARITABLE DEDUCTION.—Paragraph (6) of section 57(a) is amended by adding at the end thereof the following new subparagraph:

"(C) PARAGRAPH INAPPLICABLE DURING 1990.—This paragraph shall not apply to any contribution made during any taxable year beginning during 1990."

PART III—ACCOUNTING PROVISIONS

SEC. 6421. REPEAL OF COMPLETED CONTRACT METHOD OF ACCOUNTING FOR LONG-TERM CONTRACTS.

(a) IN GENERAL.—Subsection (a) of section 460 (relating to special rules for long-term contracts) is amended to read as follows:

"(a) REQUIREMENT THAT PERCENTAGE OF COMPLETION METHOD BE USED.—In the case of any long-term contract, the taxable income from such contract shall be determined under the percentage of completion method (as modified by subsection (b))."

(b) ELECTION TO USE MODIFIED PERCENTAGE OF COMPLETION METHOD.—Subsection (b) of section 460 is amended by adding at the end thereof the following new paragraph:

"(5) ELECTION TO USE 15-PERCENT METHOD.—

"(A) GENERAL RULE.—In the case of any long-term contract with respect to which an election under this paragraph is in effect, the 15-percent method shall apply in determining the taxable income from such contract.

"(B) 15-PERCENT METHOD.—For purposes of this paragraph—

"(i) IN GENERAL.—The 15-percent method is the percentage of completion method, modified so that any item which would otherwise be taken into account in computing taxable income with respect to a contract for any taxable year before the 15-percent year is taken into account in the 15-percent year.

"(ii) 15-PERCENT YEAR.—The term '15-percent year' means the 1st taxable year as of the close of which at least 15 percent of the estimated total contract costs have been incurred.

"(C) ELECTION.—An election under this paragraph shall apply to all long-term contracts of the taxpayer which are entered into during the taxable year in which the election is made and any subsequent taxable year.

"(D) COORDINATION WITH OTHER PROVISIONS.—

"(i) SIMPLIFIED METHOD OF COST ALLOCATION.—This paragraph shall not apply to any taxpayer which uses a simplified procedure for allocation of costs under paragraph (3)(A).

"(ii) LOOK-BACK METHOD.—The 15-percent method shall be taken into account for purposes of applying the look-back method of paragraph (2) to any taxpayer making an election under this paragraph."

(c) CONFORMING AMENDMENTS.—

(1) Subsection (b) of section 460 is amended by striking paragraph (1) and by redesignating paragraphs (2) through (5) as paragraphs (1) through (4), respectively.

(2) Paragraph (1) of section 460(b), as redesignated by paragraph (1), is amended—

(A) by striking "paragraph (4)" and inserting "paragraph (3)", and

(B) by striking "paragraph (3)" and inserting "paragraph (2)".

(3) Paragraph (3) of section 460(b), as redesignated by paragraph (1), is amended by striking "Paragraph (2)(B) and subsection (a)(2)" and inserting "Paragraph (1)(B)".

(4) Subparagraph (A) of section 460(b)(4), as redesignated by paragraph (1), is amended—

(A) by striking "paragraph (3)" each place it appears and inserting "paragraph (2)",

(B) by striking "paragraph (3)(B)" and inserting "paragraph (2)(B)", and

(C) by striking "paragraph (3)(A)" and inserting "paragraph (2)(A)".

(5) Paragraph (5) of section 460(e) is amended by striking so much of such paragraph as precedes subparagraph (A) and inserting the following:

"(5) SPECIAL RULE FOR RESIDENTIAL CONSTRUCTION CONTRACTS WHICH ARE NOT HOME CONSTRUCTION CONTRACTS.—In the case of any residential construction contract which is not a home construction contract, subsection (a) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1989) shall apply except that such subsection shall be applied—".

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in this subsection, the amendments made by this section shall apply to contracts entered into on or after July 11, 1989.

(2) BINDING BIDS.—The amendments made by this section shall not apply to any contract resulting from the acceptance of a bid made before July 11, 1989. The preceding sentence shall apply only if the bid could not have been revoked or altered at any time on or after July 11, 1989.

(3) SPECIAL RULE FOR CERTAIN SHIP CONTRACTS.—The amendment made by this section shall not apply in the case of a qualified ship contract (as defined in section 10203(b)(2)(B) of the Revenue Act of 1987).

(4) 15-PERCENT METHOD.—The amendment made by subsection (b) shall apply to contracts entered into after December 31, 1989.

(e) STUDY.—The Secretary of the Treasury or his delegate shall conduct a study of the revenue realization method of accounting for long-term contracts and of improvements to the percentage of completion method of accounting for such contracts. No later than February 28, 1990, the Secretary shall submit a report on such study to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.

SEC. 6422. CHANGES IN TREATMENT OF TRANSFERS OF FRANCHISES, TRADEMARKS, AND TRADE NAMES.

(a) CONTINGENT PAYMENTS.—Paragraph (1) of section 1253(d) (relating to treatment of payments by transferee) is amended to read as follows:

"(1) CONTINGENT SERIAL PAYMENTS.—

"(A) IN GENERAL.—Any amount described in subparagraph (B) which is paid or incurred during the taxable year on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name shall be allowed as a deduction under section 162(a) (relating to trade or business expenses).

"(B) AMOUNTS TO WHICH PARAGRAPH APPLIES.—An amount is described in this subparagraph if it—

"(i) is contingent on the productivity, use, or disposition of the franchise, trademark, or trade name, and

"(ii) is paid as part of a series of payments—

"(I) which are payable not less frequently than annually throughout the entire term of the transfer agreement, and

"(II) which are substantially equal in amount (or payable under a fixed formula)."

(b) $100,000 LIMITATION ON CERTAIN PAYMENTS.—

(1) IN GENERAL.—Paragraph (2) of section 1253(d) is amended by adding at the end thereof the following new subparagraph:

"(B) $100,000 LIMITATION ON DEDUCTIBILITY OF PRINCIPAL SUM.—Subparagraph (A) shall not apply if the principal sum referred to in such subparagraph exceeds $100,000. For purposes of the preceding sentence, all payments which are part of the same transaction (or a series of related transactions) shall be taken into account as payments with respect to each such transaction."

(2) CONFORMING AMENDMENTS.—Paragraph (2) of section 1253(d) is amended—

(A) by striking all that precedes "If" and inserting:

"(2) CERTAIN PAYMENTS IN DISCHARGE OF PRINCIPAL SUMS.—

"(A) IN GENERAL.—", and

(B) by redesignating subparagraphs (A), (B), and (C) as clauses (i), (ii), and (iii), respectively.

(c) OTHER PAYMENTS, ETC.—Section 1253(d) is amended by adding at the end thereof the following new paragraphs:

"(3) OTHER PAYMENTS.—

"(A) IN GENERAL.—Any amount to which paragraph (1) or (2) does not apply shall be treated as an amount chargeable to capital account.

"(B) ELECTION TO RECOVER AMOUNTS OVER 20 YEARS.—

"(i) IN GENERAL.—If the taxpayer elects the application of this subparagraph, any amount chargeable to capital account shall be allowed as a deduction ratably over the 20-year period beginning with the taxable year in which the transfer occurs.

"(ii) CONSISTENT TREATMENT.—An election under clause (i) shall apply to all amounts which are part of the same transaction (or a series of related transactions).

"(4) RENEWALS, ETC.—For purposes of determining the term of a transfer agreement or any period of amortization under this subsection, there shall be taken into account all renewal options (and any other period for which the parties reasonably expect the agreement to be renewed)."

(b) TECHNICAL AMENDMENTS.—

(1) DEPRECIATION ALLOWABLE.—Subsection (r) of section 167 is hereby repealed.

(2) DEDUCTION SUBJECT TO RECAPTURE.—

(A) Subparagraph (C) of section 1245(a)(2) is amended by striking "or 193" and inserting "193, or 1253(d) (2) or (3)".

(B) The material preceding subparagraph (A) of section 1245(a)(3) is amended by striking "section 185" and inserting "section 185 or 1253(d) (2) or (3)".

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to transfers after October 2, 1989.

(2) BINDING CONTRACT.—The amendments made by this section shall not apply to any transfer pursuant to a written binding contract in effect on October 2, 1989, and at all times thereafter before the transfer.

SEC. 6623. 1989 DISASTER ASSISTANCE ACT PAYMENTS INCLUDED IN SPECIAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) IN GENERAL.—The second sentence of section 451(d) is amended—

(1) by striking "or" before "title II", and

(2) by inserting "or the Disaster Assistance Act of 1989," after "1988,".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to payments received before, on, or after the date of the enactment of this Act.

SEC. 6624. EXCLUSION OF DISCHARGE OF QUALIFIED FARM INDEBTEDNESS FROM GROSS INCOME INCREASED FOR CERTAIN SOLVENT FARMERS.

(a) IN GENERAL.—Section 108(g) (relating to special rules for discharge of qualified farm indebtedness) is amended by adding at the end thereof the following new paragraph:

"(4) SPECIAL LIMITATIONS FOR CERTAIN FARMERS.—

"(A) IN GENERAL.—With respect to a taxpayer who is described in subparagraph (C) of this paragraph—

"(i) the amount excluded under subparagraph (C) of subsection (a)(1) shall not exceed $350,000, and

"(ii) paragraph (2) of this subsection shall be applied without regard to subparagraph (B) thereof.

"(B) PRIOR DISCHARGES OF INDEBTEDNESS TAKEN INTO ACCOUNT.—If for any prior year a discharge of qualified farm indebtedness is excluded from the taxpayer's gross income under this subsection, subparagraph (A) shall be applied for the taxable year with respect to such discharge by reducing the dollar amount contained in such subparagraph by the amount of such excluded prior year discharges.

"(C) TAXPAYER DESCRIBED IN THIS SUBPARAGRAPH.—A taxpayer is described in this subparagraph if—

"(i) such taxpayer's modified adjusted gross income for 6 of the 10 taxable years preceding the taxable year in which the discharge of qualified farm indebtedness occurs is less than 100 percent of the national median adjusted gross income,

"(ii) more than 50 percent of the gross receipts of the taxpayer for 6 of the 10 taxable years preceding such taxable year are attributable to—

"(I) the trade or business of farming (within the meaning of section 2032A(e)(5)), or

"(II) the sale or lease of assets used in such trade or business, or

"(III) both,

"(iii) such taxpayer materially participated (within the meaning of section 2032A(e)(6)) in the trade or business described in clause (ii)(I) at the time the qualified farm indebtedness was incurred,

"(iv) the indebtedness of the taxpayer both before and after such discharge is equal to 70 percent or more of the equity in all property held by such taxpayer,

"(v) equity in all property held by the taxpayer after such discharge is less than the greater of—

"(I) $25,000, or

"(II) 150 percent of the excess (if any) of the tax imposed by this chapter determined as if this section did not apply to the transfer, over the tax imposed by this chapter determined with regard to this section, and

"(vi) such taxpayer, in transferring property in connection with the discharge of qualified farm indebtedness, transfers only farm property or other property acquired, produced, or held in connection with the taxpayer's trade or business of farming.

"(D) DEFINITIONS.—For purposes of this paragraph—

"(i) FARM PROPERTY.—The term 'farm property' means real and personal property used by the taxpayer in the trade or business of farming (within the meaning of section 2032A(e)(5)).

"(ii) MODIFIED ADJUSTED GROSS INCOME.—The term 'modified adjusted gross income' means adjusted gross income—

"(I) determined with regard to this section, and
"(II) increased by the amount of interest received or accrued by the taxpayer during the taxable year which is exempt from tax.
"(iii) EQUITY.—The term 'equity' means, with respect to any property, an amount equal to—
"(I) the fair market value of such property, minus
"(II) any indebtedness relating to such property."

(b) CONFORMING AMENDMENT.—Subparagraph (A) of section 108(g)(3) is amended by striking out "The amount" and inserting in lieu thereof "Except as provided in paragraph (4), the amount".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to discharges of indebtedness occurring after December 31, 1986 in taxable years ending after such date.

SEC. 4625. CERTAIN GOVERNMENTAL CONTRIBUTIONS IN AID OF CONSTRUCTION NOT INCLUDED IN GROSS INCOME.

(a) IN GENERAL.—Subsection (b) of section 118 is amended to read as follows:

"(b) CONTRIBUTIONS IN AID OF CONSTRUCTION, ETC.—For purposes of subsection (a)—

"(1) IN GENERAL.—Except as provided in paragraph (2), the term 'contribution to the capital of the taxpayer' does not include any contribution in aid of construction or any other contribution as a customer or potential customer.

"(2) EXCEPTION FOR CERTAIN GOVERNMENTAL CONTRIBUTIONS IN AID OF CONSTRUCTION OF WATER SUPPLIES.—

"(A) IN GENERAL.—In the case of a qualified governmental contribution—
"(i) paragraph (1) shall not apply, and
"(ii) such contribution shall be treated as a contribution to the capital of the taxpayer.

"(B) QUALIFIED GOVERNMENTAL CONTRIBUTION.—For purposes of this paragraph—
"(i) IN GENERAL.—The term 'qualified governmental contribution' means a contribution of money or other property by a Federal, State, or local government, or political subdivision thereof, to a regulated public utility which provides water or sewage disposal services if—
"(I) such contribution relates to a contribution in aid of construction of property described in clause (ii), and
"(II) such contribution (or any property acquired or constructed with such contribution) is not included in the taxpayer's rate base for ratemaking purposes.
"(ii) PROPERTY TO WHICH EXCEPTION APPLIES.—Property described in this clause is property which is used predominantly in furnishing alternate water supply systems for the purposes of—
"(I) remedying environmental contamination, or
"(II) protecting the health of individuals threatened by environmental contamination.

"(C) OTHER RULES.—Subparagraph (A) shall not apply to a contribution unless—
"(i) the contribution is used for the purposes described in subparagraph (B) before the end of the 2nd taxable year after the year in which the contribution was received, and
"(ii) accurate records are kept of the amounts contributed and expenditures made on the basis of the project for which the contribution was made and on the basis of the taxable year of contribution or expenditure.

"(D) DISALLOWANCE OF DOUBLE TAX BENEFIT.—Notwithstanding any other provision of this subtitle—
"(i) no deduction or credit shall be allowed for, or by reason of, any expenditure which constitutes a contribution in aid of construction to which this paragraph applies, and
"(ii) the adjusted basis of any property acquired with such expenditure shall be zero.

"(E) DEFINITIONS.—For purposes of this paragraph—
"(i) CONTRIBUTIONS IN AID OF CONSTRUCTION.—The term 'contribution in aid of construction' shall be defined by regulations prescribed by the Secretary; except that such term shall not include amounts paid as customer connection fees (including amounts paid to connect the customer's line to a main water or sewer line and amounts paid as service charges for starting or stopping services).

"(ii) PREDOMINANTLY.—The term 'predominantly' means 80 percent or more.

"(iii) REGULATED PUBLIC UTILITY.—The term 'regulated public utility' has the meaning given such term by section 7701(a)(33); except that such term shall not include any such utility which is not required to provide water or sewerage disposal services to members of the general public in its service area."

(b) CONFORMING AMENDMENT.—Section 362(c) is amended by adding after paragraph (2) the following new paragraph:

"(3) CONTRIBUTIONS IN AID OF CONSTRUCTION.—This subsection shall not apply to contributions in aid of construction to which section 118(b)(2) applies."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply as if included in the amendments made by section 824 of the Tax Reform Act of 1986.

SEC. 6626. MODIFICATION OF PASSIVE LOSS MATERIAL PARTICIPATION RULES FOR TIMBER ACTIVITIES.

(a) GENERAL RULE.—In the case of any taxable year beginning after December 31, 1986, Internal Revenue Service Temporary Regulations § 1.469-5T (or any corresponding similar regulation or ruling) shall be applied to any timber activity without regard to paragraph (b)(2)(iii) thereof (or any similar provision requiring an individual to participate more than a minimum number of hours in an activity in order to determine material participation under a facts and circumstances test).

(b) TIMBER ACTIVITY.—For purposes of subsection (a), the term "timber activity" means any activity which consists predominantly of the holding of qualified timber property (as defined in section 194(c)(1)) of the Internal Revenue Code of 1986.

SEC. 6627. ANNUAL ACCRUAL ACCOUNTING METHOD.

(a) IN GENERAL.—Subparagraph (B) of section 447(g)(4) is amended by striking "sugar cane" and inserting "any crop with respect to which the taxpayer properly used the annual accrual method of accounting for its last taxable year ending before January 1, 1987".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply as if included in the amendments made by the Tax Reform Act of 1986.

SEC. 6628. MODIFICATIONS TO PROVISIONS REQUIRING INTEREST ON INSTALLMENT SALES OF TIMESHARES AND RESIDENTIAL LOTS.

(a) GENERAL RULE.—Section 453A (relating to special rules for nondealers) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) SPECIAL RULES FOR INSTALLMENT SALES OF TIMESHARES AND RESIDENTIAL LOTS.—

"(1) IN GENERAL.—Notwithstanding subsection (b)—

"(A) in the case of a disposition described in section 453(l)(2)(B) by a C corporation—

"(i) this section shall apply to any installment obligation arising from such disposition for purposes of subsection (a)(1), but not for purposes of subsection (a)(2), and

"(ii) any such installment obligation shall not be taken into account for purposes of applying this section to other obligations, and

"(B) in the case of any disposition described in section 453(l)(2)(B) by any other taxpayer, this section shall not apply to any installment obligation arising from such disposition but the provisions of section 453(l)(2)(B) shall apply to such obligation.

"(2) MODIFICATION OF INTEREST RULES.—In the case of any installment obligation arising from a disposition described in paragraph (1)(A), interest on the deferred tax liability shall be computed as follows:

"(A) APPLICABLE PERCENTAGE.—The applicable percentage for purposes of subsection (c) shall be 100 percent.

"(B) DEFERRED TAX LIABILITY.—At the election of the taxpayer, deferred tax liability shall be computed under subsection (c)(3) with respect to all such obligations, except that—

"(i) the amount determined under subsection (c)(3)(A) for any taxable year shall be reduced by the excess (if any) of the total allowable deductions for the taxable year over the total income for such taxable year, and

"(ii) the amount determined under subsection (c)(3) (after application of clause (i)) shall be reduced by the excess (if any) of—

"(I) the credits allowable under part IV of subchapter A (other than subpart (C)) for such taxable year, over

"(II) the regular tax liability (as defined in section 26(b)) for such taxable year.

"(3) TIME FOR INCREASE IN TAX.—

"(A) IN GENERAL.—Notwithstanding subsection (c)(1), and except as provided in this paragraph, the amount of interest determined under this section with respect to any installment obligation arising from a disposition described in paragraph (1)(A) shall be an addition to the tax imposed by this chapter for the taxable year following the taxable year for which such interest is determined.

"(B) OBLIGATIONS HELD FOR LESS THAN 2 YEARS OR IN DEFAULT.—No increase in tax shall be made under subparagraph (A) with respect to an obligation to which subparagraph (A) applies—

"(i) for any taxable year ending before the date 2 years after the date of such disposition, or

"(ii) for any succeeding taxable year if such obligation is in default as of the close of such taxable year.

"(C) RECAPTURE.—If an obligation described in subparagraph (B)(ii) is not in default as of the close of any taxable year ending after the close of the 2-year period referred to in subparagraph (B)(i), the tax imposed by this chapter for the taxable year following such taxable year shall be increased by—

"(i) the excess (if any) of—

"(I) any increase which would have resulted under subparagraph (A) for any prior taxable year but for subparagraph (B), over

"(II) any portion of such increase previously recaptured under this subparagraph, and

"(ii) interest on the amount under clause (i) at the underpayment rate for the taxable years to which subparagraph (A) did not apply to such amount by reason of subparagraph (B)."

(b) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Subparagraph (A) of section 453(l)(3) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall not apply in the case of any obligation arising from a disposition by a C corporation."

(2) Subsection (b) of section 453A is amended by striking paragraph (4) and by redesignating paragraph (5) as paragraph (4).

(3) The section heading for section 453A is amended by inserting "; certain sales of timeshares and residential lots" before the period at the end thereof.

(4) The table of sections for subpart B of part II of subchapter E of chapter 1 is amended by inserting "; certain sales of timeshares and residential lots" before the period at the end of the item relating to section 453A.

(5) Section 6655(g)(1)(A) is amended by striking "plus" at the end of clause (iii), by striking "over" at the end of clause (iv) and inserting "plus," and by inserting after clause (iv) the following new clause:

"(v) any addition to tax under section 453A(e), over".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to installment sales in taxable years beginning after December 31, 1989.

SEC. 6629. FAMILY CORPORATIONS MAY ELECT NOT TO HAVE SECTION 447 SUSPENSE ACCOUNT RULES APPLY.

(a) ELECTION.—Paragraph (1) of section 447(i) (relating to suspense account for family corporations) is amended by inserting ", and such family corporation does not elect on its return of tax for such taxable year to have subsection (f) apply in lieu of this subsection" before ", notwithstanding".

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect as if included in the amendments made by section 10205(b) of the Revenue Act of 1987.

SEC. 6630. TREATMENT OF ASSET SALES BY COOPERATIVES.

(a) IN GENERAL.—Section 1388 is amended by redesignating subsection (k) as subsection (l) and by inserting after subsection (j) the following new subsection:

"(k) TREATMENT OF GAINS OR LOSSES ON THE DISPOSITION OF CERTAIN ASSETS.—

"(1) IN GENERAL.—For purposes of this title, if gain or loss from the disposition of any asset by an organization to which part I of this subchapter applies, would (without regard to this subsection) be treated as gain or loss from the sale or exchange of a capital asset, such organization may elect to treat the allocable portion of such gain or loss as ordinary income or loss and to include such gain or loss in net earnings of the organization from business done with or for patrons.

"(2) ALLOCABLE PORTION.—For purposes of paragraph (1), the term 'allocable portion' means the portion which bears the same ratio to the gain or loss from the sale or exchange of an asset as—

"(A) the extent to which the asset was used by an organization to facilitate the conduct of business done with or for patrons, bears to

"(B) the total use of the asset.

For purposes of subparagraph (A), the extent of use for such purpose shall be determined on the basis of any reasonable method for making allocations of income or expense between patronage and nonpatronage operations.

"(3) ELECTION.—An election made under this subsection shall be made at such time and in such manner as the Secretary may prescribe. Such election shall apply for the taxable year for which it is made and the 2 succeeding taxable years."

(b) EFFECTIVE DATES.—

(1) GENERAL RULE.—Subject to paragraph (2), the amendments made by subsection (a) shall apply to taxable years ending after the date of the enactment of this Act.

(2) APPLICATION TO PRIOR YEARS.—An election filed pursuant to section 1388(k) of the Internal Revenue Code of 1986 with a return for the first taxable year beginning on or before the date of enactment of this Act and ending after such date, shall apply to taxable years beginning before such date.

SEC. 6630A. QUALIFYING INCOME OF REAL ESTATE INVESTMENT TRUSTS.

(a) IN GENERAL.—Subparagraph (G) of section 856(c)(6) is amended by—

(1) by inserting ", or other similar arrangement," after "agreement" in clause (i),

(2) by inserting "or arrangement" after "agreement" in clause (ii), and

(3) by adding at the end thereof the following new sentence: "For purposes of clauses (i) and (ii) of this subparagraph, a real estate investment trust shall be treated as holding directly its proportionate share of the assets of a REMIC in which it owns a residual interest and a proportionate share of the regular interests of such REMIC shall be treated as direct indebtedness of such trust."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 6630B. RESERVES OF MUTUAL SAVINGS BANKS AND OTHER THRIFT INSTITUTIONS.

(a) IN GENERAL.—Section 593 (relating to reserves for losses on loans) is amended by adding at the end thereof the following new subsection:

"(f) ORGANIZATIONS FAILING 60-PERCENT ASSET TEST.—

"(1) GENERAL RULE.—In the case of any taxpayer described in subsection (a)(1) which ceases to be so described or which fails to meet the requirements of subsection (a)(2)—

"(A) except as provided in this subsection, this section shall not apply for the disqualification year or any succeeding taxable year, and

"(B) if the taxpayer maintained any reserve for bad debts for its last taxable year before the disqualification year, the rules of paragraph (3)(A) of section 585(c) (without regard to paragraph (4) thereof) shall apply for the disqualification year with respect to the portion of such reserve allocable to additions to such reserve under the experience method of subsection (b)(3).

"(2) SUBSEQUENT LOSSES.—If paragraph (1) applies, the taxpayer shall continue to maintain its remaining reserves for loans held by the taxpayer as of the 1st day of the disqualification year and—

(A) the rules of subsection (e) shall continue to apply to such reserves, and

(B) the taxpayer shall charge against such reserves for any taxable year losses resulting from loans held by the taxpayer on such 1st day to the extent that the cumulative losses from such loans as of the close of such taxable year (reduced by recoveries) does not exceed the cumulative amount included in gross income by reason of paragraph (1)(B) as of the close of such taxable year.

"(3) DISQUALIFICATION YEAR.—The term 'disqualification year' means the 1st taxable year ending after the date of the enactment of this subsection for which a taxpayer described in subsection (a)(1) ceases to be so described or fails to meet the requirements of subsection (a)(2).

"(4) ELECTION IRREVOCABLE.—An election under paragraph (1), once made, is irrevocable."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years ending after the date of the enactment of this Act.

SEC. 6630C. RESTORATION OF INCOME AVERAGING FOR QUALIFIED FARMERS.

(a) RESTORATION OF INCOME AVERAGING.—

(1) IN GENERAL.—Section 141 of the Tax Reform Act of 1986 is hereby repealed.

(2) APPLICATION OF THE INTERNAL REVENUE CODE OF 1986.—The Internal Revenue Code of 1986 shall be applied and administered without regard to section 141 of the Tax Reform Act of 1986 (and the amendments made by such section).

(b) INCOME AVERAGING ALLOWED FOR QUALIFIED FARMERS.—

(1) IN GENERAL.—Subsection (a) of section 1303 of the Internal Revenue Code of 1986 (defining eligible individual) is amended by inserting "and who is a qualified farmer" after "United States".

(2) QUALIFIED FARMER.—Section 1303 of such Code (defining eligible individuals) is amended by adding at the end thereof the following new subsection:

"(e) QUALIFIED FARMER.—For purposes of this section—

"(1) IN GENERAL.—The term 'qualified farmer' means a taxpayer—

"(A) who is an individual who materially participated (within the meaning of section 469(h)) in the trade or business of farming for each of the 3 preceding taxable years, and

"(B) whose gross receipts for the taxable year and each of the 3 preceding taxable years from the trade or business of farming does not exceed $5,000,000 ($2,500,000 in the case of a married individual filing a separate return).

"(2) FARMING.—For purposes of paragraph (1), activities constituting farming shall be determined under the principles of paragraphs (4) and (5) of section 2032A(e)."

(3) CONFORMING AMENDMENTS.—

(A) The heading of part I of subchapter Q of chapter 1 of such Code is amended by inserting "FOR FARMERS" after "AVERAGING".

(B) The table of parts for subchapter Q of chapter 1 of such Code is amended by inserting "for farmers" after "averaging" in the item relating to part I.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1989.

PART IV—EMPLOYMENT TAX PROVISIONS

SEC. 6631. TREATMENT OF AGRICULTURAL WORKERS UNDER WAGE WITHHOLDING.

(a) IN GENERAL.—Paragraph (2) of section 3401(a) (defining wages) is amended to read as follows:

"(2) for agricultural labor (as defined in section 3121(g)) unless the remuneration paid for such labor is wages (as defined in section 3121(a)); or".

(b) CREW LEADER RULES TO APPLY.—Section 3401 is amended by adding at the end thereof the following new subsection:

"(h) CREW LEADER RULES TO APPLY.—Rules similar to the rules of section 3121(o) shall apply for purposes of this chapter."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to remuneration paid after December 31, 1989.

SEC. 6632. ACCELERATION OF DEPOSIT REQUIREMENTS.

(a) IN GENERAL.—Section 6302 (relating to mode or time for collection) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) DEPOSITS OF SOCIAL SECURITY TAXES AND WITHHELD INCOME TAXES.—If, under regulations prescribed by the Secretary, a person is required to make deposits of taxes imposed by chapters 21 and 24 on the basis of eighth-month periods, such person shall make deposits of such taxes on the first banking day after any day on which such person has $250,000 or more of such taxes for deposit. Rules similar to the rules of section 5061(e)(3) shall apply to the $250,000 amount in the preceding sentence.".

(b) EFFECTIVE DATE.—

(1) GENERAL RULE.—Except as provided in paragraphs (2) and (3), the amendment made by subsection (a) shall apply to amounts required to be deposited after July 31, 1990.

(2) SPECIAL RULE FOR 1991 AND 1992.—In the case of amounts required to be deposited under the amendment made by subsection (a) on or after January 1, 1991, and before January 1, 1993, a person shall make deposits of taxes de-

scribed in the amendment made by subsection (a) not later than the close of the third banking day after any day on which such person has $250,000 or more of such taxes for deposit.

(3) RULE FOR 1995 AND THEREAFTER.—For calendar year 1995 and thereafter, the Secretary of the Treasury shall prescribe regulations with respect to the date on which deposits of such taxes shall be made in order to minimize the unevenness in the revenue effects of the amendment made by subsection (a).

PART V—TAX-EXEMPT BOND PROVISIONS

SEC. 6641. TAX TREATMENT OF 501(c)(3) BONDS SIMILAR TO GOVERNMENTAL BONDS.

(a) IN GENERAL.—Subsection (a) of section 150 (relating to definitions and special rules) is amended by striking paragraphs (2) and (4), by redesignating paragraphs (5) and (6) as paragraphs (4) and (5), respectively, and by inserting after paragraph (1) the following new paragraph:

"(2) EXEMPT PERSON.—

"(A) IN GENERAL.—The term 'exempt person' means—

"(i) a governmental unit, or

"(ii) a 501(c)(3) organization, but only with respect to its activities which do not constitute unrelated trades or businesses as determined by applying section 513(a).

"(B) GOVERNMENTAL UNIT NOT TO INCLUDE FEDERAL GOVERNMENT.—The term 'governmental unit' does not include the United States or any agency or instrumentality thereof.

"(C) 501(c)(3) ORGANIZATION.—The term '501(c)(3) organization' means any organization described in section 501(c)(3) and exempt from tax under section 501(a)."

(b) REPEAL OF QUALIFIED 501(c)(3) BOND DESIGNATION.—Section 145 (relating to qualified 501(c)(3) bonds) is repealed.

(c) CONFORMING AMENDMENTS.—

(1) Paragraph (3) of section 141(b) is amended—

(A) by striking "government use" in subparagraph (A)(ii)(I) and subparagraph (B)(ii) and inserting "exempt person use",

(B) by striking "a government use" in subparagraph (B) and inserting "an exempt person use",

(C) by striking "related business use" in subparagraph (A)(ii)(II) and subparagraph (B) and inserting "related private business use",

(D) by striking "RELATED BUSINESS USE" in the heading of subparagraph (B) and inserting "RELATED PRIVATE BUSINESS USE", and

(E) by striking "GOVERNMENT USE" in the heading thereof and inserting "EXEMPT PERSON USE".

(2) Subparagraph (A) of section 141(b)(6) is amended by striking "a governmental unit" and inserting "an exempt person".

(3) Paragraph (7) of section 141(b) is amended—

(A) by striking "government use" and inserting "exempt person use", and

(B) by striking "GOVERNMENT USE" in the heading thereof and inserting "EXEMPT PERSON USE".

(4) Section 141(b) is amended by striking paragraph (9).

(5) Paragraph (1) of section 141(c) is amended by striking "governmental units" and inserting "exempt persons".

(6) Section 141 is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) CERTAIN ISSUES USED TO PROVIDE RESIDENTIAL RENTAL HOUSING FOR FAMILY UNITS.—

"(1) IN GENERAL.—Except as provided in paragraph (2), for purposes of this title, the term 'private activity bond' includes any bond issued as part of an issue if any portion of the net proceeds of the issue are to be used (directly or indirectly) by an exempt person described in section 150(a)(2)(A)(ii) to provide residential rental property for family units.

"(2) EXCEPTION FOR BONDS USED TO PROVIDE QUALIFIED RESIDENTIAL RENTAL PROJECTS.—Paragraph (1) shall not apply to any bond issued as part of an issue if the portion of such issue which is to be used as described in paragraph (1) is to be used to provide—

"(A) a residential rental property for family units if the first use of such property is pursuant to such issue,

"(B) qualified residential rental projects (as defined in section 142(d)), or

"(C) property which is to be substantially rehabilitated in a rehabilitation beginning within the 2-year period ending 1 year after the date of the acquisition of such property.

"(3) SUBSTANTIAL REHABILITATION.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), rules similar to the rules of section 48(g)(1)(C) shall apply in determining for purposes of paragraph (2)(C) whether property is substantially rehabilitated.

"(B) EXCEPTION.—For purposes of subparagraph (A), clause (ii) of section 48(g)(1)(C) shall not apply, but the Secretary may extend the 24-month period in section 48(g)(1)(C)(i) where appropriate due to circumstances not within the control of the owner."

(7) Section 141(f), as redesignated by paragraph (6), is amended—

(A) by adding "or" at the end of subparagraph (E),

(B) by striking ", or" at the end of subparagraph (F), and inserting in lieu thereof a period, and

(C) by striking subparagraph (G).

(8) The last sentence of section 144(b)(1) is amended by striking "(determined" and all that follows to the period.

(9) Clause (ii) of section 144(c)(2)(C) is amended by striking "governmental unit" and inserting "exempt person".

(10) Section 146(g) is amended—

(A) by striking paragraph (2), and

(B) by redesignating the remaining paragraphs after paragraph (1) as paragraphs (2) and (3), respectively.

(11) The heading of section 146(k)(3) is amended by striking "GOVERNMENTAL" and inserting "EXEMPT PERSON".

(12) The heading of section 146(m) is amended by striking "GOVERNMENT" and inserting "EXEMPT PERSON".

(13) Subsection (h) of section 147 is amended to read as follows:

"(h) CERTAIN RULES NOT TO APPLY TO MORTGAGE REVENUE BONDS AND QUALIFIED STUDENT LOAN BONDS.—Subsections (a), (b), (c), and (d) shall not apply to any qualified mortgage bond, qualified veterans' mortgage bond, or qualified student loan bond."

(14) Section 147 is amended by striking paragraph (4) of subsection (b) and redesignating paragraph (5) of such subsection as paragraph (4).

(15) Subparagraph (F) of section 148(d)(3) is amended—

(A) by striking "or which is a qualified 501(c)(3) bond", and

(B) by striking "GOVERNMENTAL USE BONDS AND QUALIFIED 501(c)(3)" in the heading thereof and inserting "EXEMPT PERSON".

(16) Subclause (II) of section 148(f)(4)(B)(ii) is amended by striking "(other than a qualified 501(c)(3) bond)".

(17) Subparagraph (A) of section 148(f)(7) is amended by striking "(other than a qualified 501(c)(3) bond)".

(18) Paragraph (2) of section 149(d) is amended—

(A) by striking "(other than a qualified 501(c)(3) bond)", and

(B) by striking "CERTAIN PRIVATE" in the heading thereof and inserting in lieu thereof "PRIVATE".

(19) Section 149(e)(2) is amended—

(A) by striking "which is not a private activity bond" in the second sentence and inserting "which is a bond issued for an exempt person described in section 150(a)(2)(A)(i)", and

(B) by adding at the end thereof the following new sentence: "Subparagraph (D) shall not apply to any bond which is not a private activity bond but which would be such a bond if the 501(c)(3) organization using the proceeds thereof were not an exempt person."

(20) The heading of subsection (b) of section 150 is amended by striking "TAX-EXEMPT PRIVATE ACTIVITY BONDS" and inserting "CERTAIN TAX-EXEMPT BONDS".

(21) Paragraph (3) of section 150(b) is amended—

(A) by inserting "owned by a 501(c)(3) organization" after "any facility" in subparagraph (A),

(B) by striking "any private activity bond which, when issued, purported to be a tax-exempt qualified 501(c)(3) bond" in subparagraph (A) and inserting "any bond which, when issued, purported to be a tax-exempt bond, and which would be a private activity bond if the 501(c)(3) organization using the proceeds thereof were not an exempt person", and

(C) by striking the heading thereof and inserting "BONDS FOR EXEMPT PERSONS OTHER THAN GOVERNMENTAL UNITS.—".

(22) Paragraph (5) of section 150(b) is amended—

(A) by striking "private activity" in subparagraph (A),

(B) by inserting "and which would be a private activity bond if the 501(c)(3) organization using the proceeds thereof were not an exempt person" after "tax-exempt bond" in subparagraph (A),

(C) by striking subparagraph (B) and inserting the following new subparagraph:

"(B) such facility is required to be owned by an exempt person, and", and

(D) by striking "GOVERNMENTAL UNITS OR 501(C)(3) ORGANIZATIONS" in the heading thereof and inserting "EXEMPT PERSONS".

(23) Section 150 is amended by adding at the end thereof the following new subsection:

"(f) CERTAIN RULES TO APPLY TO BONDS FOR EXEMPT PERSONS OTHER THAN GOVERNMENTAL UNITS.—

"(1) IN GENERAL.—Nothing in section 103(a) or any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond which would be a private activity bond if the 501(c)(3) organization using the proceeds thereof were not an exempt person unless such bond satisfies the requirements of subsections (b) and (f) of section 147.

"(2) SPECIAL RULE FOR POOLED FINANCING OF 501(C)(3) ORGANIZATION.—

"(A) IN GENERAL.—At the election of the issuer, a bond described in paragraph (1) shall be treated as meeting the requirements of section 147(b) if such bond meets the requirements of subparagraph (B).

"(B) REQUIREMENTS.—A bond meets the requirements of this subparagraph if—

"(i) 95 percent or more of the net proceeds of the issue of which such bond is a part are to be used to make or finance loans to 2 or more 501(c)(3) organizations or governmental units for acquisition of property to be used by such organizations,

"(ii) each loan described in clause (i) satisfies the requirements of section 147(b) (determined by treating each loan as a separate issue),

"(iii) before such bond is issued, a demand survey was conducted which shows a demand for financing greater than an amount equal to 120 percent of the lendable proceeds of such issue, and

"(iv) 95 percent or more of the net proceeds of such issue are to be loaned to 501(c)(3) organizations or governmental units within 1 year of issuance and, to the extent there are any unspent proceeds after such 1-year period, bonds issued as part of such issue are to be redeemed as soon as possible thereafter (and in no event later than 18 months after issuance).

A bond shall not meet the requirements of this subparagraph if the maturity date of any bond issued as part of such issue is more than 30 years after the date on which the bond was issued (or, in the case of a refunding or series of refundings, the date on which the original bond was issued)."

(24) Section 1302 of the Tax Reform Act of 1986 is repealed.

(25) Subparagraph (C) of section 57(a)(5) is amended by striking clause (ii) and redesignating clauses (iii) and (iv) as clauses (ii) and (iii), respectively.

(26) Paragraph (3) of section 103(b) is amended by inserting "and section 150(f)" after "section 149".

(27) Paragraph (3) of section 265(b) is amended—

(A) by striking clause (ii) of subparagraph (B) and inserting the following:

"(ii) CERTAIN BONDS NOT TREATED AS PRIVATE ACTIVITY BONDS.—For purposes of clause (i)(II), there shall not be treated as a private activity bond any obligation issued to refund (or which is part of a series of obligations issued to refund) an obligation issued before August 8, 1986, which was not an industrial development bond (as defined in section 103(b)(2) as in effect on the day before the date of the enactment of the Tax Reform Act of 1986 (or a private loan bond (as defined in section 103(o)(2)(A), as so in effect, but without regard to any exemption from such definition other than section 103(o)(2)(A)).''; and

(B) by striking "(other than a qualified 501(c)(3) bond, as defined in section 145)" in subparagraph (C)(ii)(I).

(f) EFFECTIVE DATE; SPECIAL RULE.—

(1) EFFECTIVE DATE.—The amendments made by this section shall apply to bonds issued after December 31, 1989.

(2) SPECIAL RULE FOR CERTAIN BONDS ISSUED AFTER DECEMBER 31, 1989.—

(A) IN GENERAL.—The amendments made by this section shall not apply to any bond which—

(i) is issued after December 31, 1989, and

(ii) is part of an issue which is subject to any transitional rule under subtitle B of title XIII of the Tax Reform Act of 1986.

(B) ELECTION OUT.—This paragraph shall not apply to any issue with respect to which the issuer elects not to have this paragraph apply.

SEC. 6642. REFINANCINGS OF CERTAIN BOND ISSUES.

(a) IN GENERAL.—Section 141(c) of the Internal Revenue Code of 1986 shall not apply to any bond (or series of bonds) issued by a qualified issuer, the proceeds of which are used exclusively to refund (other than to advance refund) another bond if—

(1) the amount of such refunding bond does not exceed the outstanding amount of the refunded bond,

(2) the final maturity date of the refunding bond is not later than 6 months following the scheduled final maturity date of the issue of which the refunded bond is a part, and

(3) any financial benefit accruing as a result of a refunding under this provision will inure solely to the benefit of a State or local government, or an agency or political subdivision thereof.

(b) QUALIFIED ISSUER.—For purposes of this section, the term "qualified issuer" means any issuer who originally issued the bond to be refunded which was issued to alleviate the risk of default on the obligations of a financially troubled issuer which is a separate political subdivision.

(c) EFFECTIVE DATE.—This section shall apply to bonds issued on or after the date of the enactment of this Act.

SEC. 6643. TAX-EXEMPT FINANCING FOR SPORTS FACILITIES.

(a) IN GENERAL.—Subsection (a) of section 142 (defining exempt facility bonds) is amended—

(1) by striking "or" at the end of paragraph (10),

(2) by striking the period at the end of paragraph (11) and inserting ", or", and

(3) by adding at the end thereof the following new paragraph:

"(12) Sports facilities."

(b) GOVERNMENTALLY OWNED.—Subparagraph (A) of section 142(b)(1) (relating to facilities must be governmentally owned) is amended by striking "or (3)" and inserting (3), or (12)".

(c) EFFECTIVE DATE.—The amendment made by this section shall apply to bonds issued after December 31, 1989.

PART VI—INSURANCE PROVISIONS

SEC. 6651. STUDY RELATING TO SECTION 833 DEDUCTION.

(a) STUDY.—The Secretary of the Treasury or his delegate shall conduct a study of the eligibility for, and operation of, the deduction provided under section 833 of the Internal Revenue Code of 1986. The study shall include an examination of whether organizations in existence on August 16, 1986, which are similar to Blue Cross and Blue Shield organizations should also be eligible for the section 833 deduction.

(b) REPORT.—Not later than March 15, 1990, the Secretary shall submit to the Finance Committee of the Senate and the Committee on Ways and Means of the House of Representatives a report on the study conducted under this section, together with such recommendations as he may deem advisable.

SEC. 6652. RESERVES ON MINIMUM PREMIUM PLANS.

(a) IN GENERAL.—For purposes of section 832(b)(4) of the Internal Revenue Code of 1986 (or any corresponding provision of prior law), the term "unearned premiums" shall include any reserve maintained pursuant to State law (or any rules or regulations thereunder) by such insurance company for future claims payments upon the termination of any minimum premium plan to the extent a premium or other consideration corresponding to such reserve has been included in the gross income of such company.

(b) EFFECTIVE DATE.—The provisions of subsection (a) shall apply to taxable years beginning before, on, or after the date of the enactment of this Act.

PART VII—COMPLIANCE

SEC. 6661. NOTICE OF UNDERREPORTING OF AMOUNTS WITHHELD.

(a) In General.—Chapter 77 (relating to miscellaneous provisions) is amended by adding at the end thereof the following new section:

"SEC. 7523. NOTICE OF UNDERREPORTING OF AMOUNTS WITHHELD.

"(a) In General.—If, in connection with 1 or more information return matching programs, the Secretary determines that with respect to information returns examined under such programs—

"(1) the amount shown on information returns as deducted and withheld as tax for any taxable year, exceeds by $5 or more,

"(2) the amount shown on the return of tax for such taxable year as deducted and withheld as tax,

the Secretary shall notify the taxpayer of such excess.

"(b) Information Return.—For purposes of subsection (a), the term 'information return' has the meaning given such term by section 6724(d)(1). The Secretary may prescribe other returns which are to be treated as information returns for purposes of this section.".

(b) Clerical Amendment.—The table of sections for chapter 77 of such Code is amended by adding at the end thereof the following new item:

"Sec. 7523. Notice of underreporting of amounts withheld.".

(c) Effective Date.—The amendments made by this section shall apply to information return matching occurring after the date of the enactment of this Act.

SEC. 6662. STATUTE OF LIMITATIONS FOR CERTAIN REFUND CLAIMS.

Notwithstanding section 6511 of the Internal Revenue Code of 1986, if a claim for credit or refund of overpayment of the tax imposed under chapter 1 of such Code relates to an overpayment of tax attributable to the taxpayer's failure to take proper credit for amounts of tax withheld by the payor of any income included in such taxpayer's gross income for the taxable year ending December 31, 1985, such credit or refund may be allowed if claim therefor is filed on or before April 15, 1990.

SEC. 6663. INCREASE IN THRESHOLD FOR JOINT COMMITTEE REFUND REVIEW.

(a) General Rule.—Subsections (a) and (b) of section 6405 (relating to reports of refunds and credits) are each amended by striking "$200,000" and inserting "$1,000,000".

(b) Effective Date.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act, except that such amendment shall not apply with respect to any refund or credit with respect to which a report has been made before the date of the enactment of this Act under subsection (a) or (b) of section 6405 of the Internal Revenue Code of 1986.

PART VIII—EXEMPT ORGANIZATIONS

SEC. 6671. COOPERATIVE SERVICE ORGANIZATIONS FOR CERTAIN FOUNDATIONS.

(a) In General.—Section 501 (relating to exemption from tax on corporations, certain trusts, etc.) is amended by redesignating subsection (n) as subsection (o) and by inserting after subsection (m) the following new subsection:

"(n) Cooperative Service Organizations for Certain Foundations.—

"(1) In general.—For purposes of this title, if an organization—

"(A) is organized and operated solely for purposes referred to in subsection (f)(1),

"(B) is comprised exclusively of members which are exempt from taxation under subsection (a) and are—

"(i) private foundations, or

"(ii) community foundations as to which section 170(b)(1)(A)(vi) applies,

"(C) has at least 20 members,

"(D) does not have a member which holds more than 10 percent (by value) of the interests in the organization,

"(E) is not controlled by any 1 member and does not have a member which controls another member of the organization, and

"(F) permits members of the organization to dismiss the organization's investment advisor, following reasonable notice, upon a vote of the members holding a majority of interest in the organization,

then such organization shall be treated as an organization organized and operated exclusively for charitable purposes.

"(2) TREATMENT OF INCOME OF MEMBERS.—If any member of an organization described in paragraph (1) is a private foundation (other than an exempt operating foundation, as defined in section 4940(d)), such private foundation's proportionate share of the net income of the organization (including capital gains) for any taxable year of the organization shall be treated, for purposes of section 4940, as net investment income of such private foundation (whether or not distributed to such foundation) for the taxable year of such private foundation in which the taxable year of the organization described in paragraph (1) ends.

"(3) APPLICABLE EXCISE TAXES.—Subchapter A of chapter 42 (other than sections 4940 and 4942) shall apply to any organization described in paragraph (1)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1989.

SEC. 6672. CERTAIN EXISTING ARRANGEMENTS EXEMPT FROM EXCISE TAX ON SELF-DEALING INVOLVING PRIVATE FOUNDATIONS.

(a) IN GENERAL.—Section 4941(d) (defining self-dealing) is amended by adding at the end thereof the following new paragraph:

"(3) EXCEPTION FOR EXISTING ARRANGEMENTS OF ORGANIZATIONS BECOMING PRIVATE FOUNDATIONS.—

"(A) GENERAL RULE.—If—

"(i) an organization becomes a private foundation with respect to any taxable year, and

"(ii) such organization is an organization described in section 501(c)(3) which met the requirements of section 509(a)(2) during at least 3 taxable years preceding the taxable year described in clause (i) (hereinafter referred to as the 'qualification period'),

then any act pursuant to a qualified existing arrangement shall not be treated as an act of self-dealing for purposes of this section for the period provided by an existing binding contract entered into more than 2 years before the beginning of the taxable year described in clause (i) or a 5-year period beginning with such year, whichever is longer.

"(B) QUALIFIED EXISTING ARRANGEMENT.—For purposes of subparagraph (A), the term 'qualified existing arrangement' means any of the following arrangements if such arrangements are the result of arm's-length transactions:

"(i) The leasing by a disqualified person to the private foundation of office space in a building with other tenants who are not disqualified persons if the leasing is pursuant to a binding lease in effect during the qualification period, or pursuant to a renewal of such lease.

"(ii) The furnishing of goods, services (including banking services), or facilities by a disqualified person to the private foundation pursuant to an arrangement in effect during the qualification period (or any renewal thereof).

"(iii) The sale of property from the private foundation to a disqualified person pursuant to a binding contract in effect during the qualification period.

"(iv) To the extent provided by regulation, any other arrangement which was in effect between a private foundation and a disqualified person during the qualification period.

"(C) RENEWALS OR MODIFICATIONS.—Any renewal or modification of a qualified existing arrangement may not substantially modify such arrangement.

"(D) EXCEPTION FOR SUBSTANTIAL CONTRIBUTORS.—Subparagraph (A) shall not apply to any qualified existing arrangement between a private foundation and a disqualified person who is a substantial contributor to the foundation."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

PART IX—OTHER PROVISIONS

SEC. 6681. ADOPTION EXPENSES.

(a) IN GENERAL.—Part VII of subchapter B of chapter 1 is amended by redesignating section 221 as section 222 and by inserting after section 221 the following new section:

"SEC. 221. SPECIAL NEEDS ADOPTION EXPENSES DEDUCTION.

"(a) ALLOWANCE OF DEDUCTION.—In the case of an individual, there shall be allowed as a deduction for the taxable year the amount of the qualified adoption expenses paid or incurred by the individual for such taxable year.

"(b) LIMITATIONS.—

"(1) MAXIMUM DOLLAR AMOUNT.—The aggregate amount of adoption expenses which may be taken into account under subsection (a) with respect to the adoption of a child shall not exceed $3,000.

"(2) DENIAL OF DOUBLE BENEFIT.—

"(A) IN GENERAL.—No deduction shall be allowable under subsection (a) for any expense for which a deduction or credit is allowable under any other provision of this chapter.

"(B) REIMBURSEMENTS.—If a taxpayer is reimbursed for any qualified adoption expenses for which a deduction was allowed under subsection (a), the amount of such reimbursement shall be includible in the gross income of the taxpayer in the taxable year in which such reimbursement was received.

"(c) DEFINITIONS.—For purposes of this section—

"(1) QUALIFIED ADOPTION EXPENSES.—The term 'qualified adoption expenses' means reasonable and necessary adoption fees, court costs, attorneys fees, and other expenses which—

"(A) are directly related to the legal adoption of a child with special needs by the taxpayer,

"(B) are not incurred in violation of State or Federal law, and

"(C) are of a type eligible for reimbursement under the adoption assistance program under part E of title IV of the Social Security Act.

"(2) CHILD WITH SPECIAL NEEDS.—The term 'child with special needs' means any child determined by the State to be a child described in paragraphs (1) and (2) of section 473(c) of the Social Security Act."

(b) DEDUCTION ALLOWED WHETHER OR NOT TAXPAYER ITEMIZES DEDUCTIONS.—Subsection (a) of section 62 is amended by inserting after paragraph (13) the following new paragraph:

"(14) ADOPTION EXPENSES.—The deduction allowed by section 221 (relating to deduction for expenses of adopting a child with special needs)."

(c) CLERICAL AMENDMENT.—The table of sections for part VII of subchapter B of chapter 1 is amended by striking the item relating to section 221 and by inserting the following new items:

"Sec. 221. Special needs adoption expenses deduction.
"Sec. 222. cross reference."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1989.

SEC. 6682. TREATMENT OF DISTRIBUTIONS BY PARTNERSHIPS OF CONTRIBUTED PROPERTY.

(a) GENERAL RULE.—Subsection (c) of section 704 (relating to contributed property) is amended to read as follows:

"(c) CONTRIBUTED PROPERTY.—

"(1) IN GENERAL.—Under regulations prescribed by the Secretary—

"(A) income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution, and

"(B) if any property so contributed is distributed by the partnership (other than to the contributing partner) within 3 years of being contributed—

"(i) the contributing partner shall be treated as recognizing gain or loss (as the case may be) from the sale of such property in an amount equal to the gain or loss which would have been allocated to such partner under subparagraph (A) by reason of the variation described in subparagraph (A) if the property had been sold at its fair market value at the time of the distribution,

"(ii) the character of such gain or loss shall be determined by reference to the character of the gain or loss which would have resulted if such property had been sold by the partnership to the distributee, and

"(iii) appropriate adjustments shall be made to the adjusted basis of the contributing partner's interest in the partnership and to the adjusted basis of the property distributed to reflect any gain or loss recognized under this subparagraph.

"(2) SPECIAL RULE FOR DISTRIBUTIONS WHERE GAIN OR LOSS WOULD NOT BE RECOGNIZED OUTSIDE PARTNERSHIPS.—Under regulations prescribed by the Secretary, if—

"(A) property contributed by a partner (hereinafter referred to as the 'contributing partner') is distributed by the partnership to another partner, and

"(B) other property of a like kind (within the meaning of section 1031) is distributed by the partnership to the contributing partner not later than the earlier of—

"(i) the 180th day after the date of the distribution described in subparagraph (A), or

"(ii) the due date (determined with regard to extensions) for the contributing partner's return of the tax imposed by this chapter for the taxable year in which the distribution described in subparagraph (A) occurs,

then to the extent of the value of the property described in subparagraph (B), paragraph (1)(B) shall be applied as if the contributing partner had contributed to the partnership the property described in subparagraph (B).

"(3) OTHER RULES.—Under regulations prescribed by the Secretary, rules similar to the rules of paragraph (1) shall apply to contributions by a partner (using the cash receipts and disbursements method of accounting) of accounts payable and other accrued but unpaid items. Any reference in paragraph (1) or (2) to the contributing partner shall be treated as including a reference to any successor of such partner."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply in the case of property contributed to the partnership after October 3, 1989, in taxable years ending after such date.

SEC. 6483. REPEAL NET INCOME LIMITATION FOR PERCENTAGE DEPLETION ON MARGINAL OIL AND GAS PRODUCTION.

(a) IN GENERAL.—Subsection (c) of section 613A (relating to limitations on percentage depletion in the case of oil and gas wells) is amended by adding at the end thereof the following new paragraph:

"(14) MARGINAL PRODUCTION.—

"(A) IN GENERAL.—In the case of marginal production the second sentence of section 613(a) shall not apply.

"(B) MARGINAL PRODUCTION.—For purposes of this paragraph—

"(i) IN GENERAL.—The term 'marginal production' means—

"(I) crude oil and natural gas which is from a stripper well, or

"(II) crude oil which is heavy oil.

"(ii) STRIPPER WELL.—The term 'stripper well' means any oil or gas well which produced at its maximum efficient rate of flow (as determined in accordance with recognized conservation practices designed to maximize the ultimate recovery of petroleum products) an average of 15 or less equivalent barrels per production day during any 6-month period beginning after December 31, 1985.

"(iii) EQUIVALENT BARRELS.—The term 'equivalent barrels' means the sum of—

"(I) the number of barrels of crude oil produced, and

"(II) the number of cubic feet of natural gas produced divided by 6,000.

"(iv) HEAVY OIL.—The term 'heavy oil' means domestic crude oil produced from any property if such crude oil had a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit).

"(v) SPECIAL RULE.—

"(I) UNITIZATIONS OR POOLINGS.—In the case of unitizations or poolings involving multiple wells, production shall be allocated to all unitized wells (including injection wells) on the basis of sound engineering principles.

"(II) PRODUCTION IN EXCESS OF STRIPPER AMOUNTS.—If an oil or gas well is classified as a stripper well under this paragraph for any period, such well shall continue to be treated as a stripper well even if production exceeds the limit under clause (ii), except that this paragraph shall only apply to production not in excess of such limit."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1990.

SEC. 6684. TREATMENT OF TUXEDOS HELD FOR RENTAL.

(a) TUXEDOS TREATED AS 3-YEAR PROPERTY.—Section 168(e)(3)(A) (relating to 3-year property) is amended—

(1) by striking "and" at the end of clause (i),

(2) by striking the period at the end of clause (ii) and inserting a comma and "and", and

(3) by adding at the end the following new clause:

"(iii) any tuxedo held for rental."

(b) RULES FOR DETERMINING CLASS LIFE.—The table in subparagraph (B) of section 168(g)(3) of such Code is amended by inserting above the item relating to subparagraph (B)(ii) the following new item:

"(A)(iii) .... 2".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to rental tuxedos placed in service after December 31, 1989.

SEC. 6685. EXPENSING OF CERTAIN CAPITAL EXPENDITURES TO ASSIST DISABLED.

(a) ADDITIONAL ITEMS ELIGIBLE FOR EXPENSING.—Section 190(b) (relating to definitions) is amended by adding at the end thereof the following new paragraph:

"(4) CERTAIN ITEMS INCLUDED.—

"(A) IN GENERAL.—The term 'qualified architectural and transportation barrier removal expense' shall include any of the following expenses in connection with a trade or business which are chargeable to capital account:

"(i) Expenses for auxiliary aids and services.

"(ii) Expenses in connection with providing reasonable accommodations to individuals with disabilities.

"(B) AUXILIARY AIDS AND SERVICES.—The term 'auxiliary aids and services' includes—

"(i) qualified interpreters or other effective methods of making aurally delivered materials available to individuals with hearing impairments;

"(ii) qualified readers, taped texts, or other effective methods of making visually delivered materials available to individuals with visual impairments;

"(iii) acquisition or modification of equipment or devices; and

"(iv) other similar services and actions.

"(C) REASONABLE ACCOMMODATION.—The term 'reasonable accommodation' includes—

"(i) making existing facilities used by employees readily accessible to and usable by individuals with disabilities; and

"(ii) job restructuring, part-time or modified work schedules, reassignment to a vacant position, acquisition or modification of equipment or devices, appropriate adjustment or modifications of examinations, training materials or policies, the provision of qualified readers or interpreters, and other similar accommodations for individuals with disabilities."

(b) DECREASE IN MAXIMUM AMOUNT WHICH MAY BE EXPENDED.—Section 190(c) is amended by striking "$35,000" and inserting "$25,000".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1989.

SEC. 6686. TAX EXEMPTION FOR OVERSEAS PRIVATE INVESTMENT CORPORATION.

(a) GENERAL RULE.—Subsection (l) of section 501 (relating to government corporations exempt under subsection (c)(1)) is amended by adding at the end thereof the following new paragraph:

"(4) The Overseas Private Investment Corporation established under the Foreign Assistance Act of 1961."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

SEC. 6687. ELIMINATION OF RETROACTIVE CERTIFICATION OF EMPLOYEES FOR WORK INCENTIVE JOBS CREDIT.

(a) IN GENERAL.—So much of subparagraph (A) of section 50B(h)(1) of the Internal Revenue Code of 1954 (as in effect for taxable years beginning before January 1, 1982) as precedes clause (i) thereof is amended to read as follows:

"(A) who has been certified (or for whom a written request for certification has been made) on or before the day the individual began work for the taxpayer by the Secretary of Labor or by the appropriate agency of State or local government as—".

(b) EFFECTIVE DATE.— The amendment made by subsection (a) shall apply for purposes of credits first claimed after March 11, 1987.

SEC. 6688. UNEARNED INCOME ATTRIBUTABLE TO PERSONAL INJURY AWARDS.

(a) IN GENERAL.—Paragraph (4) of section 1(i) (defining net unearned income) is amended by redesignating subparagraph (B) as subparagraph (C) and by inserting after subparagraph (A) the following new subparagraph:

"(B) EXCEPTION FOR UNEARNED INCOME ATTRIBUTABLE TO PERSONAL INJURY AWARDS.—

"(i) IN GENERAL.—There shall not be taken into account under clause (i) of subparagraph (A) any qualified injury award income.

"(ii) QUALIFIED INJURY AWARD INCOME.—For purposes of clause (i), the term 'qualified injury award income' means income attributable to an amount excluded from the gross income of the child by reason of section 104(a)(2) if—

"(I) such excluded amount is received by the child in a lump sum, and

"(II) such income accrues on such excluded amount while in a custodial account (other than a trust) the amounts in which are prohibited under State law from being used to satisfy any person's obligation to support or maintain such child."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1986.

PART X—ESTATE AND GIFT TAX PROVISIONS

SEC. 6691. REPEAL OF SECTION 2036(c).

(a) GENERAL RULE.—Section 2036 (relating to transfers with retained life estate) is amended by striking subsection (c) and by redesignating subsection (d) as subsection (c).

(b) CONFORMING AMENDMENTS.—

(1) Section 2207B is hereby repealed.

(2) The table of sections for subchapter C of chapter 11 is amended by striking the item relating to section 2207B.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply in the case of property transferred after December 17, 1987.

SEC. 6692. EXEMPTION FROM GENERATION-SKIPPING TAX FOR CERTAIN TRANSFERS TO GRANDCHILDREN.

(a) GENERAL RULE.—Subsection (c) of section 2612 (defining direct skip) is amended by adding at the end thereof the following new paragraph:

"(4) TREATMENT OF CERTAIN TRANSFERS TO GRANDCHILDREN.—

"(A) IN GENERAL.—The term 'direct skip' shall not include any transfer from a transferor to a grandchild of the transferor to the extent the aggregate transfers from such transferor to such grandchild do not exceed $2,000,000. Paragraph (2) shall not apply in determining whether an individual is a grandchild of the transferor.

"(B) TREATMENT OF TRANSFERS IN TRUST.—For purposes of subparagraph (A), a transfer in trust for the benefit of a grandchild shall be treated as a transfer to such grandchild if (and only if)—

"(i) during the life of the grandchild, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such grandchild, and

"(ii) the assets of the trust will be includible in the gross estate of the grandchild if the grandchild dies before the trust is terminated.

"(C) COORDINATION WITH SECTION 2653(a).—In the case of any transfer which would be a generating-skipping transfer but for subparagraph (A), the rules of section 2653(a) shall apply as if such transfer were a generation-skipping transfer.

"(D) COORDINATION WITH TAXABLE TERMINATIONS AND TAXABLE DISTRIBUTIONS.—The terms 'taxable termination' and 'taxable distribution' shall not include any transfer which would be a direct skip but for subparagraph (A)."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply to transfers after October 3, 1989.

(2) PRIOR TRANSFERS TAKEN INTO ACCOUNT.—In determining whether any transfer is not a direct skip by reason of the amendment made by subsection (a), transfers by the transferor which were not treated as direct skips by reason of section 1433(b)(3) of the Tax Reform Act of 1986 shall be taken into account.

SEC. 6693. DISALLOWANCE OF DEPRECIATION FOR CERTAIN TERM INTERESTS.

(a) GENERAL RULE—Section 167 (as amended by section 6622) is amended by inserting after subsection (q) the following new subsection:

"(r) CERTAIN TERM INTERESTS NOT DEPRECIABLE.—

"(1) IN GENERAL.—No depreciation deduction shall be allowed under this section (and no depreciation or amortization deduction shall be allowed under any other provision of this subtitle) to the taxpayer for any term interest in property for any period during which the remainder interest in such property is held (directly or indirectly) by a related person.

"(2) LOSS WHEN TERM INTEREST TERMINATES.—If any term interest to which paragraph (1) applied terminates, for the taxable year in which such termination occurs, the taxpayer shall be treated as having a loss from the sale or exchange of such interest in an amount no greater than the aggregate amount disallowed to the taxpayer under paragraph (1) with respect to such interest.

"(3) COORDINATION WITH SECTION 273.—This subsection shall not apply to any interest to which section 273 applies.

"(4) DEFINITIONS.—For purposes of this subsection—

"(A) TERM INTEREST IN PROPERTY.—The term 'term interest in property' has the meaning given such term by section 1001(e)(2).

"(B) RELATED PERSON.—The term 'related person' means any person bearing a relationship to the taxpayer described in subsection (b) or (e) of section 267.

"(5) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including regulations preventing avoidance of this subsection through cross-ownership arrangements or otherwise."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to interests acquired after July 27, 1989, in taxable years ending after such date.

SEC. 6694. CLARIFICATION OF WAIVER OF RIGHT OF RECOVERY IN CASE OF CERTAIN MARITAL DEDUCTION PROPERTY.

(a) GENERAL RULE.—Paragraph (2) of section 2207A(a) (relating to right of recovery with respect to estate tax) is amended to read as follows:

"(2) DECEDENT MAY OTHERWISE DIRECT BY WILL.—Paragraph (1) shall not apply if the decedent otherwise directs in a provision of his will (or a revocable trust) specifically referring to this section."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to the estates of decedents dying after the date of the enactment of this Act.

SEC. 6695. ADJUSTMENTS FOR GIFTS WITHIN 3 YEARS OF DECEDENT'S DEATH.

(a) GENERAL RULE.—Section 2035 is amended to read as follows:

"SEC. 2035. ADJUSTMENTS FOR GIFTS MADE WITHIN 3 YEARS OF DECEDENT'S DEATH.

"(a) INCLUSION OF CERTAIN PROPERTY IN GROSS ESTATE.—If—

"(1) the decedent made a transfer (by trust or otherwise) of an interest in any property during the 3-year period ending on the date of the decedent's death, and

"(2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest had been retained by the decedent on the date of his death,

the value of the gross estate shall include the value of any property (or interest therein) which would have been so included. The preceding sentence shall not apply to any transfer from a trust with respect to which the decedent retained the right to revoke unless such sentence would apply to such transfer if made directly by the decedent.

"(b) INCLUSION OF GIFT TAX ON GIFTS MADE DURING 3 YEARS BEFORE DECEDENT'S DEATH.—The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death.

"(c) OTHER RULES RELATING TO TRANSFERS WITHIN 3 YEARS OF DEATH.—

"(1) IN GENERAL.—For purposes of—

"(A) section 303(b) (relating to distributions in redemption of stock to pay death taxes),

"(B) section 2032A (relating to special valuation of certain farms, etc., real property), and

"(C) subchapter C of chapter 64 (relating to lien for taxes),

the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.

"(2) COORDINATION WITH SECTION 6166.—An estate shall be treated as meeting the 35 percent of adjusted gross estate requirement of section 6166(a)(1) only if the estate meets such requirement both with and without the application of paragraph (1).

"(3) SMALL TRANSFERS.—Paragraphs (1) and (2) shall not apply to any transfer (other than a transfer with respect to a life insurance policy) made during a calendar year to any donee if the decedent was not required by section 6019 (other than by reason of section 6019(a)(2)) to file any gift tax return for such year with respect to transfers to such donee.

"(d) EXCEPTION.—Subsection (a) shall not apply to any bona fide sale for an adequate and full consideration in money or money's worth."

(b) TREATMENT OF CERTAIN RELINQUISHMENTS UNDER SECTION 2038.—Paragraph (1) of section 2038(a), and the first sentence of section 2038(a)(2), are each amended by inserting before the period at the end thereof the following: "(except that such a relinquishment shall not be treated as occurring merely by reason of a transfer from a trust with respect to which the decedent had reserved the right to revoke)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to the estates of decedents dying after the date of the enactment of this Act.

SEC. 6696. CLARIFICATION OF QUALIFIED TERMINABLE INTEREST RULES.

(a) GENERAL RULE.—

(1) ESTATE TAX.—Subparagraph (B) of section 2056(b)(7) (defining qualified terminable interest property) is amended by adding at the end thereof the following new clause:

"(vi) TREATMENT OF CERTAIN INCOME DISTRIBUTIONS.—An income interest shall not fail to qualify as a qualified income interest for life solely because income for the period after the last distribution date and on or before the date of the surviving spouse's death is not required to be distributed to the surviving spouse or the estate of the surviving spouse."

(2) GIFT TAX.—Paragraph (3) of section 2523(f) is amended by striking "and (iv)" and inserting ", (iv), and (vi)".

(b) CLARIFICATION OF SUBSEQUENT INCLUSION.—Section 2044 is amended by adding at the end thereof the following new subsection:

"(d) CLARIFICATION OF CERTAIN INCOME.—The amount included in the gross estate under subsection (a) shall include the amount of any income from the property to which this section applies for the period after the last distribution date and on or before the date of the decedent's death if such income is not otherwise included in the decedent's gross estate."

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply with respect to the estates of decedents dying, and gifts made, after October 3, 1989,

(2) APPLICATION OF SECTION 2044 TO TRANSFER BEFORE OCTOBER 4, 1989.—In the case of the estate of any decedent dying after October 3, 1989, if there was a transfer of property before October 4, 1989—

(A) such property shall not be included in the gross estate of the decedent under section 2044 of the Internal Revenue Code of 1986 if no prior martial deduction was claimed by a spouse of the decedent, but

(B) such property shall be so included if such a deduction was allowed.

Subtitle G—Revision of Civil Penalties

PART I—DOCUMENT AND INFORMATION RETURN PENALTIES

SEC. 6711. UNIFORM PENALTIES FOR FAILURES TO COMPLY WITH CERTAIN INFORMATION REPORTING REQUIREMENTS.

(a) GENERAL RULE.—Part II of subchapter B of chapter 68 (relating to failure to file certain information returns or statements) is amended to read as follows:

"PART II—FAILURE TO COMPLY WITH CERTAIN INFORMATION REPORTING REQUIREMENTS

"SEC. 6721. FAILURE TO FILE CORRECT INFORMATION RETURNS.

"(a) IMPOSITION OF PENALTY.—

"(1) IN GENERAL.—In the case of a failure described in paragraph (2) by any person with respect to an information return, such person shall pay a penalty of $50 for each return with respect to which such a failure occurs, but the total amount imposed on such person for all such failures during any calendar year shall not exceed $250,000.

"(2) FAILURES SUBJECT TO PENALTY.—For purposes of paragraph (1), the failures described in this paragraph are—

"(A) any failure to file an information return with the Secretary on or before the required filing date, and

"(B) any failure to include all of the information required to be shown on the return or the inclusion of incorrect information.

"(b) REDUCTION WHERE CORRECTION IN SPECIFIED PERIOD.—

"(1) CORRECTION WITHIN 30 DAYS.—If any failure described in subsection (a)(2) is corrected on or before the day 30 days after the required filing date—

"(A) the penalty imposed by subsection (a) shall be $15 in lieu of $50, and

"(B) the total amount imposed on the person for all such failures during any calendar year which are so corrected shall not exceed $75,000.

"(2) FAILURES CORRECTED ON OR BEFORE AUGUST 1.—If any failure described in subsection (a)(2) is corrected after the 30th day referred to in paragraph (1) but on or before August 1 of the calendar year in which the required filing date occurs—

"(A) the penalty imposed by subsection (a) shall be $30 in lieu of $50, and

"(B) the total amount imposed on the person for all such failures during the calendar year which are so corrected shall not exceed $150,000.

"(c) EXCEPTION FOR DE MINIMIS FAILURES TO INCLUDE ALL REQUIRED INFORMATION.—

"(1) IN GENERAL.—If—

"(A) an information return is filed with the Secretary,

"(B) there is a failure described in subsection (a)(2)(B) (determined after application of section 6724(a)) with respect to such return, and

"(C) such failure is corrected on or before August 1 of the calendar year in which the required filing date occurs,

for purposes of this section, such return shall be treated as having been filed with all of the correct required information.

"(2) LIMITATION.—The number of information returns to which paragraph (1) applies for any calendar year shall not exceed the greater of—

"(A) 10, or

"(B) one-half of 1 percent of the total number of information returns required to be filed by the person during the calendar year.

"(d) LOWER LIMITATIONS FOR PERSONS WITH GROSS RECEIPTS OF NOT MORE THAN $5,000,000.—

"(1) IN GENERAL.—If any person meets the gross receipts test of paragraph (2) with respect to any calendar year, with respect to failures during such taxable year—

"(A) subsection (a)(1) shall be applied by substituting '$100,000' for '$250,000',

"(B) subsection (b)(1)(B) shall be applied by substituting '$25,000' for '$75,000', and

"(C) subsection (b)(2)(B) shall be applied by substituting '$50,000' for '$150,000'.

"(2) GROSS RECEIPTS TEST.—

"(A) IN GENERAL.—A person meets the gross receipts test of this paragraph for any calendar year if the average annual gross receipts of such person for the most recent 3 taxable years ending before such calendar year do not exceed $5,000,000.

"(B) CERTAIN RULES MADE APPLICABLE.—For purposes of subparagraph (A), the rules of paragraphs (2) and (3) of section 448(c) shall apply.

"(e) PENALTY IN CASE OF INTENTIONAL DISREGARD.—If 1 or more failures described in subsection (a)(2) are due to intentional disregard of the filing requirement (or the correct information reporting requirement), then, with respect to each such failure—

"(1) subsections (b), (c), and (d) shall not apply,

"(2) the penalty imposed under subsection (a) shall be $100, or, if greater—

"(A) in the case of a return other than a return required under section 6045(a), 6041A(b), 6050H, 6050J, 6050K, or 6050L, 10 percent of the aggregate amount of the items required to be reported correctly, or

"(B) in the case of a return required to be filed by section 6045(a), 6050K, or 6050L, 5 percent of the aggregate amount of the items required to be reported correctly, and

"(3) in the case of any penalty determined under paragraph (2)—

"(A) the $250,000 limitation under subsection (a) shall not apply, and

"(B) such penalty shall not be taken into account in applying such limitation (or any similar limitation under subsection (b)) to penalties not determined under paragraph (2).

"SEC. 6722. FAILURE TO FURNISH CORRECT PAYEE STATEMENTS.

"(a) GENERAL RULE.—In the case of each failure described in subsection (b) by any person with respect to a payee statement, such person shall pay a penalty of $50 for each statement with respect to which such a failure occurs, but the total amount imposed on such person for all such failures during any calendar year shall not exceed $100,000.

"(b) FAILURES SUBJECT TO PENALTY.—For purposes of subsection (a), the failures described in this subsection are—

"(1) any failure to furnish a payee statement on or before the date prescribed therefor to the person to whom such statement is required to be furnished, and

"(2) any failure to include all of the information required to be shown on a payee statement or the inclusion of incorrect information.

"(c) PENALTY IN CASE OF INTENTIONAL DISREGARD.—If 1 or more failures to which subsection (a) applies are due to intentional disregard of the requirement to furnish a payee statement (or the correct information reporting requirement), then, with respect to each failure—

"(1) the penalty imposed under subsection (a) shall be $100, or, if greater—

"(A) in the case of a payee statement other than a statement required under section 6045(b), 6041A(e) (in respect of a return required under section 6041A(b)), 6050H(d), 6050J(e), 6050K(b), or 6050L(c), 10 percent of the aggregate amount of the items required to be reported correctly, or

"(B) in the case of a payee statement required under section 6045(b), 6050K(b), or 6050L(c), 5 percent of the aggregate amount of the items required to be reported correctly, and

"(2) in the case of any penalty determined under paragraph (1)—

"(A) the $100,000 limitation under subsection (a) shall not apply, and

"(B) such penalty shall not be taken into account in applying such limitation to penalties not determined under paragraph (1).

"SEC. 6723. FAILURE TO COMPLY WITH OTHER INFORMATION REPORTING REQUIREMENTS.

"In the case of a failure by any person to comply with a specified information reporting requirement on or before the time prescribed therefor, such person shall pay a penalty of $50 for each such failure, but the total amount imposed on such person for all such failures during any calendar year shall not exceed $100,000.

"SEC. 6724. WAIVER; DEFINITIONS AND SPECIAL RULES.

"(a) REASONABLE CAUSE WAIVER.—

"(1) IN GENERAL.—No penalty shall be imposed under this part with respect to any failure if it is shown that such failure is due to reasonable cause and not to willful neglect.

"(2) APPLICATION TO PROVISION OF INCORRECT INFORMATION TO REPORTER.—Any person who is required to include on an information return information given to such person by another shall not be treated as providing incorrect information if such person provides the information given to such person and had no reason to believe such information was incorrect.

"(b) PAYMENT OF PENALTY.—Any penalty imposed by this part shall be paid on notice and demand by the Secretary and in the same manner as tax.

"(c) SPECIAL RULE FOR FAILURE TO MEET MAGNETIC MEDIA REQUIREMENTS.—No penalty shall be imposed under section 6721 solely by reason of any failure to comply with the requirements of the regulations prescribed under section 6011(e), except to the extent that such a failure occurs with respect to more than 250 information returns.

"(d) DEFINITIONS.—For purposes of this part—

"(1) INFORMATION RETURN.—The term 'information return' means—

"(A) any statement of the amount of payments to another person required by—

"(i) section 408(i) (relating to individual retirement account reports),

"(ii) section 6041(a) or (b) (relating to certain information at source),

"(iii) section 6042(a)(1) (relating to payments of dividends),

"(iv) section 6044(a)(1) (relating to payments of patronage dividends),

"(v) section 6047(d) (relating to reports by employers, plan administrators, etc.),

"(vi) section 6049(a) (relating to payments of interest),

"(vii) section 6050A(a) (relating to reporting requirements of certain fishing boat operators),

"(viii) section 6050N(a) (relating to payments of royalties), or

"(ix) section 6051(d) (relating to information returns with respect to income tax withheld), and

"(B) any return required by—

"(i) section 6041A(a) or (b) (relating to returns of direct sellers),

"(ii) section 6045(a) or (d) (relating to returns of brokers),

"(iii) section 6050H(a) (relating to mortgage interest received in trade or business from individuals),

"(iv) section 6050I(a) (relating to cash received in trade or business),

"(v) section 6050J(a) (relating to foreclosures and abandonments of security),

"(vi) section 6050K(a) (relating to exchanges of certain partnership interests),

"(vii) section 6050L(a) (relating to returns relating to certain dispositions of donated property),

"(viii) section 6052(a) (relating to reporting payment of wages in the form of group-life insurance),

"(ix) section 6053(c)(1) (relating to reporting with respect to certain tips),

"(x) section 1060(b) (relating to reporting requirements of transferors and transferees in certain asset acquisitions), or

"(xi) subparagraph (A) or (C) of subsection (c)(4), or subsection (e), of section 4093 (relating to information reporting with respect to tax on diesel and aviation fuels).

Such term also includes any form, statement, or schedule required to be filed with the Secretary with respect to any amount from which tax was required to be deducted and withheld under chapter 3 (or from which tax would be required to be so deducted and withheld but for an exemption under this title or any treaty obligation of the United States). For purposes of clauses (i) and (v) of subparagraph (A), references to such sections are only with respect to reports filed with the Secretary, with respect to information required to be supplied to both the Secretary and the beneficiary.

"(2) PAYEE STATEMENT.—The term 'payee statement' means any statement required to be furnished under—

"(A) section 408(i) (relating to individual retirement account reports),

"(B) section 6031(b) or (c), 6034A, or 6037(b) (relating to statements furnished by certain pass-thru entities),

"(C) section 6039(a) (relating to information required in connection with certain options),

"(D) section 6041(d) (relating to information at source),
"(E) section 6041A(e) (relating to returns regarding payments of remuneration for services and direct sales),
"(F) section 6042(c) (relating to returns regarding payments of dividends and corporate earnings and profits),
"(G) section 6044(e) (relating to returns regarding payments of patronage dividends),
"(H) section 6045(b) or (d) (relating to returns of brokers),
"(I) section 6047(d) (relating to reports by employers, plan administrators, etc.),
"(J) section 6049(c) (relating to returns regarding payments of interest),
"(K) section 6050A(b) (relating to reporting requirements of certain fishing boat operators),
"(L) section 6050H(d) relating to returns relating to mortgage interest received in trade or business from individuals),
"(M) section 6050I(e) (relating to returns relating to cash received in trade or business),
"(N) section 6050J(e) (relating to returns relating to foreclosures and abandonments of security),
"(O) section 6050K(b) (relating to returns relating to exchanges of certain partnership interests),
"(P) section 6050L(c) (relating to returns relating to certain dispositions of donated property),
"(Q) section 6050N(b) (relating to returns regarding payments of royalties),
"(R) section 6051 (relating to receipts for employees),
"(S) section 6052(b) (relating to returns regarding payment of wages in the form of group-term life insurance),
"(T) section 6053 (b) or (c) (relating to reports of tips), or
"(U) section 4093(c)(4)(B) (relating to certain purchasers of diesel and aviation fuels).

Such term also includes any form, statement, or schedule required to be furnished to the recipient of any amount from which tax was required to be deducted and withheld under chapter 3 (or from which tax would be required to be so deducted and withheld but for an exemption under this title or any treaty obligation of the United States). For purposes of subparagraphs (A) and (I), references to such sections are only with respect to reports furnished to the beneficiary, with respect to information required to be supplied to both the Secretary and the beneficiary.

"(3) SPECIFIED INFORMATION REPORTING REQUIREMENT.—The term 'specified information reporting requirement' means—
"(A) the notice required by section 6050K(c)(1) (relating to requirement that transferor notify partnership of exchange),
"(B) any requirement contained in the regulations prescribed under section 6109 that a person—
"(i) include his TIN on any return, statement, or other document (other than an information return or payee statement),
"(ii) furnish his TIN to another person, or
"(iii) include on any return, statement, or other document (other than an information return or payee statement) made with respect to another person the TIN of such person,
"(C) any requirement contained in the regulations prescribed under section 215 that a person—
"(i) furnish his TIN to another person, or
"(ii) include on his return the TIN of another person, and
"(D) the requirement of section 6109(e) that a person include the TIN of any dependent on his return.

"(4) REQUIRED FILING DATE.—The term 'required filing date' means the date prescribed for filing an information return with the Secretary (determined with regard to any extension of time for filing)."

(b) MODIFICATION OF REPORTABLE DESIGNATED DISTRIBUTIONS.—
(1) SECTION 408.—Subsection (i) of section 408 (relating to individual retirement account reports) is amended by inserting "aggregrating $10 or more" after "distributions".
(2) SECTION 6047.—Subsection (d)(1) of section 6047 (relating to reports by employers, plan administrators, etc.) is amended—

(A) by inserting "aggregating $10 or more" after "designated distributions" in subparagraph (A), and

(B) by inserting "such" before "designated distributions" in subparagraph (B).

(c) TECHNICAL AMENDMENTS.—

(1) Sections 6017A, 6676, and 6687 are hereby repealed.

(2) Paragraph (1) of section 6047(e) is amended by striking "section 6652(e)" and inserting "sections 6652(e), 6721, and 6722".

(3) Section 6652(e) is amended by inserting "(other than reports described in section 6724(d)(1)(A)(v) and (2)(I))" after "6047".

(4) Section 6693(a) is amended by inserting "(other than reports described in section 6724(d) (1)(A)(i) and (2)(A)" after "annuity".

(5) Subsection (b) of section 7205 is amended to read as follows:

"(b) BACKUP WITHHOLDING ON INTEREST AND DIVIDENDS.—If any individual willfully makes a false certification under paragraph (1) or (2)(C) of section 3406(d), then such individual shall, in addition to any other penalty provided by law, upon conviction thereof, be fined not more than $1,000, or imprisoned not more than 1 year, or both."

(6) The table of sections for subpart B of part II of subchapter A of chapter 61 is amended by striking the item relating to section 6017A.

(7) The table of sections for part I of subchapter B of chapter 68 is amended by striking the items relating to sections 6676 and 6687.

(8) The table of parts for subchapter B of chapter 68 is amended by striking the item relating to part II and inserting the following:

"Part II. Failure to comply with certain information reporting requirements."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to returns and statements the due date for which (determined without regard to extensions) is after December 31, 1989.

SEC. 6712. INFORMATION REQUIRED WITH RESPECT TO CERTAIN FOREIGN CORPORATIONS.

(a) CLARIFICATION OF REPORTING REQUIREMENTS UNDER SECTION 6038.—

(1) Subsection (a) of section 6038 (relating to information with respect to certain foreign corporations) is amended by adding at the end thereof the following new paragraph:

"(4) INFORMATION REQUIRED FROM CERTAIN SHAREHOLDERS IN CERTAIN CASES.—If any foreign corporation is treated as a controlled foreign corporation for any purpose under subpart F of part III of subchapter N of chapter 1, the Secretary may require any United States person treated as a United States shareholder of such corporation for any purpose under subpart F to furnish the information required under paragraph (1)."

(2) Paragraph (1) of section 6038(a) is amended by inserting before the period at the end of the second sentence the following: "or which the Secretary determines to be appropriate to carry out the provisions of this title."

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to returns and statements the due date for which (determined without regard to extensions) is after December 31, 1989.

SEC. 6713. UNIFORM REQUIREMENTS FOR RETURNS ON MAGNETIC MEDIA.

(a) GENERAL RULE.—Subsection (e) of section 6011 (relating to regulations requiring returns on magnetic tape, etc.) is amended to read as follows:

"(e) REGULATIONS REQUIRING RETURNS ON MAGNETIC MEDIA, ETC.—

"(1) IN GENERAL.—The Secretary shall prescribe regulations providing standards for determining which returns must be filed on magnetic media or in other machine-readable form. The Secretary may not require returns of any tax imposed by subtitle A on individuals, estates, and trusts to be other than on paper forms supplied by the Secretary.

"(2) REQUIREMENTS OF REGULATIONS.—In prescribing regulations under paragraph (1), the Secretary—

"(A) shall not require any person to file returns on magnetic media unless such person is required to file at least 250 returns during the calendar year, and

"(B) shall take into account (among other relevant factors) the ability of the taxpayer to comply at reasonable cost with the requirements of such regulations."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to returns the due date for which (determined without regard to extensions) is after December 31, 1989.

SEC. 6714. STUDY OF PROCEDURES TO PREVENT MISMATCHING.

(a) GENERAL RULE.—The Comptroller General (in consultation with the Secretary of the Treasury or his delegate) shall conduct a study on procedures to resolve, with the least disclosure of return information possible, discrepancies between taxpayer-identity information shown on information returns and such information in the records of the Internal Revenue Service.

(b) REPORT.—Not later than June 1, 1990, the Comptroller General shall submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report on the study conducted under subsection (a), together with such recommendations as he may deem advisable.

SEC. 6715. STUDY OF SERVICE BUREAUS.

(a) GENERAL RULE.—The Comptroller General (in consultation with the Secretary of the Treasury or his delegate) shall conduct a study of whether persons engaged in the business of transmitting information returns or other documents to the Internal Revenue Service on behalf of other persons should be subject to registration or other regulation.

(b) REPORT.—Not later than July 1, 1990, the Comptroller General shall submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report on the study conducted under subsection (a), together with such recommendations as he may deem advisable.

PART II—REVISION OF ACCURACY-RELATED PENALTIES

SEC. 6721. REVISION OF ACCURACY-RELATED PENALTIES.

(a) GENERAL RULE.—Subchapter A of chapter 68 (relating to additions to the tax and additional amounts) is amended by striking section 6662 and inserting the following:

"PART II—ACCURACY-RELATED AND FRAUD PENALTIES

"SEC. 6662. IMPOSITION OF ACCURACY-RELATED PENALTY.

"(a) IMPOSITION OF PENALTY.—If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

"(b) PORTION OF UNDERPAYMENT TO WHICH SECTION APPLIES.—This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:

"(1) Negligence or disregard of rules or regulations.
"(2) Any substantial understatement of income tax.
"(3) Any substantial valuation overstatement under chapter 1.
"(4) Any substantial overstatement of pension liabilities.
"(5) Any substantial estate or gift tax valuation understatement.

This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663.

"(c) NEGLIGENCE.—For purposes of this section, the term 'negligence' includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term 'disregard' includes any careless, reckless, or intentional disregard.

"(d) SUBSTANTIAL UNDERSTATEMENT OF INCOME TAX.—

"(1) SUBSTANTIAL UNDERSTATEMENT.—

"(A) IN GENERAL.—For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of—

"(i) 10 percent of the tax required to be shown on the return for the taxable year, or

"(ii) $5,000.

"(B) SPECIAL RULE FOR CORPORATIONS.—In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), paragraph (1) shall be applied by substituting "$10,000" for "$5,000".

"(2) UNDERSTATEMENT.—

"(A) IN GENERAL.—For purposes of paragraph (1), the term 'understatement' means the excess of—

"(i) the amount of the tax required to be shown on the return for the taxable year, over

"(ii) the amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211(b)(2)).

"(B) REDUCTION FOR UNDERSTATEMENT DUE TO POSITION OF TAXPAYER OR DISCLOSED ITEM.—The amount of the understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to—

"(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

"(ii) any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.

"(C) SPECIAL RULES IN CASES INVOLVING TAX SHELTERS.—

"(i) IN GENERAL.—In the case of any item attributable to a tax shelter—

"(I) subparagraph (B)(ii) shall not apply, and

"(II) subparagraph (B)(i) shall not apply unless (in addition to meeting the requirements of such subparagraph) the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.

"(ii) TAX SHELTER.—For purposes of clause (i), the term 'tax shelter' means—

"(I) a partnership or other entity,

"(II) any investment plan or arrangement, or

"(III) any other plan or arrangement,

if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

"(D) SECRETARIAL LIST.—The Secretary shall prescribe (and revise not less frequently than annually) a list of positions—

"(i) for which the Secretary believes there is not substantial authority, and

"(ii) which affect a significant number of taxpayers.

Such list (and any revision thereof) shall be published in the Federal Register.

"(e) SUBSTANTIAL VALUATION OVERSTATEMENT UNDER CHAPTER 1.—

"(1) IN GENERAL.—For purposes of this section, there is a substantial valuation overstatement under chapter 1 if the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

"(2) LIMITATION.—No penalty shall be imposed by reason of subsection (b)(3) unless the portion of the underpayment for the taxable year attributable to substantial valuation overstatements under chapter 1 exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company (as defined in section 542)).

"(f) SUBSTANTIAL OVERSTATEMENT OF PENSION LIABILITIES.—

"(1) IN GENERAL.—For purposes of this section, there is a substantial overstatement of pension liabilities if the actuarial determination of the liabilities taken into account for purposes of computing the deduction under paragraph (1) or (2) of section 404(a) is 200 percent or more of the amount determined to be the correct amount of such liabilities.

"(2) LIMITATION.—No penalty shall be imposed by reason of subsection (b)(4) unless the portion of the underpayment for the taxable year attributable to substantial overstatements of pension liabilities exceeds $1,000.

"(g) SUBSTANTIAL ESTATE OR GIFT TAX VALUATION UNDERSTATEMENT.—

"(1) IN GENERAL.—For purposes of this section, there is a substantial estate or gift tax valuation understatement if the value of any property claimed on any return of tax imposed by subtitle B is 50 percent or less of the amount determined to be the correct amount of such valuation.

"(2) LIMITATION.—No penalty shall be imposed by reason of subsection (b)(5) unless the portion of the underpayment attributable to substantial estate or gift tax valuation understatements for the taxable period (or, in the case of the tax imposed by chapter 11, with respect to the estate of the decedent) exceeds $5,000.

"(h) INCREASE IN PENALTY IN CASE OF GROSS VALUATION MISSTATEMENTS.—

"(1) IN GENERAL.—To the extent that a portion of the underpayment to which this section applies is attributable to one or more gross valuation misstatements, subsection (a) shall be applied with respect to such portion by substituting '40 percent' for '20 percent'.

"(2) GROSS VALUATION MISSTATEMENTS.—The term 'gross valuation misstatements' means—

"(A) any substantial valuation overstatement under chapter 1 as determined under subsection (e) by substituting '400 percent' for '200 percent',

"(B) any substantial overstatement of pension liabilities as determined under subsection (f) by substituting '400 percent' for '200 percent', and

"(C) any substantial estate or gift tax valuation understatement as determined under subsection (g) by substituting '25 percent' for '50 percent'.

"SEC. 6663. IMPOSITION OF FRAUD PENALTY.

"(a) IMPOSITION OF PENALTY.—If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.

"(b) DETERMINATION OF PORTION ATTRIBUTABLE TO FRAUD.—If the Secretary establishes that any portion of an underpayment is attributable to fraud, the entire underpayment shall be treated as attributable to fraud, except with respect to any portion of the underpayment which the taxpayer establishes (by a preponderance of the evidence) is not attributable to fraud.

"(c) SPECIAL RULE FOR JOINT RETURNS.—In the case of a joint return, this section shall not apply with respect to a spouse unless some part of the underpayment is due to the fraud of such spouse.

"SEC. 6664. DEFINITIONS AND SPECIAL RULES.

"(a) UNDERPAYMENT.—For purposes of this part, the term 'underpayment' means the amount by which any tax imposed by this title exceeds the excess of—

"(1) the sum of—

"(A) the amount shown as the tax by the taxpayer on his return, plus

"(B) amounts not so shown previously assessed (or collected without assessment), over

"(2) the amount of rebates made.

For purposes of paragraph (2), the term 'rebate' means so much of an abatement, credit, refund, or other repayment, as was made on the ground that the tax imposed was less than the excess of the amount specified in paragraph (1) over the rebates previously made.

"(b) PENALTIES APPLICABLE ONLY WHERE RETURN FILED.—The penalties provided in this part shall apply only in cases where a return of tax is filed (other than a return prepared by the Secretary under the authority of section 6020(b)).

"(c) REASONABLE CAUSE EXCEPTION.—

"(1) IN GENERAL.—No penalty shall be imposed under this part with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

"(2) SPECIAL RULE FOR CERTAIN VALUATION OVERSTATEMENTS.—In the case of any underpayment attributable to a substantial or gross valuation overstatement under chapter 1 with respect to charitable deduction property, paragraph (1) shall not apply unless—

"(A) the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and

"(B) in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

"(3) DEFINITIONS.—For purposes of this subsection—

"(A) CHARITABLE DEDUCTION PROPERTY.—The term 'charitable deduction property' means any property contributed by the taxpayer in a contribution for which a deduction was claimed under section 170. For purposes of paragraph (2), such term shall not include any securities for which (as of the date of the contribution) market quotations are readily available on an established securities market.

"(B) Qualified appraiser.—The term 'qualified appraiser' means any appraiser meeting the requirements of the regulations prescribed under section 170(a)(1).

"(C) Qualified appraisal.—The term 'qualified appraisal' means any appraisal meeting the requirements of the regulations prescribed under section 170(a)(1).

"PART III—APPLICABLE RULES

"Sec. 6665. Applicable rules.

"SEC. 6665. APPLICABLE RULES.

"(a) Additions Treated as Tax.—Except as otherwise provided in this title—

"(1) the additions to the tax, additional amounts, and penalties provided by this chapter shall be paid upon notice and demand and shall be assessed, collected, and paid in the same manner as taxes; and

"(2) any reference in this title to 'tax' imposed by this title shall be deemed also to refer to the additions to the tax, additional amounts, and penalties provided by this chapter.

"(b) Procedure for Assessing Certain Additions to Tax.—For purposes of subchapter B of chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes), subsection (a) shall not apply to any addition to tax under section 6651, 6654, or 6655; except that it shall apply—

"(1) in the case of an addition described in section 6651, to that portion of such addition which is attributable to a deficiency in tax described in section 6211; or

"(2) to an addition described in section 6654 or 6655, if no return is filed for the taxable year."

(b) Repeal of Increase in Interest on Certain Substantial Underpayments.—Subsection (c) of section 6621 (relating to interest on substantial underpayments attributable to tax motivated transactions) is hereby repealed.

(c) Technical and Conforming Amendments.—

(1) Section 6653 is amended to read as follows:

"SEC. 6653. FAILURE TO PAY STAMP TAX.

"Any person (as defined in section 6671(b)) who—

"(1) willfully fails to pay any tax imposed by this title which is payable by stamp, coupons, tickets, books, or other devices or methods prescribed by this title or by regulations under the authority of this title, or

"(2) willfully attempts in any manner to evade or defeat any such tax or the payment thereof,

shall, in addition to other penalties provided by law, be liable for a penalty of 50 percent of the total amount of the underpayment of the tax."

(2) Sections 6659, 6659A, 6660, and 6661 are hereby repealed.

(3) Subsection (b) of section 5684 is amended—

(A) by striking "6662(a)" and inserting "6665(a)", and

(B) by striking "6662" in the subsection heading and inserting "6665".

(4) Subsection (a) of section 5761 is amended by striking "or 6653" and inserting "or 6653 or part II of subchapter A of chapter 68".

(5) Subsection (c) of section 5761 is amended—

(A) by striking "6662(a)" and inserting "6665(a)", and

(B) by striking "6662" in the subsection heading and inserting "6665".

(6) Subparagraph (A) of section 6013(b)(5) is amended—

(A) by striking "section 6653" and inserting "part II of subchapter A of chapter 68", and

(B) by striking "section 6653" in the subparagraph heading and inserting "part II of subchapter A of chapter 68".

(7) Subsection (d) of section 6222 is amended by striking "section 6653(a)" and inserting "part II of subchapter A of chapter 68".

(8) Paragraph (2) of section 6601(e) is amended by striking "section 6651(a)(1), 6653, 6659, 6660, or 6661" each place it appears and inserting "section 6651(a)(1) or 6653 or under part II of subchapter A of chapter 68".

(9) Subsection (a) of section 6672 is amended by striking "under section 6653" and inserting "under section 6653 or part II of subchapter A of chapter 68".

(10) Subparagraph (C) of section 461(i)(3) is amended by striking "section 6662(b)(2)(C)(ii)" and inserting "section 6662(d)(2)(C)(ii)".

(11) Clause (i) of section 1274(b)(3)(B) is amended by striking "section 6661(b)(2)(C)(ii)" and inserting "section 6662(d)(2)(C)(ii)".

(12) Subparagraph (B) of section 7519(f)(4) is amended by striking "section 6653" and inserting "part II of subchapter A of chapter 68".

(13) Subchapter A of chapter 68 is amended by inserting after the subchapter heading the following:

"Part I. General provisions.
"Part II. Accuracy-related and fraud penalties.
"Part III. Applicable rules.

"PART I—GENERAL PROVISIONS".

(14) The table of sections for part I of subchapter A of chapter 68 (as amended by paragraph (1)) is amended—

(A) by striking out the items relating to sections 6659, 6659A, 6660, and 6661, and

(B) by striking the item relating to section 6653 and inserting:

"Sec. 6653. Failure to pay stamp tax."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to returns the due date for which (determined without regard to extensions) is after December 31, 1989.

PART III—PREPARER, PROMOTER, AND PROTESTER PENALTIES

SEC. 6731. PENALTY FOR INSTITUTING PROCEEDINGS BEFORE TAX COURT PRIMARILY FOR DELAY, ETC.

(a) GENERAL RULE.—Section 6673 (relating to damages assessable for instituting proceedings before the Tax Court primarily for delay, etc.) is amended to read as follows:

"SEC. 6673. SANCTIONS AND COSTS AWARDED BY COURTS.

"(a) TAX COURT PROCEEDINGS.—

"(1) PROCEDURES INSTITUTED PRIMARILY FOR DELAY, ETC.—Whenever it appears to the Tax Court that—

"(A) proceedings before it have been instituted or maintained by the taxpayer primarily for delay,

"(B) the taxpayer's position in such proceeding is frivolous or groundless, or

"(C) the taxpayer unreasonably failed to pursue available administrative remedies,

the Tax Court, in its decision, may require the taxpayer to pay to the United States a penalty not in excess of $25,000.

"(2) COUNSEL'S LIABILITY FOR EXCESSIVE COSTS.—Whenever it appears to the Tax Court that any attorney or other person admitted to practice before the Tax Court has multiplied the proceedings in any case unreasonably and vexatiously, the Tax Court may require—

"(A) that such attorney or other person pay personally the excess costs, expenses, and attorneys' fees reasonably incurred because of such conduct, or

"(B) if such attorney is appearing on behalf of the Commissioner of Internal Revenue, that the United States pay such excess costs, expenses, and attorneys' fees in the same manner as such an award by a district court.

"(b) PROCEEDINGS IN OTHER COURTS.—

"(1) CLAIMS UNDER SECTION 7433.—Whenever it appears to the court that the taxpayer's position in the proceedings before the court instituted or maintained by such taxpayer under section 7433 is frivolous or groundless, the court may require the taxpayer to pay to the United States a penalty not in excess of $10,000.

"(2) COLLECTION OF SANCTIONS AND COSTS.—In any civil proceeding before any court (other than the Tax Court) which is brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty under this title, any monetary sanctions, penalties, or costs awarded by the court to the United States may be assessed by the Secretary and, upon notice and demand, may be collected in the same manner as a tax.

"(3) SANCTIONS AND COSTS AWARDED BY A COURT OF APPEALS.—In connection with any appeal from a proceeding in the Tax Court or a civil proceeding described in paragraph (2), an order of a United States Court of Appeals or the Supreme Court awarding monetary sanctions, penalties or court costs to the United States may be registered in a district court upon filing a certified copy of such order and shall be enforceable as other district court judgments."

(b) CLARIFICATION OF AUTHORITY TO IMPOSE PENALTIES BY APPELLATE COURTS.—Paragraph (4) of section 7482(c) (relating to power to impose damages) is amended to read as follows:

"(4) TO IMPOSE PENALTIES.—The United States Court of Appeals and the Supreme Court shall have the power to require the taxpayer to pay to the United States a penalty in any case where the decision of the Tax Court is affirmed and it appears that the appeal was instituted or maintained primarily for delay or that the taxpayer's position in the appeal is frivolous or groundless."

(c) CLERICAL AMENDMENT.—The table of sections for part I of subchapter B of chapter 68 is amended by striking the item relating to section 6673 and inserting the following:

"Sec. 6673. Sanctions and costs awarded by courts."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to positions taken after December 31, 1989, in proceedings which are pending on, or commenced after such date.

SEC. 6732. MODIFICATIONS TO OTHER ASSESSABLE PENALTIES WITH RESPECT TO RETURN PREPARERS.

(a) FAILURE TO FURNISH COPY TO TAXPAYER.—Subsection (a) of section 6695 is amended—

(1) by striking "$25" and inserting "$50", and

(2) by adding at the end thereof the following new sentence: "The maximum penalty imposed under this subsection on any person with respect to documents filed during any calendar year shall not exceed $25,000."

(b) FAILURE TO SIGN RETURN.—Subsection (b) of section 6695 is amended—

(1) by striking "$25" and inserting "$50", and

(2) by adding at the end thereof the following new sentence: "The maximum penalty imposed under this subsection on any person with respect to documents filed during any calendar year shall not exceed $25,000."

(c) FAILURE TO FURNISH IDENTIFYING NUMBER.—Subsection (c) of section 6695 is amended—

(1) by striking "$25" and inserting "$50", and

(2) by adding at the end thereof the following new sentence: "The maximum penalty imposed under this subsection on any person with respect to documents filed during any calendar year shall not exceed $25,000."

(d) FAILURE TO FILE CORRECT INFORMATION RETURNS.—Subsection (e) of section 6695 is amended to read as follows:

"(e) FAILURE TO FILE CORRECT INFORMATION RETURNS.—Any person required to make a return under section 6060 who fails to comply with the requirements of such section shall pay a penalty of $50 for—

"(1) each failure to file a return as required under such section, and

"(2) each failure to set forth an item in the return as required under section, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection on any person with respect to any return period shall not exceed $25,000."

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to documents prepared after December 31, 1989.

SEC. 6733. MODIFICATIONS TO PENALTY FOR PROMOTING ABUSIVE TAX SHELTERS, ETC.

(a) GENERAL RULE.—Subsection (a) of section 6700 is amended—

(1) by inserting "(directly or indirectly)" after "participates" in paragraph (1)(B),

(2) by inserting "or causes another person to make or furnish" after "makes or furnishes" in paragraph (2), and

(3) by striking the material following paragraph (2) and inserting the following:

"shall pay, with respect to each activity described in paragraph (1), a penalty equal to the $1,000 or, if the person establishes that it is lesser, 100 percent of the gross income derived (or to be derived) by such person from such activity. For purposes of the preceding sentence, activities described in paragraph (1)(A) with respect to each entity or arrangement shall be treated as a separate activity and participation in each sale described in paragraph (1)(B) shall be so treated."

(b) STATUTE OF LIMITATIONS.—Section 6700 is amended by adding at the end thereof the following new subsection:

"(d) STATUTE OF LIMITATIONS.—The period for assessing any penalty imposed by this section shall not expire before the date 6 years after the occurrence of the activity described in subsection (a)."

(c) EFFECTIVE DATE.—The amendment made by this section shall apply to activities after December 31, 1989.

SEC. 6734. MODIFICATIONS TO PENALTIES FOR AIDING AND ABETTING UNDERSTATEMENT OF TAX LIABILITY.

(a) GENERAL RULE.—Subsection (a) of section 6701 (relating to penalties for aiding and abetting understatement of tax liability) is amended—

(1) by striking "in connection with any matter arising under the internal revenue laws" in paragraph (1),

(2) by striking "who knows" in paragraph (2) and inserting "who knows (or has reason to believe)", and

(3) by striking "will result" in paragraph (3) and inserting "would result".

(b) COORDINATION WITH PENALTY UNDER SECTION 6700.—

(1) IN GENERAL.—Subsection (f) of section 6701 is amended by adding at the end thereof the following new paragraph:

"(3) COORDINATION WITH SECTION 6700.—No penalty shall be assessed under section 6700 on any person with respect to any document for which a penalty is assessed on such person under subsection (a)."

(2) TECHNICAL AMENDMENT.—Paragraph (1) of section 6701(f) is amended by striking "paragraph (2)" and inserting "paragraphs (2) and (3)".

(c) STATUTE OF LIMITATIONS.—Section 6701 is amended by adding at the end thereof the following new subsection:

"(g) STATUTE OF LIMITATIONS.—The period for assessing any penalty imposed by this section shall not expire before the date 6 years after the occurrence of the activity described in subsection (a)."

(d) EFFECTIVE DATE.—The amendments made by this section shall take effect on December 31, 1989.

SEC. 6735. MODIFICATION TO PENALTY FOR FRIVOLOUS INCOME TAX RETURN.

(a) REQUIREMENT OF FULL PAYMENT OF PENALTY.—Subsection (c) of section 6703 is amended by striking "section 6700, 6701, or 6702" each place it appears and inserting "section 6700 or 6701".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to returns filed after December 31, 1989.

SEC. 6736. AUTHORITY TO COUNTERCLAIM FOR BALANCE OF PENALTY IN PARTIAL REFUND SUITS.

(a) GENERAL RULE.—Sections 6672(b)(1), 6694(c)(1), and 6703(c)(1) are each amended by adding at the end thereof the following new sentence: "Nothing in this paragraph shall be construed to prohibit any counterclaim for the remainder of such penalty in a proceeding begun as provided in paragraph (2)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

SEC. 6737. REPEAL OF BONDING REQUIREMENT UNDER SECTION 7407.

(a) GENERAL RULE.—Subsection (c) of section 7407 (relating to bond to stay injunction) is hereby repealed.

(b) CONFORMING AMENDMENT.—Subsection (a) of section 7407 is amended by striking "Except as provided in subsection (c), a civil" and inserting "A civil".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to actions commenced after December 31, 1989.

SEC. 6738. CERTAIN DISCLOSURES OF INFORMATION BY PREPARERS PERMITTED.

(a) GENERAL RULE.—Paragraph (3) of section 7216(b) (relating to exceptions) is amended by adding at the end thereof the following new sentence: "Such regulations shall permit (subject to such conditions as such regulations shall provide) the disclosure or use of information for quality or peer reviews."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

PART IV—FAILURES TO FILE OR PAY

SEC. 6741. INCREASE IN PENALTY FOR FRAUDULENT FAILURE TO FILE.

(a) GENERAL RULE.—Section 6651 (relating to failure to file tax return or pay tax) is amended by adding at the end thereof the following new subsection:

"(f) INCREASE IN PENALTY FOR FRAUDULENT FAILURE TO FILE.—If any failure to file any return is fraudulent, paragraph (1) of subsection (a) shall be applied—

"(1) by substituting '15 percent' for '5 percent' each place it appears, and

"(2) by substituting '75 percent' for '25 percent'."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply in the case of failures to file returns the due date for which (determined without regard to extensions) is after December 31, 1989.

SEC. 6742. FAILURE TO MAKE DEPOSIT OF TAXES.

(a) GENERAL RULE.—Section 6656 (relating to failure to make deposit of taxes or overstatement of deposits) is amended to read as follows:

"SEC. 6656. FAILURE TO MAKE DEPOSIT OF TAXES.

"(a) UNDERPAYMENT OF DEPOSITS.—In the case of any failure by any person to deposit (as required by this title or by regulations of the Secretary under this title) on the date prescribed therefor any amount of tax imposed by this title in such government depository as is authorized under section 6302(c) to receive such deposit, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be imposed upon such person a penalty equal to the applicable percentage of the amount of the underpayment.

"(b) DEFINITIONS.—For purposes of subsection (a)—

"(1) APPLICABLE PERCENTAGE.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'applicable percentage' means—

"(i) 2 percent if the failure is for not more than 5 days,

"(ii) 5 percent if the failure is for more than 5 days but not more than 15 days, and

"(iii) 10 percent if the failure is for more than 15 days.

"(B) SPECIAL RULE.—In any case where the tax is not deposited on or before the earlier of—

"(i) the day 10 days after the date of the first delinquency notice to the taxpayer under section 6303, or

"(ii) the day on which notice and demand for immediate payment is given under section 6861 or 6862 or the last sentence of section 6331(a),

the applicable percentage shall be 15 percent.

"(2) UNDERPAYMENT.—The term 'underpayment' means the excess of the amount of the tax required to be deposited over the amount, if any, thereof deposited on or before the date prescribed therefor."

(b) CLERICAL AMENDMENT.—The table of sections for part I of subchapter A of chapter 68 (as amended by title II) is amended by striking the item relating to section 6656 and inserting the following:

"Sec. 6656. Failure to make deposit of taxes."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to deposits required to be made after December 31, 1989.

SEC. 6743. EFFECT OF PAYMENT OF TAX BY RECIPIENT ON CERTAIN PENALTIES.

(a) GENERAL RULE.—Section 1463 (relating to tax paid by recipient of income) is amended to read as follows:

"SEC. 1463. TAX PAID BY RECIPIENT OF INCOME.

"If—

"(1) any person, in violation of the provisions of this chapter, fails to deduct and withhold any tax under this chapter, and

"(2) thereafter the tax against which such tax may be credited is paid,

the tax so required to be deducted and withheld shall not be collected from such person; but this subsection shall in no case relieve such person from liability for interest or any penalties or additions to the tax otherwise applicable in respect of such failure to deduct and withhold."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to failures after December 31, 1989.

Subtitle H—Technical Corrections

SEC. 6801. DEFINITIONS; COORDINATION WITH OTHER SUBTITLES.

(a) DEFINITIONS.—For purposes of this subtitle—

(1) 1988 ACT.—The term "1988 Act" means the Technical and Miscellaneous Revenue Act of 1988.

(2) 1987 ACT.—The term "1987 Act" means the Revenue Act of 1987.

(b) COORDINATION WITH OTHER SUBTITLES.—For purposes of applying the amendments made by any subtitle of this title other than this subtitle, the provisions of this subtitle shall be treated as having been enacted immediately before the provisions of such other subtitles.

PART I—AMENDMENTS RELATED TO TECHNICAL AND MISCELLANEOUS REVENUE ACT OF 1988

SEC. 6811. AMENDMENTS RELATED TO TITLE I OF THE 1988 ACT.

(a) AMENDMENTS RELATED TO SECTION 1003 OF THE 1988 ACT.—

(1) Subparagraph (C) of section 643(a)(6) is amended by striking "(i)" and by striking ", and (ii)" and all that follows and inserting a period.

(2) Paragraph (6) of section 643(a) is amended by striking subparagraph (D).

(b) AMENDMENTS RELATED TO SECTION 1006 OF THE 1988 ACT.—

(1) Subparagraphs (C) and (D) of section 26(b)(2) are amended to read as follows:

"(C) subsection (m)(5)(B), (q), (t), or (v) of section 72 (relating to additional taxes on certain distributions),

"(D) section 143(m) (relating to recapture of proration of Federal subsidy from use of mortgage bonds and mortgage credit certificates),".

(2) Paragraph (2) of section 26(b) is amended by striking subparagraph (K) and all that follows and inserting the following new subparagraphs:

"(K) sections 871(a) and 881 (relating to certain income of nonresident aliens and foreign corporations),

"(L) section 860E(e) (relating to taxes with respect to certain residual interests), and

"(M) section 884 (relating to branch profits tax).".

(3) Subparagraph (B) of section 6724(d)(1) is amended by striking clause (viii) and all that follows and inserting the following:

"(viii) section 6052(a) (relating to reporting payment of wages in the form of group-term life insurance),

"(ix) section 6053(c)(1) (relating to reporting with respect to certain tips),

"(x) section 1060(b) (relating to reporting requirements of transferors and transferees in certain asset acquisitions), or

"(xi) subparagraph (A) or (C) of subsection (c)(4), or subsection (e), of section 4093 (relating to information reporting with respect to tax on diesel and aviation fuel).".

(4) Clause (i) of section 1374(d)(2)(A) is amended by striking "(except as provided in subsection (b)(2))".

(5)(A) Paragraph (6) of section 382(h) is amended—

(i) by striking "during the recognition period" in subparagraph (B) and inserting "during the recognition period (determined without regard to any carryover)", and

(ii) by striking "treated as recognized built-in gains or losses under this paragraph" in subparagraph (C) and inserting "which would be treated as recognized built-in gains or losses under this paragraph if such amounts were properly taken into account (or allowable as a deduction) during the recognition period".

(B) Paragraph (5) of section 1374(d) is amended—

(i) by striking "during the recognition period" in subparagraph (B) and inserting "during the recognition period (determined without regard to any carryover)", and

(ii) by striking "treated as recognized built-in gains or losses under this paragraph" in subparagraph (C) and inserting "which would be treated as recognized built-in gains or losses under this paragraph if such amounts were properly taken into account (or allowable as a deduction) during the recognition period".

(6) Subparagraph (B) of section 1361(b)(2) is amended to read as follows:

"(B) a financial institution to which section 585 applies (or would apply but for subsection (c) thereof) or to which section 593 applies,".

(7) Paragraph (2) of section 1366(f) is amended to read as follows:

"(2) TREATMENT OF TAX IMPOSED ON BUILT-IN GAINS.—If any tax is imposed under section 1374 for any taxable year on an S corporation, for purposes of subsection (a), the amount so imposed shall be treated as a loss sustained by the S corporation during such taxable year. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax."

(8) Subparagraph (B) of section 1374(b)(3) is amended by adding at the end thereof the following new sentence: "A similar rule shall apply in the case of the minimum tax credit under section 53 to the extent attributable to taxable years for which the corporation was a C corporation.".

(c) AMENDMENTS RELATED TO SECTION 1007 OF THE 1988 ACT.—

(1)(A) Subsection (g) of section 59 is amended by striking "for any taxable year" and inserting "for the taxable year for which the item is taken into account or for any other taxable year".

(B) The provisions of section 58(h) of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) shall apply to the determination of tax liability for taxable years beginning after December 31, 1986, with respect to items of tax preferences arising in taxable years beginning before January 1, 1987.

(2) Subclause (II) of section 53(d)(1)(B)(i) is amended by inserting before the period at the end thereof the following: "and if section 59(a)(2) did not apply".

(3) Paragraph (3) of section 56(b) is amended—

(A) by inserting after the first sentence the following new sentence: "Section 422A(c)(2) shall apply in any case where the disposition and the inclusion for purposes of this part are within the same taxable year and such section shall not apply in any other case.", and

(B) by striking "the preceding sentence" and inserting "this paragraph".

(d) AMENDMENTS RELATED TO SECTION 1008 OF THE 1988 ACT.—

(1) Paragraph (2) of section 460(a) is amended by inserting "(or, with respect to any amount properly taken into account after completion of the contract, when such amount is so properly taken into account)" after "any long-term contract".

(2) Subparagraph (B) of section 460(b)(2) is amended—

(A) by striking "any amount received or accrued" and inserting "any amount properly taken into account", and

(B) by striking "is so received or accrued" and inserting "is so properly taken into account".

(3) Paragraph (3) of section 460(b) is amended—

(A) by striking "any amount received or accrued" in the second sentence and inserting "any amount properly taken into account", and

(B) by striking "such amount was received or accrued" in the second sentence and inserting "such amount was properly taken into account".

(4) Paragraph (2) of section 460(b) is amended by adding at the end thereof the following new sentence:

"In the case of any long-term contract with respect to which the percentage of completion method is used, except for purposes of applying the look-back method of paragraph (3), any income under the contract (to the extent not previously includible in gross income) shall be included in gross income for the taxable year following the taxable year in which the contract was completed.".

(5) Paragraph (2) of section 460(e) is amended by striking "and" at the end of subparagraph (A), by inserting "and" at the end of subparagraph (B), and by inserting after subparagraph (B) the following new subparagraph:

"(C) any predecessor of the taxpayer or a person described in subparagraph (A) or (B),".

(6) Paragraph (2) of section 460(b) is amended by adding at the end thereof the following new sentence:

"For purposes of subtitle F (other than sections 6654 and 6655), any interest required to be paid by the taxpayer under subparagraph (B) shall be treated as an increase in the tax imposed by this chapter for the taxable year in which the contract is completed (or, in the case of interest payable with respect to any amount properly taken into account after completion of the contract, for the taxable year in which the amount is so properly taken into account).".

(e) AMENDMENTS RELATED TO SECTION 1009 OF THE 1988 ACT.—

(1) Subparagraph (A) of section 643(a)(6) is amended by striking "section 265(1)" and inserting "section 265(a)(1)".

(2) Subparagraph (B) of section 1009(b)(3) of the 1988 Act is amended by striking "section 265(b)(3)(B)(iii)" and inserting "section 265(b)(3)(B)(i)(III)".

(f) AMENDMENT RELATED TO SECTION 1011 OF THE 1988 ACT.—

(1) Subsection (a) of section 401 is amended by moving paragraph (30) from the end thereof and inserting it after paragraph (29).

(2) The last sentence of section 402(g)(3) is amended by inserting "involving a one-time irrevocable election" after "similar arrangement".

(g) AMENDMENT RELATED TO SECTION 1011B OF THE 1988 ACT.—Paragraph (5) of section 409(l) is amended by striking "the last sentence" and inserting "the second sentence".

(h) AMENDMENTS RELATED TO SECTION 1012 OF THE 1988 ACT.—

(1) Subparagraph (H) of section 904(d)(1) is amended by striking "qualified interest and carrying charges (as defined in section 245(c))" and inserting "interest or carrying charges (as defined in section 927(d)(1)) derived from a transaction which results in foreign trade income (as defined in section 923(b))".

(2) Sections 861(a)(6), 862(a)(6), 863(b)(2), and 863(b)(3) are each amended by striking "865(h)(1)" and inserting "865(i)(1)".

(3) Subparagraph (A) of section 954(c)(3) is amended—

(A) by striking "is created" in clause (i) and inserting "is a corporation created", and

(B) by striking "from a related person" in clause (ii) and inserting "from a corporation which is a related person".

(4) Paragraph (5) of section 1297(b) is amended—

(A) by inserting "STOCK" after "WHERE" in the paragraph heading,

(B) by striking "any disposition of" in subparagraph (A)(ii) and inserting "any distribution of", and

(C) by striking "treated as a disposition to" in subparagraph (A) and inserting "treated as a disposition by, or distribution to".

(5) Subparagraph (B) of section 1012(q)(1) of the 1988 Act is amended—

(A) by striking "1021(e)(2)(C)" and inserting "1021(c)(2)(C)", and

(B) by striking "823(b)(4)(C)" and inserting "832(b)(4)(C)".

(6)(A) Subparagraph (B) of section 1446(b)(2) is amended by striking "section 11(b)" and inserting "section 11(b)(1)".

(B) Paragraph (2) of section 1446(d) is amended to read as follows:

"(2) CREDIT TREATED AS DISTRIBUTED TO PARTNER.—Except as provided in regulations, a foreign partner's share of any withholding tax paid by the partnership under this section shall be treated as distributed to such partner by such partnership on the earlier of—

"(A) the day on which such tax was paid by the partnership, or

"(B) the last day of the partnership's taxable year for which such tax was paid.".

(C) Subsection (f) of section 1446 is amended to read as follows:

"(f) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section, including—

"(1) regulations providing for the application of this section in the case of publicly traded partnerships, and

"(2) regulations providing—

"(A) that, for purposes of section 6655, the withholding tax imposed under this section shall be treated as a tax imposed by section 11 and any partnership required to pay such tax shall be treated as a corporation, and

"(B) appropriate adjustments in applying section 6655 with respect to such withholding tax.".

(7) Subsection (a) of section 988 is amended by inserting after the subsection heading the following: "Notwithstanding any other provision of this chapter—".

(8)(A) Subsection (b) of section 887 is amended by redesignating paragraph (3) as paragraph (4) and by inserting after paragraph (2) the following new paragraph:

"(3) EXCEPTION FOR CERTAIN INCOME TAXABLE IN POSSESSIONS.—The term 'United States source gross transportation income' does not include any income taxable in a possession of the United States under the provisions of this title as made applicable in such possession.".

(B) Paragraph (1) of section 887(b) is amended by striking "paragraph (2)" and inserting "paragraphs (2) and (3)".

(C) Subsection (b) of section 872 is amended by adding at the end thereof the following new paragraph:

"(7) TREATMENT OF POSSESSIONS.—To the extent provided in regulations, a possession of the United States shall be treated as a foreign country for purposes of this subsection.".

(D) Paragraph (4) of section 883(a) is amended by striking "(5) and (6)" and inserting "(5), (6), and (7)".

(9) Paragraph (4) of section 887(b) (as redesignated by paragraph (8) is amended by striking "transportation income" the first two places it appears and inserting "United States source gross transportation income".

(10) Subsection (a) of section 883 is amended by adding at the end thereof the following new paragraph:

"(5) SPECIAL RULE FOR COUNTRIES WHICH TAX ON RESIDENCE BASIS.—For purposes of this subsection, there shall not be taken into account any failure of a foreign country to grant an exemption to a corporation organized in the United States if such corporation is subject to tax by such foreign country on a residence basis pursuant to provisions of foreign law which meets such standards (if any) as the Secretary may prescribe.".

(11) Paragraph (2) of section 4371 is amended by striking ", unless the insurer is subject to tax under section 842(b)".

(12) Subsection (g) of section 995 is amended by striking "section 511" and inserting "section 511 (or any other person otherwise subject to tax under section 511)".

(i) AMENDMENTS RELATED TO SECTION 1014 OF THE 1988 ACT.—

(1) The subparagraph (C) of section 1(i)(3) added by section 1014(e)(7) of the 1988 Act is redesignated as subparagraph (D).

(2) Paragraph (1) of section 2654(a) is amended by adding at the end thereof the following new sentence: "The preceding shall be applied after any basis adjustment under section 1015 with respect to the transfer.".

(3) Subsection (g) of section 642 is amended by inserting after the first sentence the following new sentence: "Rules similar to the rules of the preceding sentence shall apply to amounts which may be taken into account under 2621(a)(2) or 2622(b).".

(4) Paragraphs (1) and (3) of section 2642(b) are each amended by striking "a timely filed gift tax return required by section 6019" and inserting "a gift tax return filed on or before the date prescribed by section 6075(b)".

(5) Paragraph (1) of section 6654(l) is amended by striking "this subsection shall" and inserting "this section shall".

(6) Clause (ii) of section 6654(l)(2)(B) is amended by inserting before the period at the end thereof the following: "(or, if no will is admitted to probate, which is the trust primarily responsible for paying debts, taxes, and expenses of administration)".

(j) AMENDMENTS RELATED TO SECTION 1015 OF THE 1988 ACT.—

(1) Paragraph (3) of section 1015(r) of the 1988 Act is amended by striking "section 6211" and inserting "section 6213".

(2) The last sentence of section 6502(a) is amended by striking "enforceable" and inserting "unenforceable".

(k) AMENDMENT RELATED TO SECTION 1016 OF THE 1988 ACT.—The subparagraph (E) of section 514(c)(9) added by section 1016 of the 1988 Act is redesignated as subparagraph (F).

(l) AMENDMENTS RELATED TO SECTION 1018 OF THE 1988 ACT.—

(1) The subsection (f) of section 2503 added by section 1018 of the 1988 Act is redesignated as subsection (g).

(2) Paragraph (4) of section 1018(d) of the 1988 Act is amended by inserting "the first place it appears" before "and inserting".

(3) Paragraph (20) of section 1018(u) of the 1988 Act is amended by striking "section 9507(b)" and inserting "section 9509(b)".

SEC. 6812. AMENDMENT RELATED TO TITLE II OF THE 1988 ACT.

Section 2005(e) of the 1988 Act is amended by inserting ", except that the amendment made by subsection (a)(1) shall take effect as if included in the amendment made by section 1131(c) of the Tax Reform Act of 1986".

SEC. 6813. AMENDMENTS RELATED TO TITLE III OF THE 1988 ACT.

(a) AMENDMENT RELATED TO SECTION 3001 OF THE 1988 ACT.—Paragraph (2) of section 6724(d) is amended by redesignating subparagraph (U) as subparagraph (S), by striking "or" at the end of subparagraph (Q), and by striking the period at the end of subparagraph (R) and inserting ", or".

(b) AMENDMENTS RELATED TO SECTION 3011 OF THE 1988 ACT.—Paragraphs (4) and (5) of section 3011(b) of the 1988 Act are each amended—

(1) by striking "111B(a)" and inserting "1011B(a)", and
(2) by striking "162(k)(2)" and inserting "162(k)".

(c) AMENDMENT RELATED TO SECTION 3021 OF THE 1988 ACT.—Clause (ii) of section 89(g)(3)(D) is amended—

(1) by striking "SUBSECTION (d) (1) (a) (ii)" in the heading and inserting "SUBSECTION (d) (1) (A) (ii)", and

(2) by striking "shall treated as" in the material preceding subclause (I) and inserting "shall be treated as".

SEC. 6814. AMENDMENTS RELATED TO TITLE IV OF THE 1988 ACT.

(a) AMENDMENT RELATED TO SECTION 4001 OF THE 1988 ACT.—Subsection (c) of section 127 is amended by striking paragraph (8).

(b) AMENDMENTS RELATED TO SECTION 4005 OF THE 1988 ACT.—

(1) The paragraph (3) of section 6045(e) added by section 4005 of the 1988 Act is redesignated as paragraph (4).

(2) Clause (ii) of section 148(d)(3)(E) is amended by striking "a qualified mortgage bond or".

(c) AMENDMENT RELATED TO SECTION 4006 OF THE 1988 ACT.—Section 4006 of the 1988 Act is amended—

(1) by striking "December 31, 1988" and inserting "Dec. 31, 1988", and
(2) by striking "December 31, 1989" and inserting "Dec. 31, 1989".

(d) AMENDMENTS RELATED TO SECTION 4008 OF THE 1988 ACT.—

(1) Subsection (d) of section 196 is amended by striking "substituting" and all that follows through "in the case of—" and inserting "substituting 'an amount equal to 50 percent of' for 'an amount equal to' in the case of—".

(2)(A) Subsection (c) of section 280C is amended by redesignating paragraph (3) as paragraph (4) and by inserting after paragraph (2) the following new paragraph:

"(3) ELECTION OF REDUCED CREDIT.—

"(A) IN GENERAL.—In the case of any taxable year for which an election is made under this paragraph—

"(i) paragraphs (1) and (2) shall not apply, and

"(ii) the amount of the credit under section 41(a) shall be the amount determined under subparagraph (B).

"(B) AMOUNT OF REDUCED CREDIT.—The amount of credit determined under this subparagraph for any taxable year shall be the amount equal to the excess of—

"(i) the amount of credit determined under section 41(a) without regard to this paragraph, over

"(ii) the product of—

"(I) 50 percent of the amount described in clause (i), and

"(II) the maximum rate of tax under section 11(b)(1).

"(C) ELECTION.—An election under this paragraph for any taxable year shall be made not later than the time for filing the return of tax for such year (including extensions), shall be made on such return, and shall be made in such manner as the Secretary may prescribe. Such an election, once made, shall be irrevocable.".

(B) In the case of a taxable year for which the last date for making the election under section 280C(c)(3) of the Internal Revenue Code of 1986 (as added by subparagraph (A)) is on or before the date which is 75 days after the date of the enactment of this Act, such an election for such year may be made—

(i) at any time before the date which is 75 days after such date of enactment, and

(ii) in such form and manner as the Secretary of the Treasury or his delegate may prescribe.

(C) Section 41 is amended by striking subsection (h) and by redesignating subsection (i) as subsection (h).

(D) Paragraph (4) of section 196(c) is amended by inserting "(other than such credit determined under section 280C(c)(3))" after "section 41(a)".

(E) Subsection (n) of section 6501 is amended by striking ", 41(h),".

SEC. 6815. AMENDMENTS RELATED TO TITLE V OF THE 1988 ACT.

(a) AMENDMENTS RELATED TO SECTION 5012 OF THE 1988 ACT.—

(1) Subparagraph (B) of section 7702A(c)(3) is amended to read as follows:

"(B) TREATMENT OF CERTAIN BENEFIT INCREASES.—For purposes of subparagraph (A), the term 'material change' includes any increase in the death benefit under the contract or any increase in, or addition of, a qualified additional benefit under the contract. Such term shall not include—

"(i) any increase which is attributable to the payment of premiums necessary to fund the lowest level of the death benefit and qualified additional benefits payable in the 1st 7 contract years (determined after taking into account death benefit increases described in subparagraph (A) or (B) of section 7702(e)(2)) or to crediting of interest or other earnings (including policyholder dividends) in respect of such premiums, and

"(ii) to the extent provided in regulations, any cost-of-living increase based on an established broad-based index if such increase is funded ratably over the remaining period during which premiums are required to be paid under the contract.".

(2) Paragraph (2) of section 5012(e) of the 1988 Act is amended by striking "continues to make level annual premium payments over the life of the contract" and inserting "makes at least 7 level annual premium payments".

(3) Subparagraph (A) of section 72(e)(11) is amended by adding at the end thereof the following new sentence:
"The preceding sentence shall not apply to any contract described in paragraph (5)(D).".

(4) Paragraph (4) of section 7702A(c) is amended—

(A) by striking "UNDER $10,000" in the paragraph heading and inserting "OF $10,000 OR LESS", and

(B) by striking "the same insurer" and inserting "the same policyholder".

(5) Section 72(e)(11)(A) is amended by striking "12-month period" and inserting "calendar year".

(b) AMENDMENT RELATED TO SECTION 5021 OF THE 1988 ACT.—Subsection (e) of section 5021 of the 1988 Act is amended by striking "no provision in any law (whether enacted before, on, or after the date of the enactment of this Act)" and inserting "no provision in any law enacted after the date of the enactment of this Act".

(c) AMENDMENT RELATED TO SECTION 5032 OF THE 1988 ACT.—Subsection (b) of section 2101 is amended by adding at the end thereof the following new sentence:
"For purposes of the preceding sentence, there shall be appropriate adjustments in the application of section 2001(c)(3) to reflect the difference between the amount of the credit provided under section 2102(c) and the amount of the credit provided under section 2010.".

(d) AMENDMENTS RELATED TO SECTION 5033 OF THE 1988 ACT.—

(1)(A) Paragraph (2) of section 2523(i) is amended by striking "made by the donor to such spouse" and inserting "which are made by the donor to such spouse and with respect to which a deduction would be allowable under this section but for paragraph (1)".

(B) The amendment made by subparagraph (A) shall apply with respect to gifts made after June 29, 1989.

(2) Subsection (a) of section 2523 is amended by striking "who is a citizen or resident".

(3) Paragraph (3) of section 2106(a) is amended by striking "ALLOWED WHERE SPOUSE IS CITIZEN".

(4)(A) Subparagraph (B) of section 2056(d)(2) is amended to read as follows:

"(B) SPECIAL RULE.—If any property passes from the decedent to the surviving spouse of the decedent, for purposes of subparagraph (A), such property shall be treated as passing to such spouse in a qualified domestic trust if—

"(i) such property is transferred to such a trust before the date on which the return of the tax imposed by this chapter is made, or

"(ii) such property is irrevocably assigned to such a trust under an irrevocable assignment made on or before such date which is enforceable under local law.".

(B) In the case of the estate of a decedent dying before the date of the enactment of this Act, the period during which the transfer (or irrevocable assignment) referred to in section 2056(d)(2)(B) of the Internal Revenue Code of 1986 (as amended by subparagraph (A)) may be made shall not expire before the date 1 year after such date of enactment.

(5) Subsection (d) of section 2056 is amended by adding at the end thereof the following new paragraph:

"(4) SPECIAL RULE WHERE RESIDENT SPOUSE BECOMES CITIZEN.—Paragraph (1) shall not apply if—

"(A) the surviving spouse of the decedent becomes a citizen of the United States before the day on which the return of the tax imposed by this chapter is made, and

"(B) such spouse was a resident of the United States at all times after the date of the death of the decedent and before becoming a citizen of the United States.".

(6) Paragraph (3) of section 2056(d) is amended—

(A) by striking "section 2001" and inserting "this chapter", and

(B) by inserting before the period at the end thereof the following: "and without regard to subsection (d)(3) of such section".

(7)(A) Subsection (a) of section 2056A is amended—

(i) by amending paragraph (1) to read as follows:

"(1) the trust instrument requires that at least 1 trustee of the trust be an individual citizen of the United States or a domestic corporation and that no distribution from the trust may be made without the approval of such a trustee,", and

(ii) by striking paragraph (2) and redesignating paragraphs (3) and (4) as paragraphs (2) and (3), respectively.

(B) Subsection (b) of section 2056A is amended by redesignating paragraphs (3) through (8) as paragraphs (4) through (9), respectively, and by inserting after paragraph (2) the following new paragraph:

"(3) CERTAIN LIFETIME DISTRIBUTIONS EXEMPT FROM TAX.—

"(A) INCOME DISTRIBUTIONS.—No tax shall be imposed by paragraph (1)(A) on any distribution of income to the surviving spouse.

"(B) HARDSHIP EXEMPTION.—No tax shall be imposed by paragraph (1)(A) on any distribution to the surviving spouse on account of hardship."

(C) Subparagraph (A) of section 2056A(b)(1) is amended by striking "other than a distribution of income required under subsection (a)(2)".

(D) Paragraph (4) of section 2056A(b) (as redesignated by subparagraph (B)) is amended to read as follows:

"(4) TAX WHERE TRUST CEASES TO QUALIFY.—If any qualified domestic trust ceases to meet the requirements of paragraphs (1) and (2) of subsection (a), the tax imposed by paragraph (1) shall apply as if the surviving spouse died on the date of such cessation.".

(8) Subsection (d) of section 2056 is amended by adding at the end thereof the following new paragraph:

"(4) REFORMATIONS PERMITTED.—

"(A) IN GENERAL.—In the case of any property with respect to which a deduction would be allowable under subsection (a) but for this subsection, the determination of whether a trust is a qualified domestic trust shall be made—

"(i) as of the date on which the return of the tax imposed this chapter is made, or

"(ii) if a judicial proceeding is commenced on or before the due date (determined with regard to extensions) for filing such return to change such trust into a trust which is a qualified domestic trust, as of the time when the changes pursuant to such proceeding are made.

"(B) STATUTE OF LIMITATIONS.—If a judicial proceeding described in subparagraph (A)(ii) is commenced with respect to any trust, the period for assessing any deficiency of tax attributable to any failure of such trust to be a qualified domestic trust shall not expire before the date 1 year after the date on which the Secretary is notified that the trust has been changed pursuant to such judicial proceeding or that such proceeding has been terminated.".

(9) Subsection (b) of section 2056A is amended by adding at the end thereof the following new paragraphs:

"(10) CERTAIN BENEFITS ALLOWED.—

"(A) IN GENERAL.—If any property remaining in the qualified domestic trust on the date of the death of the surviving spouse is includible in the gross estate of such spouse for purposes of this chapter (or would be includible if such spouse were a citizen or resident of the United States), any benefit which is allowable (or would be allowable if such spouse were a citizen or resident of the United States) with respect to such property to the estate of such spouse under section 2032, 2032A, 2055, 2056, or 6166 shall be allowed for purposes of the tax imposed by paragraph (1)(B).

"(B) SECTION 303.—If the estate of the surviving spouse meets the requirements of section 303 with respect to any property described in subparagraph (A), for purposes of section 303, the tax imposed by paragraph (1)(B) with respect to such property shall be treated as a Federal estate tax payable with respect to the estate of the surviving spouse.

"(C) SECTION 6161(a)(2).—The provisions of section 6161(a)(2) shall apply with respect to the tax imposed by paragraph (1)(B), and the reference in such section to the executor shall be treated as a reference to the trustees of the trust.

"(11) SPECIAL RULE WHERE DISTRIBUTION TAX PAID OUT OF TRUST.—For purposes of this subsection, if any portion of the tax imposed by paragraph (1)(A) with respect to any distribution is paid out of the trust, an amount equal to the portion so paid shall be treated as a distribution described in paragraph (1)(A).

"(12) SPECIAL RULE WHERE SPOUSE BECOMES CITIZEN.—If the surviving spouse of the decedent becomes a citizen of the United States and if—

"(A) such spouse was a resident of the United States at all times after the date of the death of the decedent and before such spouse becomes a citizen of the United States,

"(B) no tax was imposed by paragraph (1)(A) with respect to any distribution before such spouse becomes such a citizen, or

"(C) such spouse elects—

"(i) to treat any distribution on which tax was imposed by paragraph (1)(A) as a taxable gift made by such spouse for purposes of—

"(I) section 2001, and

"(II) determining the amount of the tax imposed by section 2501 on actual taxable gifts made by such spouse during the year in which the spouse becomes a citizen or any subsequent year, and

"(ii) to treat any reduction in the tax imposed by paragraph (1)(A) by reason of the credit allowable under section 2010 with respect to the decedent as a credit allowable to such surviving spouse under section 2505 for purposes of determining the amount of the credit allowable under section 2505 with respect to taxable gifts made by the surviving spouse during the year in which the spouse becomes a citizen or any subsequent year,

paragraph (1)(A) shall not apply to any distributions after such spouse becomes such a citizen (and paragraph (1)(B) shall not apply).

"(13) COORDINATION WITH SECTION 1015.—For purposes of section 1015, any distribution on which tax is imposed by paragraph (1)(A) shall be treated as a transfer by gift, and any tax paid under paragraph (1)(A) shall be treated as a gift tax.".

(10) Paragraph (2) of section 2056A(c) is amended by striking "The term" and inserting "Except as provided in regulations, the term".

(11) Clause (ii) of section 2056A(b)(2)(B) is amended by striking "as a credit or refund" and inserting "as a credit or refund (with interest)".

(12) Paragraph (2) of section 2056A(b) is amended by adding at the end thereof the following new subparagraph:

"(C) SPECIAL RULE WHERE DECEDENT HAS MORE THAN 1 QUALIFIED DOMESTIC TRUST.—If there is more than 1 qualified domestic trust with respect to any decedent, the amount of the tax imposed by paragraph (1) with respect to such trusts shall be determined by using the highest rate of tax in effect under section 2001 as of the date of the decedent's death (and the provisions of paragraph (3)(B) shall not apply) unless, pursuant to a designation made by the decedent's executor, there is 1 person—

"(i) who is an individual citizen of the United States or a domestic corporation and is responsible for filing all returns of tax imposed under paragraph (1) with respect to such trusts and for paying all tax so imposed, and

"(ii) who meets such requirements as the Secretary may by regulations prescribe.".

(13) Section 2056A is amended by adding at the end thereof the following new subsection:

"(e) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations under which an annuity includible in the decedent's gross estate under section 2039 may be treated as a qualified domestic trust.".

(14) In the case of the estate of, or gift by, an individual who was not a citizen or resident of the United States but was a resident of a foreign country with which the United States has a tax treaty with respect to estate, inheritance, or gift taxes, the amendments made by section 5033 of the 1988 Act shall not apply to the extent such amendments would be inconsistent with the provisions of such treaty relating to estate, inheritance, or gift tax marital deductions.

(15) Paragraph (5) of section 2056A(b) (as redesignated by paragraph (7)(B) of this subsection) is amended to read as follows:

"(5) DUE DATE.—

"(A) TAX ON DISTRIBUTIONS.—The estate tax imposed by paragraph (1)(A) shall be due and payable on the 15th day of the 4th month following the calendar year in which the taxable event occurs; except that the estate tax imposed by paragraph (1)(A) on distributions during the calendar year in which the surviving spouse dies shall be due and payable not later than the date on which the estate tax imposed by paragraph (1)(B) is due and payable.

"(B) TAX AT DEATH OF SPOUSE.—The estate tax imposed by paragraph (1)(B) shall be due and payable on the date 9 months after the date of such death.".

(16) For purposes of applying section 2040(a) of the Internal Revenue Code of 1986 with respect to any joint interest to which section 2040(b) of such Code does not apply solely by reason of section 2056(d)(1)(B) of such Code, any consideration furnished before July 14, 1988, by the decedent for such interest to the extent treated as a gift to the spouse of the decedent for purposes of chapter 12 of such Code shall be treated as consideration originally belonging to such spouse and never acquired by such spouse from the decedent.

(e) AMENDMENTS RELATED TO SECTION 5041 OF THE 1988 ACT.—

(1) Subparagraph (A) of section 460(e)(6) is amended—

(A) by striking "the building, construction, reconstruction, or rehabilitation of" and inserting "activities referred to in paragraph (4) with respect to", and

(B) by striking clause (i) and inserting the following:

"(i) dwelling units (as defined in section 167(k)) contained in buildings containing 4 or fewer dwelling units (as so defined), and".

(2)(A) Paragraph (4) of section 5041(b) of the 1988 Act is amended by inserting ", as amended by title I of this Act," after "1986 Code".

(B) Paragraph (3) of section 56(a) is amended by striking "The preceding sentence shall not" and inserting "The first sentence of this paragraph shall not".

(3) Subparagraph (C) of section 5041(e)(1) of 1988 Act is amended by striking "subsections (a), (b), and (c)" and inserting "subsections (a) and (b)".

(4) Clause (i) of section 56(g)(4)(D) is amended by adding "and" at the end of subclause (III) and by striking subclauses (IV) and (V) and inserting the following new subclause:

"(IV) paragraphs (6), (7), and (8) shall not apply.".

(f) AMENDMENT RELATED TO SECTION 5053 OF THE 1988 ACT.—Subsection (d) of section 145 is amended by redesignating paragraph (3) as paragraph (4) and by inserting after paragraph (2) the following new paragraph:

"(3) CERTAIN PROPERTY TREATED AS NEW PROPERTY.—Solely for purposes of determining under paragraph (2)(A) whether the 1st use of property is pursuant to tax-exempt financing—

"(A) IN GENERAL.—If—

"(i) the 1st use of property is pursuant to taxable financing,

"(ii) there was a reasonable expectation (at the time such taxable financing was provided) that such financing would be replaced by tax-exempt financing, and

"(iii) the taxable financing is in fact so replaced within a reasonable period after the taxable financing was provided,

then the 1st use of such property shall be treated as being pursuant to the tax-exempt financing.

"(B) SPECIAL RULE WHERE STATE LAW INITIALLY PROHIBITED TAX-EXEMPT FINANCING.—If, at the time of the 1st use of property, State law prohibited tax-exempt financing of the property, the 1st use of the property shall be treated as pursuant to the 1st tax-exempt financing of the property.

"(C) DEFINITIONS.—For purposes of this paragraph—

"(i) TAX-EXEMPT FINANCING.—The term 'tax-exempt financing' means financing provided by tax-exempt bonds.

"(ii) TAXABLE FINANCING.—The term 'taxable financing' means financing which is not tax-exempt financing."

(g) AMENDMENT RELATED TO SECTION 5076 OF THE 1988 ACT.—Paragraph (3) of section 453A(b) is amended to read as follows:

"(3) EXCEPTION FOR PERSONAL USE AND FARM PROPERTY.—An installment obligation shall not be treated as described in paragraph (1) if it arises from the disposition—

"(A) by an individual of personal use property (within the meaning of section 1275(b)(3)), or

"(B) of any property used or produced in the trade or business of farming (within the meaning of section 2032A(e) (4) or (5)).".

(h) AMENDMENT RELATED TO SECTION 5077 OF THE 1988 ACT.—Clause (ii) of section 382(l)(3)(C) is amended by striking "for purposes of subclause (III)," and inserting "For purposes of subclause (III),".

SEC. 6816. AMENDMENTS RELATED TO TITLE VI OF THE 1988 ACT.

(a) AMENDMENT RELATED TO SECTION 6006 OF THE 1988 ACT.—Subparagraph (A) of section 1(i)(7) is amended by inserting "(other than for purposes of this paragraph)" after "shall be treated".

(b) AMENDMENTS RELATED TO SECTION 6026 OF THE 1988 ACT.—

(1) Subparagraph (D) of section 263A(h)(3) is amended to read as follows:

"(D) TREATMENT OF CERTAIN CORPORATIONS.—

"(i) IN GENERAL.—If—

"(I) substantially all of the stock of a corporation is owned by a qualified employee-owner and members of his family (as defined in section 267(c)(4)), and

"(II) the principal activity of such corporation is performance of personal services directly related to the activities of the qualified employee-owner and such services are substantially performed by the qualified employee-owner,

this subsection shall apply to any expense of such corporation which directly relates to the activities of such employee-owner in the same manner as if such expense were incurred by such employee-owner.

"(ii) QUALIFIED EMPLOYEE-OWNER.—For purposes of this subparagraph, the term 'qualified employee-owner' means any individual who is an employee-owner of the corporation (as defined in section 269A(b)(2)) and who is a writer, photographer, or artist.".

(2) Subparagraph (B) of section 6026(d)(2) of the 1988 Act is amended by striking "the taxpayer made" and inserting "a taxpayer engaged in a farming business involving the production of animals having a preproductive period of more than 2 years made".

(c) AMENDMENTS RELATED TO SECTION 6028 OF THE 1988 ACT.—

(1) Paragraph (5) of section 168(b) is amended by striking "paragraph (2)(B)" and inserting "paragraph (2)(C)".

(2) Paragraph (2) of section 168(c) is amended by striking "subsection (b)(2)(B)" and inserting "subsection (b)(2)(C)".

(d) AMENDMENT RELATED TO SECTION 6029 OF THE 1988 ACT.—The subparagraph (D) of section 168(b)(3) added by section 6029 of the 1988 Act is redesignated as subparagraph (E).

(e) AMENDMENT RELATED TO SECTION 6061 OF THE 1988 ACT.—Section 6061 of the 1988 Act is amended—

(1) by striking "section 111B(h)(5)(A)" and inserting "section 1011B(h)(5)(A)", and

(2) by striking "section 111B(h)" and inserting "section 1011B(h)".

(f) AMENDMENT RELATED TO SECTION 6064 OF THE 1988 ACT.—Paragraph (13) of section 457(e) is amended to read as follows:

"(13) SPECIAL RULE FOR CHURCHES.—The term 'eligible employer' shall not include a church (as defined in section 3121(w)(3)(A)) or qualified church-controlled organization (as defined in section 3121(w)(3)(B)).".

(g) AMENDMENT RELATED TO SECTION 6067 OF THE 1988 ACT.—Subsection (c) of section 6067 of the 1988 Act is amended by striking "section 205(c)" and inserting "section 2005(c)".

(h) PROVISION RELATED TO SECTION 6076 OF THE 1988 ACT.—If, for the 1st taxable year beginning on or after January 1, 1987, a qualified group self-insurers' fund changes its treatment of policyholder dividends to take into account such dividends no earlier than the date that the State regulatory authority determines the amount of the policyholder dividend that may be paid, then such change shall be treated as a change in a method of accounting and no adjustment under section 481(a) of the Internal Revenue Code of 1986 shall be made with respect to such change in method of accounting.

(i) AMENDMENTS RELATED TO SECTION 6077 OF THE 1988 ACT.—

(1) Paragraph (1) of section 847 is amended—

(A) by striking "separate estimated tax" and inserting "special estimated tax", and

(B) by striking "after December 31, 1986" and inserting "in taxable years beginning after December 31, 1986".

(2) The first sentence of section 847(2) is amended to read as follows: "The deduction under paragraph (1) shall be allowed only to the extent that such deduction would result in a tax benefit for the taxable year for which such deduction is allowed or any carryback year and only to the extent that special estimated tax payments are made in an amount equal to the tax benefit attributable to such deduction on or before the due date (determined without regard to extensions) for filing the return for the taxable year for which the deduction is allowed.".

(3) Paragraph (5) of section 847 is amended by adding at the end thereof the following new sentence:

"To the extent that any amount added to the special loss discount account is not subtracted from such account before the 15th year after the year for which the amount was so added, such amount shall be subtracted from such account for such 15th year and included in gross income for such 15th year.".

(4) Paragraph (9) of section 847 is amended by striking "and" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", and", and by adding at the end thereof the following new subparagraph:

"(C) providing for the application of this section in cases where the deduction allowed under paragraph (1) for any taxable year is less than the excess referred to in paragraph (1) for such year.".

(5) Section 847 (as amended by paragraph (4)) is amended by redesignating paragraph (9) as paragraph (10) and by inserting after paragraph (8) the following new paragraph:

"(9) EFFECT ON EARNINGS AND PROFITS.—In determining the earnings and profits.—

"(A) any special estimated tax payment made for any taxable year shall be treated as a payment of income tax imposed by this title for such taxable year, and

"(B) any deduction or inclusion under this section shall not be taken into account.

Nothing in the preceding sentence shall be construed to affect the application of section 56(g) (relating to adjustments based on adjusted current earnings)."

(6) Paragraph (8) of section 847 is amended by adding at the end thereof the following new sentence: "The limitations on consolidation contained in section 1503(c) shall not apply to the deduction allowed under paragraph (1)."

(j) AMENDMENTS RELATED TO SECTION 6105 OF THE 1988 ACT.—

(1) The subsection (c) of section 5276 added by section 6105 of the 1988 Act is amended—

(A) by striking "(c) EXEMPTION" and inserting "(d) EXCEPTION",

(B) by striking "section 5271(a)(2)" in paragraph (1) and inserting "section 5271", and

(C) by striking "specially denatured distilled spirits" in paragraph (2) and inserting "distilled spirits free of tax".

(2) Subsection (a) of section 5276 is amended by striking "Except as provided in subsection (c)," and inserting "Except as otherwise provided in this section,".

(k) AMENDMENT RELATED TO SECTION 6135 OF THE 1988 ACT.—Paragraph (3) of section 953(d) is amended by striking "(as defined in section 1503(d))" and inserting "for purposes of section 1503(d) without regard to paragraph (2)(B) thereof".

(l) AMENDMENT RELATED TO SECTION 6152 OF THE 1988 ACT.—Subparagraph (C) of section 2056(b)(7) is amended by striking "an annuity" and inserting "an annuity included in the gross estate of the decedent under section 2039".

(m) AMENDMENTS RELATED TO SECTION 6180 OF THE 1988 ACT.—

(1) Paragraph (1) of section 142(i) is amended by inserting "IN GENERAL.—" after "(1)".

(2) The paragraph (3) of section 146(g) added by section 6180 of the 1988 Act is redesignated as paragraph (4).

(3) Paragraph (3) of section 147(c) is amended by inserting a comma after "mass commuting facility" each place it appears.

(n) AMENDMENTS RELATED TO SECTION 6183 OF THE 1988 ACT.—Subclause (II) of section 148(f)(4)(C)(ii) is amended by striking "on behalf of" and inserting "to make loans to".

(o) AMENDMENTS RELATED TO SECTION 6228 OF THE 1988 ACT.—

(1) The section 7520 added by section 6228 of the 1988 Act is redesignated as section 7521.

(2) The table of sections for chapter 77 is amended by striking the item added by section 6228 of the 1988 Act and inserting the following:

"Sec. 7521. Procedures involving taxpayer interviews.".

(p) AMENDMENTS RELATED TO SECTION 6242 OF THE 1988 ACT.—

(1) The section 6712 added by section 6242 of the 1988 Act is redesignated as section 6713.

(2) The table of sections for part I of subchapter B of chapter 68 is amended by striking the item added by section 6242 of the 1988 Act and inserting the following:

"Sec. 6713. Disclosure or use of information by preparers of returns.".

(q) AMENDMENT RELATED TO SECTION 6253 OF THE 1988 ACT.—Section 6253 of the 1988 Act is amended by inserting ", as amended by title I of this Act," after "1986 Code".

SEC. 6817. EFFECTIVE DATE.

Except as otherwise provided in this part, any amendment made by this part shall take effect as if included in the provision of the 1988 Act to which such amendment relates.

PART II—AMENDMENTS RELATED TO REVENUE ACT OF 1987

SEC. 6821. AMENDMENTS RELATED TO SUBTITLE B.

(a) AMENDMENTS RELATED TO SECTION 10202 OF THE 1987 ACT.—

(1) Subparagraph (B) of section 453A(b)(2) is amended by striking "all obligations of the taxpayer described in paragraph (1)" and inserting "all such obligations held by the taxpayer".

(2) Subparagraph (B) of section 453A(d)(2) is amended by striking "before such secured indebtedness was incurred" and inserting "before the later of the times referred to in subparagraph (A) or (B) of paragraph (1)".

(3) Subparagraph (B) of section 453A(d)(1) is amended by inserting "the time" before the "the proceeds".

(4)(A) Paragraph (2) of section 26(b) (as amended by section 11811) is amended by striking "and" at the end of subparagraph (L), by striking the period at the end of subparagraph (M) and inserting ", and", and by adding at the end thereof the following new subparagraph:

"(N) sections 453(l)(3) and 453A(c) (relating to interest on certain deferred tax liabilities).".

(B) Subsection (c) of section 453A is amended by redesignating paragraph (5) as paragraph (6) and by inserting after paragraph (4) the following new paragraph:

"(5) TREATMENT AS INTEREST.—Any amount payable under this subsection shall be taken into account in computing the amount of any deduction allowable to the taxpayer for interest paid or accrued during the taxable year.".

(5) In the case of taxable years beginning in 1987, the reference to section 453 contained in section 56(a)(6) of the Internal Revenue Code of 1986 shall be treated as including a reference to section 453A.

(b) AMENDMENTS RELATED TO SECTION 10206 OF THE 1987 ACT.—Effective with respect to taxable years beginning after 1988, the last sentence of section 7519(d)(4) is amended—

(1) by striking "for taxable years beginning after 1987,",

(2) by striking "if more than 50 percent" and inserting "unless more than 50 percent", and

(3) by striking "who would not have been entitled" and inserting "who would have been entitled".

(c) AMENDMENT RELATED TO SECTION 10222 OF THE 1987 ACT.—Clause (ii) of section 1503(e)(2)(A) is amended by striking "another member" and inserting "another corporation which is or was a member".

(d) AMENDMENTS RELATED TO SECTION 10242 OF THE 1987 ACT.—

(1) The item relating to section 842 in the table of sections for part III of subchapter L of chapter 1 is amended by striking "corporations" and inserting "companies".

(2) The heading for paragraph (4) of section 842(c) is amended by striking "YEILDS" and inserting "YIELDS".

SEC. 6822. AMENDMENT RELATED TO SUBTITLE C AND FOLLOWING SUBTITLES.

(a) AMENDMENT RELATED TO SECTION 10301 OF THE 1987 ACT.—Paragraph (1) of section 6655(e) is amended by striking "section (d)(1)" and inserting "subsection (d)(1)".

(b) AMENDMENTS RELATED TO SECTION 10502 OF THE 1987 ACT.—

(1) Paragraph (1) of section 6427(i) is amended by striking "subsection (a)" and all that follows through "by any person" and inserting "subsection (a), (b), (d), (e), (g), (h), (l), or (p) by any person".

(2) Clause (i) of section 6427(i)(2)(A) is amended to read as follows:

"(i) $1,000 or more is payable under subsections (a), (b), (d), (e), (g), (h), and (p), or".

(3) Subparagraph (B) of section 6427(i)(2) is amended to read as follows:

"(B) SPECIAL RULE.—If the requirements of subparagraph (A)(ii) are met by any person for any quarter but the requirements of subparagraph (A)(i) are not met by such person for such quarter, such person may file a claim under subparagraph (A) for such quarter only with respect to amounts referred to in subparagraph (A)(ii).".

(4) The subsection of section 6427 relating to payments for taxes imposed by section 4041(d) is redesignated as subsection (p).

(5) Paragraph (3) of section 9502(b) is amended by striking ", and" and inserting "; and".

(6) Subparagraph (A) of section 9503(b)(4) is amended by striking "sections 4041(d)" and inserting "section 4041(d)".

(7) Subsections (b)(3) and (c)(2)(A) of section 9508 are each amended by striking "Storage Trust Fund" and inserting "Storage Tank Trust Fund".

(c) AMENDMENT RELATED TO SECTION 10611 OF THE 1987 ACT.—The table of sections for part II of subchapter B of chapter 1 is amended by inserting "Illegal" before "Federal" in the item relating to section 90.

(d) AMENDMENTS RELATED TO SECTION 10713 OF THE 1987 ACT.—

(1) Subparagraph (G) of section 10713(b)(2) of the 1987 Act is amended to read as follows:

"(G) Paragraph (3) of section 7611(i) is amended by striking all that follows 'income tax)' and inserting ', section 6852 (relating to termination assessments in case of flagrant political expenditures of section 501(c)(3) organizations), or section 6861 (relating to jeopardy assessments of income taxes, etc.),'.".

(2) Clause (iii) of section 10713(b)(2)(E) of the 1987 Act is amended to read as follows:

"(iii) by striking '6851(a) nor 6861(a)' in subsection (b)(3)(A)(iii) and inserting '6851(a), 6852(a), nor 6861(a)'.".

SEC. 6823. EFFECTIVE DATE.

Except as otherwise provided in this part, any amendment made by this part shall take effect as if included in the provision of the 1987 Act to which such amendment relates.

PART III—AMENDMENTS RELATED TO TAX REFORM ACT OF 1986

SEC. 6831. AMENDMENTS RELATED TO TAX REFORM ACT OF 1986.

(a) AMENDMENT RELATED TO SECTION 201 OF THE 1986 ACT.—Paragraph (5) of section 1250(b) is amended—

(1) by striking "in the case of recovery property" in subparagraph (A) and inserting "in the case of property to which section 168 applies", and

(2) by striking "in the case of any property which is not recovery property" in subparagraph (B) and inserting "in the case any property to which section 168 does not apply".

(b) AMENDMENTS RELATED TO SECTION 252 OF THE 1986 ACT.—

(1) Subparagraph (B) of section 42(i)(3) (defining low-income unit) is amended by inserting "(as determined under regulations prescribed by the Secretary taking into account local health, safety, and building codes)" after "suitable for occupancy".

(2) Paragraph (3) of section 42(i) is amended by adding at the end thereof the following new subparagraph:

"(D) Students in government-supported job training programs not to disqualify unit.—A unit shall not fail to be treated as a low-income unit merely because it is occupied by an individual who is enrolled in a job training program receiving assistance under the Job Training Partnership Act or under other similar Federal, State, or local laws."

(3) Subsection (i) of section 42 (relating to special rules) is amended by adding at the end thereof the following new paragraph:

"(6) Application to estates and trusts.—In the case of an estate or trust, the amount of the credit determined under subsection (a) and any increase in tax under subsection (j) shall be apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each."

(4) Subsection (f) of section 42 is amended by adding at the end thereof the following new paragraph:

"(4) Dispositions of property.—If a building (or an interest therein) is disposed of during any year for which credit is allowable under subsection (a), such credit shall be allocated between the parties on the basis of the number of days during such year the building (or interest) was held by each."

(5) Subsection (m) of section 42 (relating to regulations) is amended by striking "and" at the end of paragraph (2), by striking the period at the end of paragraph (3) and inserting ", and", and by adding at the end thereof the following new paragraph:

"(4) providing the opportunity for housing credit agencies to correct administrative errors and omissions with respect to allocations and record keeping within a reasonable period after their discovery, taking into account the availability of regulations and other administrative guidance from the Secretary."

(6) Subparagraph (A) of section 42(d)(7) is amended by inserting "(or interest therein)" after "a building described in subparagraph (B)".

(c) Amendments Related to Section 803 of the 1986 Act.—

(1) Subparagraph (A) of section 803(d)(4) of the Tax Reform Act of 1986 is amended by striking so much of such subparagraph as precedes clause (i) thereof and inserting the following:

"(A) Transition property exempted from interest capitalization.—Section 263A of the Internal Revenue Code of 1986 (as added by this section) and the amendment made by subsection (b)(1) shall not apply to interest costs which are allocable to any property—".

(2) If any interest costs incurred after December 31, 1986, are attributable to costs incurred before January 1, 1987, the amendments made by section 803 of the Tax Reform Act of 1986 shall apply to such interest costs only to the extent such interest costs are attributable to costs which were required to be capitalized under section 263 of the Internal Revenue Code of 1954 and which would have been taken into account in applying section 189 of the Internal Revenue Code of 1954 (as in effect before its repeal by section 803 of the Tax Reform Act of 1986) or, if applicable, section 266 of such Code.

(d) Application of Future Legislation to Transitioned Bonds.—Section 1318 of the Tax Reform Act of 1986 is amended by adding at the end thereof the following new paragraph:

"(8) Application of future legislation to transitioned bonds.—In the case of any bond to which the amendments made by section 1301 do not apply by reason of a provision of this Act, any amendment of the 1986 Code (and any other provision applicable to such Code) included in any law enacted after October 22, 1986, shall be treated as included in section 103 and section 103A (as appropriate) of the 1954 Code with respect to such bond unless—

"(A) such law expressly provides that such amendment (or other provision) shall not apply to such bond, or

"(B) such amendment (or other provision) applies to a provision of the 1986 Code—

"(i) for which there is no corresponding provision in section 103 and section 103A (as appropriate) of the 1954 Code, and

"(ii) which is not otherwise treated as included in such sections 103 and 103A with respect to such bond.".

(e) Effective Date.—Any amendment made by this section shall take effect as if included in the provision of the Tax Reform Act of 1986 to which such amendment relates.

PART IV—MISCELLANEOUS CHANGES

SEC. 6841. MISCELLANEOUS CHANGES.

(a) AMENDMENT RELATED TO TRANSFERS INCIDENT TO DIVORCE OR SEPARATION.—

(1) Paragraph (6) of section 408(d) is amended by striking "his former spouse under a divorce decree or under a written instrument incident to such divorce" and inserting "his spouse or former spouse under a divorce or separation instrument described in subparagraph (A) of section 71(b)(2)".

(2) Subsection (p) of section 414 is amended by redesignating paragraph (11) as paragraph (12) and by inserting after paragraph (10) the following new paragraph:

"(11) APPLICATION OF RULES TO GOVERNMENTAL AND CHURCH PLANS.—For purposes of this title, a distribution or payment from a governmental plan (as defined in subsection (d)) or a church plan (as described in subsection (e)) shall be treated as made pursuant to a qualified domestic relations order if it is made pursuant to a domestic relations order which meets the requirement of clause (i) of paragraph (1)(A)."

(3) The amendments made by this subsection shall apply to transfers after the date of the enactment of this Act in taxable years ending after such date.

(b) AMENDMENT RELATED TO SINGLE-EMPLOYER PENSION PLAN AMENDMENTS ACT OF 1986.—

(1) Section 404(g)(1) is amended by inserting "4041(b)," before "4062".

(2) The amendment made by paragraph (1) shall apply to payments made after January 1, 1986, in taxable years ending after such date.

(c) DEFINITION OF COMPENSATION.—

(1) Paragraph (1) of section 219(f) (defining compensation) is amended by adding at the end thereof the following new sentence: "For purposes of this paragraph, section 401(c)(2) shall be applied as if the term trade or business for purposes of section 1402 included service described in subsection (c)(6).

(2) The amendment made by paragraph (1) shall apply to contributions after the date of the enactment of this Act in taxable years ending after such date.

(d) MISCELLANEOUS CLERICAL CHANGES.—

(1) Paragraph (1) of section 6103(d) is amended by striking "45,".

(2) Section 6871 is amended by striking "44, or 45" each place it appears and inserting "or 44".

(3) Paragraph (5) of section 691(c) is amended by striking "paragraph (1)(D)" and inserting "paragraph (1)(C)".

(4) The table of chapters for subtitle D is amended by striking the comma in the item relating to chapter 42 and inserting a semicolon.

(5) Section 6652 is amended—

(A) by redesignating the subsection relating to information with respect to includible employee benefits as subsection (k), and

(B) by redesignating the subsection relating to alcohol and tobacco taxes as subsection (l).

(6) Paragraph (2) of section 410(a) is amended by striking the comma before the period.

(7) The heading of paragraph (1) of section 132(h) is amended by striking "OFFICERS, ETC.," and inserting "HIGHLY COMPENSATED EMPLOYEES".

(8) Paragraph (1) of section 66(d) is amended by striking "section 911(b)" and inserting "section 911(d)(2)".

(9) Subsection (e) of section 861 is amended by striking "section 826(a)" and inserting "section 862(a)".

(10) Paragraph (27) of section 381(a) (relating to credit under section 53) is redesignated as paragraph (26).

(11) Subclause (III) of section 382(l)(3)(B)(i) is amended by striking "divorce," and inserting "divorce),".

(12) The last sentence of section 6157(a) is amended by striking "subsections (c) and (d)" and inserting "subsection (c)".

(13) Clause (i) of section 42(d)(6)(A) is amended by striking "Farmers' Home Administration" and inserting "Farmers Home Administration".

(14) Clause (ii) of section 42(d)(7)(A) is amended by striking "sebsection (a)" and inserting "subsection (a)".

(15) Subparagraph (A) of section 42(e)(2) is amended by striking "captial account" and inserting "capital account".

(16) Paragraph (2) of section 844(a) is amended by striking "for the taxable year" and inserting "for a prior taxable year".

(17) Subsection (c) of section 4221 is amended by striking "or 4083".

(18) Clause (i) of section 274(n)(2)(F) is amended by inserting "any" before "Federal".

PART V—AMENDMENTS RELATED TO PENSION PROVISIONS

SEC. 6851. DEFINITIONS.

For purposes of this part—

(1) REFORM ACT.—Except where incompatible with the intent, the term "Reform Act" means the Tax Reform Act of 1986.

(2) ERISA.—The term "ERISA" means the Employee Retirement Income Security Act of 1974.

Subpart A—Amendments Related To Tax Reform Act of 1986

SEC. 6861. AMENDMENTS RELATED TO TITLE XI OF THE REFORM ACT.

(a) AMENDMENTS RELATED TO SECTION 1113 OF THE REFORM ACT.—

(1) Section 203(a)(2) of ERISA is amended—

(A) by striking "following" the first place it appears, and

(B) by striking "414(f)(1)(B)" in subparagraph (C)(ii)(I) and inserting "3(37)(A)(ii)".

(2) Section 1113(e)(3) of the Reform Act is amended by striking "Section 202(B)(i)" and inserting "Section 202(a)(1)(B)(i)".

(3) The second subsection (e) of section 1113 of the Reform Act is redesignated as subsection (f).

(4) Section 1113(f) of the Reform Act, as redesignated by paragraph (3), is amended by adding at the end thereof the following new paragraph:

"(4) REPEAL OF CLASS YEAR VESTING.—If a plan amendment repealing class year vesting is adopted after October 22, 1986, such amendment shall not apply to any employee for the 1st plan year to which the amendments made by subsections (b) and (e)(2) apply (and any subsequent plan year) if—

"(A) such plan amendment would reduce the nonforfeitable right of such employee for such year, and

"(B) such employee has at least 1 hour of service before the adoption of such plan amendment and after the beginning of such 1st plan year.

This paragraph shall not apply to an employee who has 5 consecutive 1-year breaks in service (as defined in section 411(a)(6)(A) of the Internal Revenue Code of 1986) which include the 1st day of the 1st plan year to which the amendments made by subsection (b) and (e)(2) apply. A plan shall not be treated as failing to meet the requirements of section 401(a)(26) of such Code by reason of complying with the provisions of this paragraph."

(5)(A) Section 411(a)(3) is amended by adding at the end thereof the following new subparagraph:

"(G) TREATMENT OF MATCHING CONTRIBUTIONS FORFEITED BY REASON OF EXCESS DEFERRAL OR CONTRIBUTION.—A matching contribution (within the meaning of section 401(m)) shall not be treated as forfeitable merely because such contribution is forfeitable if the contribution to which the matching contribution relates is treated as an excess contribution under section 401(k)(8)(B), an excess deferral under section 402(g)(2)(A), or an excess aggregate contribution under section 401(m)(6)(B).".

(B) Paragraph (3) of section 203(a) of ERISA is amended by adding at the end thereof the following new subparagraph:

"(F) A matching contribution (within the meaning of section 401(m) of the Internal Revenue Code of 1986) shall not be treated as forfeitable merely because such contribution is forfeitable if the contribution to which the matching contribution relates is treated as an excess contribution under section 401(k)(8)(B) of such Code, an excess deferral under section 402(g)(2)(A) of such Code, or an excess aggregate contribution under section 401(m)(6)(B) of such Code.".

(6)(A) Section 411(a)(4)(A) is amended to read as follows:

"(A) years of service before age 18,".

(B) Subparagraph (A) of section 203(b)(1) of ERISA is amended to read as follows:

"(A) years of service before age 18,".

(b) AMENDMENTS RELATED TO SECTION 1140 OF THE REFORM ACT.—

(1)(A) Subsection (a) of section 1140 of the Reform Act is amended by striking "January 1, 1989" each place it appears and inserting "January 1, 1990".

(B) Section 1140(c) of the Reform Act is amended by striking all after "the first plan year beginning" and inserting "after the later of—

"(1) December 31, 1989, or

"(2) the earlier of—

"(A) December 31, 1990, or

"(B) the date on which the last of such collective bargaining agreements terminate (without regard to any extension after February 28, 1986)."

(2) Subsection (a) of section 1140 of the Reform Act is amended by striking "or subtitle C" and inserting ", subtitle C, or title XVIII of this Act".

(3) Section 1140(c) of the Reform Act is amended by inserting "on or" after "beginning" the second place it appears.

(4) Section 1140(c) is amended by adding at the end thereof the following new flush sentence:

"For purposes of paragraph (1)(B) and any other provision of this title, an agreement shall not be treated as terminated merely because the plan is amended pursuant to such agreement to meet the requirements of any amendment made by this title or title XVIII of this Act.".

(c) AMENDMENTS RELATED TO SECTION 1145 OF THE REFORM ACT.—

(1) Subsection (f) of section 303 of the Retirement Equity Act of 1984 is amended by striking "July 24, 1984" and inserting "July 17, 1984".

(2) Paragraph (3) of section 205(b) of ERISA, as added by section 1145(b) of the Reform Act, is redesignated as paragraph (4).

SEC. 6862. AMENDMENTS RELATED TO TITLE XVIII OF THE REFORM ACT.

(a) AMENDMENT RELATED TO SECTION 1852 OF THE REFORM ACT.—Paragraph (1) of section 4402(h) of ERISA is amended by striking "January 12, 1982" the second place it appears and inserting "January 16, 1982".

(b) AMENDMENT RELATED TO SECTION 1879 OF THE REFORM ACT.—Subsection (u) of section 1879 of the Reform Act is amended—

(1) by striking "206(h)" each place it appears in paragraphs (1) and (4)(B) and inserting "204(h)",

(2) by redesignating paragraph (4) as paragraph (5), and

(3) by inserting after paragraph (3) the following:

"(4) CORRECTION OF CROSS REFERENCE.—Section 4218(1)(A) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1398(1)(A)) is amended by striking 'section 4062(d)' and inserting 'section 4069(b)'."

(c) AMENDMENTS RELATED TO SECTION 1895 OF THE REFORM ACT.—

(1)(A) Section 106(b)(2) (relating to exception to certain plans) is amended by striking the last sentence thereof.

(B) Sections 601(b) of ERISA and 2201(b) of the Public Health Service Act are each amended by striking the last sentence thereof.

(C) The amendments made by this paragraph shall apply to years beginning after December 31, 1986.

(2)(A) Sections 607(2) of ERISA and 2208(2) of the Public Health Service Act are each amended by striking "the individual's employment or previous employment with an employer" and inserting "the performance of services by the individual for 1 or more persons maintaining the plan (including as an employee defined in section 401(c)(1) of the Internal Revenue Code of 1986)".

(B) Section 4980B(f)(7), as added by the Technical and Miscellaneous Revenue Act of 1988, is amended by striking "the individual's employment or previous employment with an employer" and inserting "the performance of services by the individual for 1 or more persons maintaining the plan (including as an employee defined in section 401(c)(1))".

(C) The amendments made by this paragraph shall apply to plan years beginning after December 31, 1989.

(3)(A) Clause (iv) of section 162(k)(2)(B) of the 1986 Code (as in effect before the amendments made by the Technical and Miscellaneous Revenue Act of 1988) is amended to read as follows:

"(iv) MEDICARE ENTITLEMENT.—In the case of a qualified beneficiary other than a qualified beneficiary described in paragraph (7)(B)(iv), the date on which the qualified beneficiary first becomes, after the date of the election, entitled to benefits under title XVIII of the Social Security Act."

(B) Section 602(2)(D) of ERISA is amended to read as follows:

"(D) MEDICARE ENTITLEMENT.—In the case of a qualified beneficiary other than a qualified beneficiary described in section 607(3)(D), the date on which the qualified beneficiary first becomes, after the date of the election, entitled to benefits under title XVIII of the Social Security Act."

(C) Clause (iv) of section 4980B(f)(2)(B) of the 1986 Code, as added by the Technical and Miscellaneous Revenue Act of 1988, is amended to read as follows:

"(iv) MEDICARE ENTITLEMENT.—In the case of a qualified beneficiary other than a qualified beneficiary described in subsection (g)(1)(D), the date on which the qualified beneficiary first becomes, after the date of the election, entitled to benefits under title XVIII of the Social Security Act."

(D) Section 2202(2)(D) of the Public Health Service Act is amended to read as follows:

"(D) MEDICARE ENTITLEMENT.—In the case of a qualified beneficiary other than a qualified beneficiary described in section 2207(3)(D), the date on which the qualified beneficiary first becomes, after the date of the election, entitled to benefits under title XVIII of the Social Security Act."

(E) The amendments made by this paragraph shall apply to—

(i) events occurring after December 31, 1989, in plan years ending after such date, and

(ii) with respect to qualified beneficiaries—

(I) who elected continuation coverage during 1989, but

(II) only with respect to periods for which timely payment of the premium was made.

(4)(A) The last sentence of sections 602(3) of ERISA and 2202(3) of the Public Health Service Act are each amended to read as follows:

"In no event may the plan require the payment of any premium before the day which is 45 days after the day on which the qualified beneficiary made the initial election for continuation coverage.".

(B) The last sentence of section 4980B(f)(2)(C), as added by the Technical and Miscellaneous Revenue Act of 1988, is amended to read as follows:

"In no event may the plan require the payment of any premium before the day which is 45 days after the day on which the qualified beneficiary made the initial election for continuation coverage.".

(C) The amendments made by this paragraph shall apply to plan years beginning after December 31, 1989.

(5)(A) Subclause (II) of section 4980B(f)(2)(B)(i) of the 1986 Code is amended by striking out "paragraph (3)(F)" and inserting in lieu thereof "paragraph (3)(B) or (3)(F)".

(B) Clause (ii) of section 602(2)(A) of ERISA is amended by striking out "section 603(6)" and inserting in lieu thereof "section 603(2) or 603(6)".

(C) Clause (ii) of section 2202(2)(A) of the Public Health Service Act is amended by striking out "section 2303(6)" and inserting in lieu thereof "section 2303(2) or 2303(6)".

(D) The amendments made by this paragraph shall apply to plan years beginning after December 31, 1989.

(6)(A) Clause (i) of section 4980B(f)(2)(B) is amended by adding at the end thereof the following new subclause:

"(V) QUALIFYING EVENT FOLLOWING MEDICARE ENTITLEMENT.—If a qualifying event described in paragraph (3)(B) occurs within 18 months after an event described in paragraph (3)(D) which did not result in a loss of coverage, with respect to qualified beneficiaries other than the covered employee, the date which is 36 months after the date of the qualifying event."

(B) Section 602(2)(A) of ERISA is amended by adding at the end thereof the following new clause:

"(v) QUALIFYING EVENT FOLLOWING MEDICARE ENTITLEMENT.—If a qualifying event described in section 603(2) occurs within 18 months after an event described in section 603(4) which did not result in a loss of coverage, with respect to qualified beneficiaries other than the covered employee, the date which is 36 months after the date of the qualifying event."

(C) Section 2202(2)(A) of the Public Health Service Act is amended by adding at the end thereof the following new clause:

"(v) QUALIFYING EVENT FOLLOWING MEDICARE ENTITLEMENT.—If a qualifying event described in section 2203(2) occurs within 18 months after an event described in section 2203(4) which did not result in a loss of coverage, with respect to qualified beneficiaries other than the covered employee, the date which is 36 months after the date of the qualifying event."

(D) The amendments made by this paragraph shall apply to plan years beginning after December 31, 1989.

(d) AMENDMENTS RELATED TO SECTION 1898 OF THE REFORM ACT.—

(1)(A) Clause (ii) of section 417(a)(3)(B) (defining applicable period) is amended by striking subclause (V) and inserting at the end thereof the following new flush sentence:

"In the case of a participant who separates from service before attaining age 35, the applicable period shall be a reasonable period after separation.".

(B) Clause (ii) of section 205(c)(3)(B) of ERISA is amended by striking subclause (V) and inserting at the end thereof the following new flush sentence:

"In the case of a participant who separates from service before attaining age 35, the applicable period shall be a reasonable period after separation.".

(2) Section 1898(b)(8) of the Reform Act is amended by adding at the end thereof the following new subparagraph:

"(C) EFFECTIVE DATE.—The amendments made by this paragraph shall apply to distributions after the date of the enactment of this Act.".

(3) Paragraph (12) of section 1898(b) of the Reform Act is amended by striking all of subparagraph (B) from "(B) AMENDMENT" through "follows:" and inserting the following:

"(B) AMENDMENT TO ERISA.—Section 205(h) of the Employee Retirement Income Security Act of 1974 is amended—

"(i) by striking 'the term' in paragraphs (1) and (3) and inserting 'The term',

"(ii) by striking the comma in paragraph (1) and inserting a period, and

"(iii) by striking paragraph (2) and inserting the following:".

(4) Subparagraph (B) of section 1898(d)(1) of the Reform Act is amended by striking "Paragraph (1)" and inserting "Subsection (e)(1)".

(5) Subsection (e)(1) of section 203 of ERISA is amended—

(A) by inserting "(e)" before "(1)", and

(B) by striking "vested" and inserting "nonforfeitable".

(6) Subclause (IV) of section 205(c)(3)(B)(ii) of ERISA is amended by striking "401(a)(11)" and inserting "205".

(7) Subparagraph (B) of section 1898(b)(7) of the Reform Act is amended by striking "Subparagraph (C) of section 205(b)(1)" and inserting "Clause (i) of section 205(b)(1)(C)".

(8) Section 205(e)(2) of ERISA is amended by striking "nonforfeitable accrued benefit" and inserting "nonforfeitable right (within the meaning of section 203)".

SEC. 6863. EFFECTIVE DATE.

Except as otherwise provided in this subpart, any amendment made by this subpart shall take effect as if included in the provision of the Reform Act to which such amendment relates.

Subpart B—Amendments Related to Omnibus Budget Reconciliation Act of 1986

SEC. 6871. AMENDMENTS RELATED TO OMNIBUS BUDGET RECONCILIATION ACT OF 1986.

(a) AMENDMENTS RELATED TO SECTION 9202 OF THE ACT.—

(1)(A) Section 411(b)(2) of the Internal Revenue Code of 1986 is amended by striking subparagraph (B) and by redesignating subparagraphs (C) and (D) as subparagraphs (B) and (C), respectively.

(B) Section 204(b)(2) of ERISA is amended by striking subparagraph (C) and by redesignating subparagraph (D) as subparagraph (C).

(2) Section 411(b)(2)(C), as redesignated by paragraph (1), is amended by striking "subparagraph" and inserting "paragraph".

(3) Section 204(b)(2)(C) of ERISA, as redesignated by paragraph (1), is amended by striking "(C) and (D)" and inserting "(B) and (C)".

(4) The amendments made by this subsection shall take effect as if included in the amendments made by section 9202 of the Omnibus Budget Reconciliation Act of 1986.

(b) AMENDMENTS RELATED TO SECTION 9203 OF THE ACT.—

(1) Sections 411(a)(8)(B) of the Internal Revenue Code of 1986 and 3(24)(B) of ERISA are each amended to read as follows:

"(B) the later of—

"(i) the time a plan participant attains age 65, or

"(ii) the 5th anniversary of the time a plan participant commenced participation in the plan.".

(2) The amendments made by this subsection shall take effect as if included in the amendments made by section 9203 of the Omnibus Budget Reconciliation Act of 1986.

Subpart C—Amendments Related to Pension Protection Act

SEC. 6881. AMENDMENTS RELATED TO PENSION PROTECTION ACT.

(a) AMENDMENTS RELATED TO SECTION 9303.—

(1)(A) Subclause (II) of section 412(l)(3)(C)(ii) is amended by inserting "(but not below zero)" after "reducing".

(B) Subclause (II) of section 302(d)(3)(C)(ii) of ERISA is amended by inserting "(but not below zero)" after "reducing".

(2)(A) Clause (i) of section 412(l)(4)(B) is amended by inserting "and the unamortized portion of the unfunded existing benefit increase liability" after "liability".

(B) Clause (i) of section 302(d)(4)(B) of ERISA is amended by inserting "and the unamortized portion of the unfunded existing benefit increase liability" after "liability".

(3)(A) Section 412(l)(5)(C) is amended by striking "October 17, 1987" and inserting "the first plan year beginning after December 31, 1988".

(B) Section 302(d)(5)(C) of ERISA is amended by striking "October 17, 1987" and inserting "the first plan year beginning after December 31, 1988".

(4)(A) Section 412(l)(7)(D) is amended—

(i) by striking "and" at the end of clause (iii)(I), by striking the period at the end of clause (iii)(II) and inserting ", and", and by adding at the end of clause (iii) the following new subclause:

"(III) has years of service greater than the minimum years of service necessary for eligibility to participate in the plan.", and

(ii) by adding at the end thereof the following new clause:

"(iv) ELECTION.—An employer may elect not to have this subparagraph apply. Such an election, once made, may be revoked only with the consent of the Secretary.".

(B) Section 302(d)(7)(D) of ERISA is amended—

(i) by striking "and" at the end of clause (iii)(I), by striking the period at the end of clause (iii)(II) and inserting ", and", and by adding at the end of clause (iii) the following new subclause:

"(III) has years of service greater than the minimum years of service necessary for eligibility to participate in the plan.", and

(ii) by adding at the end thereof the following new clause:

"(iv) ELECTION.—An employer may elect not to have this subparagraph apply. Such an election, once made, may be revoked only with the consent of the Secretary of the Treasury.".

(5)(A) Section 412(l)(8) is amended—

(i) by striking "reduced by any credit balance in the funding standard account" in subparagraph (A)(ii), and

(ii) by adding at the end thereof the following new subparagraph:

"(E) DEDUCTION FOR CREDIT BALANCES.—For purposes of this subsection, the amount determined under subparagraph (A)(ii) shall be reduced by any credit balance in the funding standard account. The Secretary may provide for such reduction for purposes of any other provision which references this subsection.".

(B) Section 302(d)(8) of ERISA is amended—

(i) by striking "reduced by any credit balance in the funding standard account" in subparagraph (A)(ii), and

(ii) by adding at the end thereof the following new subparagraph:

"(E) DEDUCTION FOR CREDIT BALANCES.—For purposes of this subsection, the amount determined under subparagraph (A)(ii) shall be reduced by any credit balance in the funding standard account. The Secretary of the Treasury may provide for such reduction for purposes of any other provision which references this subsection.".

(6)(A) Section 412(c)(9) is amended—
(i) by striking "3 years" and inserting "year", and
(ii) by striking "3-YEAR" in the heading and inserting "ANNUAL".
(B) Section 302(c)(9) of ERISA is amended by striking "3 years" and inserting "year".
(7) Subclause (II) of section 9303(e)(3)(C)(ii) of the Pension Protection Act is amended by inserting "(and any income allocable to such amount)" after "clause (i)".
(b) AMENDMENTS RELATED TO SECTION 9304.—
(1)(A) Subparagraph (A) of section 412(c)(10) is amended—
(i) by inserting "defined benefit" before "plan other", and
(ii) by striking "PLANS" in the heading and inserting "DEFINED BENEFIT PLANS".
(B) Subparagraph (A) of section 302(c)(10) of ERISA is amended by inserting "defined benefit" before "plan other".
(2)(A) Subparagraph (B) of section 412(c)(10) is amended—
(i) by striking "multiemployer plan" and inserting "plan not described in subparagraph (A)", and
(ii) by striking "MULTIEMPLOYER" in the heading and inserting "OTHER".
(B) Subparagraph (B) of section 302(c)(10) of ERISA is amended by striking "multiemployer plan" and inserting "plan not described in subparagraph (A)".
(3)(A) Section 412(m)(1) is amended by inserting "defined benefit" before "plan (other".
(B) Section 302(e)(1) is amended by inserting "defined benefit" before "plan (other".
(4)(A) Subparagraph (D) of section 412(m)(4) is amended to read as follows:
"(D) SPECIAL RULES FOR UNPREDICTABLE CONTINGENT EVENT BENEFITS.—In the case of a plan to which subsection (l) applies for any calendar year and which has any unpredictable contingent event benefit liabilities—
"(i) LIABILITIES NOT TAKEN INTO ACCOUNT.—Such liabilities shall not be taken into account in computing the required annual payment under subparagraph (B).
"(ii) INCREASE IN INSTALLMENTS.—Each required installment shall be increased by the greater of—
"(I) the unfunded percentage of the amount of benefits described in subsection (d)(5)(A)(i) paid during the 3-month period preceding the month in which the due date for such installment occurs, or
"(II) 25 percent of the amount determined under subsection (l)(5)(A)(ii) for the plan year.
"(iii) UNFUNDED PERCENTAGE.—For purposes of clause (ii)(I), the term 'unfunded percentage' means the percentage determined under subsection (l)(5)(A)(i)(I) for the plan year.
"(iv) LIMITATION ON INCREASE.—In no event shall the increases under clause (ii) exceed the amount necessary to increase the funded current liability percentage (within the meaning of subsection (l)(8)(B)) for the plan year to 100 percent.".
(B) Subparagraph (D) of section 302(e)(4) of ERISA is amended to read as follows:
"(D) SPECIAL RULES FOR UNPREDICTABLE CONTINGENT EVENT BENEFITS.—In the case of a plan to which subsection (d) applies for any calendar year and which has any unpredictable contingent event benefit liabilities—
"(i) LIABILITIES NOT TAKEN INTO ACCOUNT.—Such liabilities shall not be taken into account in computing the required annual payment under subparagraph (B).
"(ii) INCREASE IN INSTALLMENTS.—Each required installment shall be increased by the greater of—
"(I) the unfunded percentage of the amount of benefits described in subsection (d)(5)(A)(i) paid during the 3-month period preceding the month in which the due date for such installment occurs, or
"(II) 25 percent of the amount determined under subsection (d)(5)(A)(ii) for the plan year.
"(iii) UNFUNDED PERCENTAGE.—For purposes of clause (ii)(I), the term 'unfunded percentage' means the percentage determined under subsection (d)(5)(A)(i)(I) for the plan year.
"(iv) LIMITATION ON INCREASE.—In no event shall the increases under clause (ii) exceed the amount necessary to increase the funded current

liability percentage (within the meaning of subsection (d)(8)(B)) for the plan year to 100 percent.".

(5)(A) Section 101(d)(1) of ERISA is amended by striking "an employer of a plan" and inserting "an employer maintaining a plan".

(B) Section 502(c) of ERISA is amended by adding at the end thereof the following new paragraph:

"(3) Any employer maintaining a plan who fails to meet the notice requirement of section 101(d) with respect to any participant or beneficiary may in the court's discretion be liable to such participant or beneficiary in the amount of up to $100 a day from the date of such failure, and the court may in its discretion order such other relief as it deems proper.".

(C) Section 9304(d) of the Pension Protection Act is amended by striking "Section" and inserting "Effective with respect to plan years beginning after December 31, 1987, section".

(6)(A)(i) Subparagraph (B) of section 412(m)(1) is amended to read as follows:

"(B) the rate of interest used under the plan in determining costs (including adjustments under subsection (b)(5)(B)).".

(ii) Clause (ii) of section 412(d)(1)(A) is amended by inserting "(including adjustments under subsection (b)(5)(B))" after "costs".

(B)(i) Subparagraph (B) of section 302(e)(1) of ERISA is amended to read as follows:

"(B) the rate of interest used under the plan in determining costs (including adjustments under subsection (b)(5)(B)).".

(ii) Section 303(a) of ERISA is amended—

(I) by redesignating subparagraphs (A) and (B) as paragraphs (1) and (2),

(II) by redesignating clauses (i) and (ii) of paragraph (1) (as so redesignated) as subparagraphs (A) and (B), and

(III) by inserting "(including adjustments under section 302(b)(5)(B))" after "costs" in paragraph (1)(B) (as so redesignated).

(c) Amendments Related to Section 9306.—

(1) The last sentence of section 412(f)(4)(A) is amended by striking "the benefit liabilities" and inserting "for benefit liabilities".

(2) The last sentence of section 303(e)(1) of ERISA is amended by striking "the benefit liabilities" and inserting "for benefit liabilities".

(3) Section 9306(f)(3) of the Pension Protection Act is amended to read as follows:

"(3) Subsection (b).—The amendments made by subsection (b) shall apply to waivers for plan years beginning after December 31, 1987. For purposes of applying such amendments, the number of waivers which may be granted for plan years after December 31, 1987, shall be determined without regard to any waivers granted for plan years beginning before January 1, 1988.".

(d) Amendments Related to Section 9307.—

(1)(A) Clause (iii) of section 412(b)(5)(B) is amended by striking "for purposes of this section and for purposes of determining current liability,".

(B) Clause (iii) of section 302(b)(5)(B) of ERISA is amended by striking "for purposes of this section and for purposes of determining current liability,".

(2)(A) Section 302(b)(5)(B) of ERISA is amended by inserting the following matter after the heading and before clause (i): "For purposes of determining a plan's current liability and for purposes of determining a plan's required contribution under section 302(d) for any plan year—".

(B) Section 302(b)(5) of ERISA is amended by striking the matter following the heading thereof and preceding subparagraph (A).

(C) Subclause (I) of section 302(b)(5)(B)(ii) of ERISA is amended by striking "average rate" and inserting "the weighted average of the rates".

(3) Section 9307(f) of the Pension Protection Act is amended to read as follows:

"(f) Effective Date.—

"(1) In general.—Except as provided in paragraph (2), the amendments made by this section shall apply to years beginning after December 31, 1987.

"(2) Amortization of gains and losses.—Sections 412(b)(2)(B)(iv) and 412(b)(3)(B)(ii) of the Internal Revenue Code of 1986 and sections 302(b)(2)(B)(iv) and 302(b)(3)(B)(ii) of the Employee Retirement Income Security Act of 1974 (as amended by paragraphs (1)(A) and (2)(A) of subsection (a)) shall apply to gains and losses established in years beginning after December 31, 1987. For purposes of the preceding sentence, any gain or loss determined by a valuation occurring as of January 1, 1988, shall be treated as established in years beginning before 1988 or, at the election of the employer, shall be amortized in accordance with Internal Revenue Service Notice 89–52.".

(e) AMENDMENTS RELATED TO SECTION 9311.—

(1) Section 9311(a)(2) of the Pension Protection Act is amended by striking "plan assets to the employer for purposes of section 4044(d)(1)(C) of the Employee Retirement Income Security Act of 1974" and inserting "residual plan assets upon termination".

(2) Section 9311(d) of the Pension Protection Act is amended—

(A) by striking "section 4041(c)" and inserting "section 4041" in paragraph (1), and

(B) by adding at the end thereof the following new flush sentence:

"Except as provided in subsection (a)(2), the amendments made by subsection (a) shall apply to any provision of the plan or plan amendment adopted after December 17, 1987."

(3) Section 9311(a)(2) of the Pension Protection Act is amended by striking the last sentence.

(f) AMENDMENTS RELATED TO SECTION 9312.—

(1) Section 9312(b)(3)(B)(i) of the Pension Protection Act is amended—

(A) by striking "section 4022(c)(1)" in subclause (I) and inserting "section 4022(c)(3)", and

(B) by striking "subparagraph (B) of section 4022(c)(1)" and inserting "subparagraph (C) of section 4022(c)(3)".

(2) Section 4062(a) of ERISA is amended—

(A) by striking paragraph (2) and by redesignating paragraph (3) as paragraph (2), and

(B) by striking "subsection (d)" in paragraph (2) (as so redesignated) and by inserting "subsection (c)".

(3)(A) Section 4064(b) of ERISA is amended by striking "and clauses (i)(II) and (ii) of section 4062(b)(1)(A)" and inserting "and section 4068(a)".

(B) Section 4068(a) of ERISA is amended by striking the last sentence.

(4) Section 4022(c)(1) of ERISA is amended by striking "(or in the case of a deceased participant)".

(5) Section 4022(c)(3)(B)(ii) of ERISA is amended by inserting ", and during the 5-Federal fiscal year period ending with the fiscal year preceding the fiscal year in which occurs the date of the notice of intent to terminate with respect to the plan termination for which the recovery ratio is being determined" after "1987".

(6) Section 9312(b)(3)(B) of the Pension Protection Act is amended by striking clause (ii).

(7) Section 4041(c) of ERISA is amended—

(A) by striking "(or its designee under section 4049(b))" in paragraph (2)(A)(iii)(II),

(B) by striking "section 4049" in paragraph (2)(A)(iii)(II) and inserting "section 4022(c)", and

(C) by striking the last sentence of paragraph (3)(C)(i).

(8) Section 4070(a) of ERISA is amended by striking "4049,".

(9) Section 9312(d)(1) of the Pension Reform Act is amended by striking "section 4041(c)" and inserting "section 4041".

(g) AMENDMENTS RELATED TO SECTION 9313.—

(1) Section 4041(d)(1) of ERISA is amended by striking "sufficient for benefit commitments" and inserting "sufficient for benefit liabilities".

(2) Section 4041(c)(2)(B) of ERISA is amended by inserting "proposed" before "termination" in the parenthetical in the second sentence.

(3) Clause (ii) of section 4041(c)(2)(A) of ERISA is amended—

(A) by inserting "unless the corporation determines the information is not necessary for purposes of paragraph (3)(A) or section 4062," before "certification",

(B) by inserting "and, if applicable, the proposed distribution date" after "termination date" in subclause (I), and

(C) by striking "date" and inserting "dates" in subclauses (II) through (V).

(h) AMENDMENT RELATED TO SECTION 9331.—Subparagraph (E) of section 4006(a)(3) of ERISA is amended by adding at the end thereof the following new clause:

"(v) No premium shall be determined under this subparagraph for any plan year if, as of the close of the preceding plan year, contributions to the plan for the preceding plan year were not less than the full funding limitation for the preceding plan year under section 412(c)(7) of the Internal Revenue Code of 1986.".

(i) AMENDMENTS RELATED TO SECTION 9341.—

(1)(A) Section 401(a)(29)(C)(i)(II) is amended by inserting "and any other plan amendments adopted after December 22, 1987, and before such plan amendment" after "amendment".

(B) Section 307(c)(1)(B) of ERISA is amended by inserting "and any other plan amendments adopted after December 22, 1987, and before such plan amendment".

(2) Section 307(d) of ERISA is amended by inserting "of the Treasury" after "Secretary".

(3)(A) Section 307 of ERISA is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) NOTICE.—A contributing sponsor which is required to provide security under subsection (a) shall notify the Corporation within 30 days after the amendment requiring such security takes effect. Such notice shall contain such information as the Corporation may require.".

(B) Section 4071 of ERISA is amended—

(i) by striking "or subtitle A, B, or C" and inserting ", subtitle A, B, or C, as section 302(f)(4) or 307(e)", and

(ii) by inserting "or such section" after "such subtitle".

(4)(A) Clause (i) of section 401(a)(29)(A) is amended by inserting "to which the requirements of section 412 apply" after "multiemployer plan)".

(B) Section 307(a)(1) of ERISA is amended by inserting "to which the requirements of section 302 apply" after "multiemployer plan)".

(5) Section 9341(c) of the Pension Protection Act is amended by inserting "(without regard to any extension, amendment, or modification of such agreements on or after such date of enactment)" after "ratified before the date of enactment".

(j) AMENDMENTS RELATED TO SECTION 9342.—

(1) Paragraph (11) of section 103(d) of ERISA is amended—

(A) by striking "60 percent" and inserting "70 percent", and

(B) by striking "such percentage" and inserting "the percentage which such value is of such liability".

(2) Section 502(a)(6) of ERISA is amended by striking "subsection (i)" and inserting "subsection (c)(2) or (i)".

(3) Section 502(c)(2) of ERISA is amended—

(A) by inserting "against any plan administrator" after "civil penalty", and

(B) by striking "a plan administrator's" and inserting "such plan administrator's".

(k) AMENDMENT RELATED TO SECTION 9343.—Section 403(c) of ERISA is amended by striking paragraph (3) and by redesignating paragraph (4) as paragraph (3).

(l) AMENDMENTS RELATED TO SECTION 9345.—

(1) Section 407(d)(9) of ERISA is amended by striking "such arrangement" and inserting "such individual account plan".

(2) Section 407(f) of ERISA is amended by striking paragraph (3).

(m) AMENDMENTS RELATED TO SECTION 9346.—

(1)(A) Clause (iii) of section 411(c)(2)(C) is amended to read as follows:

"(iii) interest on the sum of the amounts determined under clauses (i) and (ii) compounded annually—

"(I) at the rate of 120 percent of the Federal mid-term rate (as in effect under section 1274 for the 1st month of a plan year) for the period beginning with the 1st plan year to which subsection (a)(2) applies (by reason of the applicable effective date) and ending with the date on which the determination is being made, and

"(II) at the interest rate which would be used under the plan under section 417(e)(3) (as of the determination date) for the period beginning with the determination date and ending on the date on which the employee attains normal retirement age.".

(B) Subparagraph (B) of section 411(c)(2) is amended to read as follows:

"(B) DEFINED BENEFIT PLANS.—In the case of a defined benefit plan, the accrued benefit derived from contributions made by an employee as of any applicable date is the amount equal to the employee's accumulated contributions expressed as an annual benefit commencing at normal retirement age, using an interest rate which would be used under the plan under section 417(e)(3) (as of the determination date).".

(C) Section 411(c)(2) is amended by striking subparagraph (E).

(D) Section 411(a)(7) is amended by adding at the end thereof the following new subparagraph:

"(D) ACCRUED BENEFIT ATTRIBUTABLE TO EMPLOYEE CONTRIBUTIONS.—The accrued benefit of an employee shall not be less than the amount determined under subsection (c)(2)(B) with respect to the employee's accumulated contributions.".

(2)(A) Clause (iii) of section 204(c)(2)(C) of ERISA is amended to read as follows:

"(iii) interest on the sum of the amounts determined under clauses (i) and (ii) compounded annually—

"(I) at the rate of 120 percent of the Federal mid-term rate (as in effect under section 1274 of the Internal Revenue Code of 1986 for the 1st month of a plan year for the period beginning with the 1st plan year to which subsection (a)(2) applies by reason of the applicable effective date) and ending with the date on which the determination is being made, and

"(II) at the interest rate which would be used under the plan under section 205(g)(3) (as of the determination date) for the period beginning with the determination date and ending on the date on which the employee attains normal retirement age.".

(B) Subparagraph (B) of section 204(c)(2) of ERISA is amended to read as follows:

"(B) DEFINED BENEFIT PLANS.—In the case of a defined benefit plan, the accrued benefit derived from contributions made by an employee as of any applicable date is the amount equal to the employee's accumulated contributions expressed as an annual benefit commencing at normal retirement age, using an interest rate which would be used under the plan under section 205(g)(3) (as of the determination date).".

(C) Section 204(c)(2) of ERISA is amended by striking subparagraph (E).

(D) Paragraph (23) of section 3 of ERISA is amended by adding at the end thereof the following new flush sentence: "The accrued benefit of an employee shall not be less than the amount determined under section 204(c)(2)(B) with respect to the employee's accumulated contribution."

(3) If—

(A) during the period beginning December 22, 1987, and ending June 21, 1988, a plan was amended to reflect the amendments made by section 9346 of the Pension Protection Act, and

(B) such plan is amended to reflect the amendments made by this subsection,

any plan amendment described in subparagraph (B) shall not be treated as reducing accrued benefits for purposes of section 411(d)(6) of the Internal Revenue Code of 1986 or section 204(g) of ERISA.

SEC. 6882. EFFECTIVE DATE.

Except as otherwise provided in this subpart, any amendment made by this subpart shall take effect as if included in the provision of the Pension Protection Act to which such amendment relates.

Subtitle I—Tax Credit for Certain Health Insurance Premiums and Child Care and Supplemental Earned Income Credit for Families With Young Children

SEC. 6901. CREDIT FOR HEALTH INSURANCE PREMIUM COSTS.

(a) ALLOWANCE OF CREDIT.—Paragraph (1) of section 21(a) (relating to credit for expenses for household and dependent care services necessary for gainful employment) is amended to read as follows:

"(1) IN GENERAL.—In the case of an individual who maintains a household which includes as a member 1 or more qualifying individuals, there shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the sum of—

"(A) the applicable percentage of the employment-related expenses paid by such individual during the taxable year, plus

"(B) the credit percentage of the qualified health insurance expenses paid by such individual during the taxable year."

(b) CREDIT PERCENTAGE.—Section 21(a) is amended by adding at the end thereof the following new paragraph:

"(3) Credit percentage.—For purposes of paragraph (1), the term 'credit percentage' means 50 percent reduced (but not below zero) by 5 percentage points for each $1,000 (or fraction thereof) by which the taxpayer's adjusted gross income for the taxable year exceeds $12,000."

(c) Limitations.—

(1) Dollar limitation.—Section 21(c) is amended to read as follows:

"(c) Limitations.—

"(1) Dollar limit on employment-related expenses.—The amount of the employment-related expenses paid during any taxable year which may be taken into account under subsection (a)(1)(A) shall not exceed—

"(A) $2,400 if there is 1 qualifying individual with respect to the taxpayer for such taxable year, or

"(B) $4,800 if there are 2 or more such qualifying individuals.

The amount determined under subparagraph (A) or (B) (whichever is applicable) shall be reduced by the aggregate amount excludable from gross income under section 129 for the taxable year.

"(2) Qualified health insurance expenses.—The amount of the qualified health insurance expenses paid during any taxable year which may be taken into account under subsection (a)(1)(B) shall not exceed $1,000."

(2) Earned income limitation.—

(A) In general.—Section 21(d) is amended by adding at the end thereof the following new paragraph:

"(3) Special rule for qualified health insurance expenses.—The amount of the qualified health insurance expenses paid during any taxable year which may be taken into account under subsection (a)(1)(B) shall not exceed the excess (if any) of—

"(A) the earned income of the taxpayer for the taxable year, over

"(B) the amount of employment-related expenses taken into account under subsection (a)(1)(A)."

(B) Conforming amendment.—Paragraph (1) of section 21(d) is amended by striking "subsection (a)" and inserting "subsection (a)(1)(A)".

(d) Definitions and Rules.—

(1) Qualified health insurance expenses.—Section 21(b) is amended by adding at the end thereof the following new paragraph:

"(3) Qualified health insurance expenses.—

"(A) In general.—The term 'qualified health insurance expenses' means amounts paid during the taxable year for insurance—

"(i) which constitutes medical care (within the meaning of section 213(d)(1)(C)), and

"(ii) under which coverage includes at least 1 qualifying individual.

For purposes of this subparagraph, the rules of section 213(d)(6) shall apply.

"(B) Qualifying individual.—For purposes of this paragraph and subsection (a)(1)(B), the term 'qualifying individual' means an individual described in paragraph (1)(A), except that such paragraph shall be applied by substituting 'age of 19' for 'age of 13'.

"(C) Election not to take credit.—A taxpayer may elect for any taxable year to have amounts described in subparagraph (A) not treated as qualified health insurance expenses."

(2) Identifying information required.—Section 21(e)(9) is amended by adding at the end thereof the following new sentence: "In the case of the credit allowable under subsection (a)(1)(B) for qualified health insurance expenses, the Secretary may require an insurance policy number in addition to (or in lieu of) the taxpayer identification number."

(e) Coordination With Deduction for Self-Employed Individuals.—Section 162(l) (relating to special rules for health insurance costs of self-employed individuals) is amended by redesignating paragraph (5) as paragraph (6) and by inserting after paragraph (4) the following new paragraph:

"(5) Coordination with health insurance premium credit.—Paragraph (1) shall not apply to any amount taken into account in computing the amount of the credit allowed under section 21."

(f) Conforming Amendments.—

(1) The heading for section 21 is amended by inserting "; health insurance expenses" after "employment".

(2) The item relating to section 21 in the table of sections for subpart A of part IV of subchapter A of chapter 1 is amended by inserting "; health insurance expenses" after "employment".

(g) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1990.

SEC. 6902. DEPENDENT CARE AND HEALTH INSURANCE PREMIUM CREDIT MADE REFUNDABLE.

(a) CREDIT MADE REFUNDABLE.—Section 21 (relating to credit for household and dependent care services) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) CREDIT REFUNDABLE FOR LOW AND MODERATE INCOME TAXPAYERS.—

"(1) IN GENERAL.—Except as provided in section 6401(b)(1), for purposes of this title, in the case of an applicable taxpayer, the credit allowable under subsection (a) for any taxable year shall be treated as a credit allowable under subpart C of this part.

"(2) APPLICABLE TAXPAYER.—For purposes of this subsection, the term 'applicable taxpayer' means a taxpayer whose adjusted gross income for the taxable year does not exceed $28,000.

"(3) COORDINATION WITH ADVANCE PAYMENTS AND MINIMUM TAX.—Rules similar to the rules of subsections (g) and (h) of section 32 shall apply with respect to the portion of any credit to which this subsection applies."

(b) LIMITATION ON REFUNDABLE DEPENDENT CARE PORTION OF CREDIT.—Subsection (b) of section 6401 (relating to excessive credits) is amended by adding at the end thereof the following new paragraph:

"(3) SPECIAL RULE FOR SECTION 21(f).—

"(A) IN GENERAL.—The amount of the overpayment determined under paragraph (1) shall be reduced by 10 percent of the portion of such overpayment attributable to the credit allowed under section 21(a)(1)(A) and treated as allowable under subpart C of part IV of subchapter A of chapter 1 by reason of section 21(f).

"(B) ORDERING RULE.—For purposes of subparagraph (A), paragraph (1) shall be treated as having been applied as if the amount of tax described in such paragraph (if any) was first reduced by the portion of the credit allowed under section 21(a)(1)(A) and treated as allowable under subpart C of part IV of subchapter A of chapter 1 by reason of section 21(f)."

(c) CERTAIN SUBSIDIZED EXPENSES NOT ELIGIBLE FOR CREDIT.—Section 21(e) is amended by adding at the end thereof the following new paragraph:

"(10) SUBSIDIZED EXPENSES.—No expense shall be treated as an employment-related expense or qualified health insurance expense to the extent—

"(A) such expense is paid, reimbursed, or subsidized (whether by being disregarded for purposes of another program or otherwise) by the Federal Government, a State or local government, or any agency or instrumentality thereof, and

"(B) the payment, reimbursement, or subsidy of such expense is not includible in the gross income of the recipient."

(d) ADVANCE PAYMENT OF CREDIT.—

(1) IN GENERAL.—Chapter 25 is amended by inserting after section 3507 the following new section:

"SEC. 3507A. ADVANCE PAYMENT OF DEPENDENT CARE CREDIT.

"(a) GENERAL RULE.—Except as otherwise provided in this section, every employer making payment of wages with respect to whom a dependent care eligibility certificate is in effect shall, at the time of paying such wages, make an additional payment equal to such employee's dependent care advance amount.

"(b) DEPENDENT CARE ELIGIBILITY CERTIFICATE.—For purposes of this title, a dependent care eligibility certificate is a statement furnished by an employee to the employer which—

"(1) certifies that the employee will be eligible to receive the credit provided by section 21 for the taxable year,

"(2) certifies that the employee reasonably expects to be an applicable taxpayer for the taxable year,

"(3) certifies that the employee does not have a dependent care eligibility certificate in effect for the calendar year with respect to the payment of wages by another employer,

"(4) states whether or not the employee's spouse has a dependent care eligibility certificate in effect,

"(5) states the number of qualifying individuals in the household maintained by the employee, and

"(6) estimates the amount of employment-related expenses and qualified health insurance expenses for the calendar year.

For purposes of this section, a certificate shall be treated as being in effect with respect to a spouse if such a certificate will be in effect on the first status determination date following the date on which the employee furnishes the statement in question.

"(c) DEPENDENT CARE ADVANCE AMOUNT.—

"(1) IN GENERAL.—For purposes of this title, the term 'dependent care advance amount' means, with respect to any payroll period, the amount determined—

"(A) on the basis of the employee's wages from the employer for such period,

"(B) on the basis of the number of qualifying individuals in the household maintained by the employee,

"(C) on the basis of the employee's estimated employment-related expenses and qualified health insurance expenses included in the dependent care eligibility certificate, and

"(D) in accordance with tables provided by the Secretary.

"(2) ADVANCE AMOUNT TABLES.—The tables referred to in paragraph (1)(D) shall be similar in form to the tables prescribed under section 3402 and, to the maximum extent feasible, shall be coordinated with such tables and the tables prescribed under section 3507(c).

"(d) DEFINITIONS.—For purposes of this section, any term which is used in this section and in section 21, where appropriate, shall have the meaning given to such term by section 21.

"(e) OTHER RULES.—For purposes of this section, rules similar to the rules of subsections (d) and (e) of section 3507 shall apply.

"(f) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section."

(2) CONFORMING AMENDMENT.—The table of sections for chapter 25 is amended by adding after the item relating to section 3507 the following new item:

"Sec. 3507A. Advance payment of dependent care credit."

(e) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in this subsection, the amendments made by this section shall apply to taxable years beginning after December 31, 1990.

(2) ADVANCE PAYMENT OF CREDIT.—The amendments made by subsection (d) shall apply to taxable years beginning after December 31, 1991.

SEC. 6003. SUPPLEMENTAL EARNED INCOME CREDIT FOR FAMILIES WITH YOUNG CHILDREN.

(a) IN GENERAL.—Subsections (a) and (b) of section 32 (relating to earned income credit) are amended to read as follows:

"(a) ALLOWANCE OF CREDIT.—There is allowed as a credit against the tax imposed by this subtitle for the taxable year an amount equal to the sum of the following amounts:

"(1) GENERAL CREDIT.—In the case of an eligible individual, an amount equal to 14 percent of so much of the earned income for the taxable year as does not exceed $5,714.

"(2) SUPPLEMENT FOR YOUNG CHILDREN.—

"(A) IN GENERAL.—In the case of an eligible individual with 1 or more qualifying children, an amount equal to the lesser of—

"(i) the applicable percentage of so much of the earned income for the taxable year as does not exceed $5,714, or

"(ii) $750 ($500 for an eligible individual with only 1 qualifying child).

"(B) APPLICABLE PERCENTAGE.—The term 'applicable percentage' means 10 percent (7 percent for an eligible individual with only 1 qualifying child).

"(b) LIMITATIONS.—

"(1) GENERAL CREDIT.—The amount of the credit allowable to a taxpayer under subsection (a)(1) for any taxable year shall be reduced (but not below zero) by 10 percent of so much of the adjusted gross income (or, if greater, the earned income) of the taxpayer for the taxable year as exceeds $9,000.

"(2) SUPPLEMENT FOR YOUNG CHILDREN.—The amount of the credit allowable to a taxpayer under subsection (a)(2) for any taxable year shall be reduced (but not below zero) by 15 percent (10 percent for an eligible individual with only 1 qualifying child) of so much of the adjusted gross income (or, if greater, the earned income) of the taxpayer for the taxable year as exceeds the lesser of—

"(i) $10,000, as adjusted under subsection (i), or

"(ii) $12,000."

(b) QUALIFYING CHILD DEFINED.—Subsection (c) of section 32 is amended by adding at the end thereof the following new paragraph:

"(3) QUALIFYING CHILD.—The term 'qualifying child' means, for the taxable year, an individual—

"(A) with respect to whom the taxpayer qualifies as an eligible individual, and

"(B) who, as of the end of such taxable year, has not attained the age of 4."

(c) COORDINATION WITH HOUSING PROGRAMS.—Section 32 is amended by adding at the end the following new subsection:

"(j) DETERMINATION OF INCOME FOR PURPOSES OF HOUSING PROGRAMS.—For purposes of—

"(1) the United States Housing Act of 1937,

"(2) section 101 of the Housing and Urban Development Act of 1965, and

"(3) sections 235 and 236 of the National Housing Act,

the term 'income' does not include the amount of any individual's earned income tax credit under this section."

(d) CONFORMING AMENDMENTS.—

(1) Subsection (f)(1) of section 32 is amended by inserting "(including separate tables for individuals with qualifying children)" after "Secretary".

(2) Subsection (i) of section 32 is amended—

(A) by inserting "('calendar year 1990' for 'calendar year 1987' in the case of the dollar amount referred to in clause (iii) of paragraph (2)(B))" before the period at the end of paragraph (1)(B), and

(B) by striking paragraph (2) and inserting the following new paragraph:

"(2) DEFINITIONS, ETC.—For purposes of paragraph (1)—

"(A) APPLICABLE CALENDAR YEAR.—The term 'applicable calendar year' means—

"(i) 1986 in the case of the dollar amount referred to in clause (i) of subparagraph (B),

"(ii) 1987 in the case of the dollar amount referred to in clause (ii) of subparagraph (B), and

"(iii) 1991 in the case of the dollar amount referred to in clause (iii) of subparagraph (B).

"(B) DOLLAR AMOUNTS.—The dollar amounts referred to in this subparagraph are—

"(i) the $5,714 amount contained in paragraphs (1) and (2)(A)(i) of subsection (a),

"(ii) the $9,000 amount contained in subsection (b)(1), and

"(iii) the $10,000 amount contained in subsection (b)(2)(A)."

(3) Subsection (b) of section 3507 (relating to advance payment of earned income credit) is amended by striking "and" at the end of paragraph (2), by striking the period at the end of paragraph (3) and inserting ", and", and by inserting after paragraph (3) the following new paragraph:

"(4) states the number of qualifying children (as defined in section 32(c)(3)) of the employee for the taxable year.".

(4) Paragraph (1) of section 3507(c) is amended—

(A) by striking "and" at the end of subparagraph (A),

(B) by redesignating subparagraph (B) as subparagraph (C), and

(C) by inserting after subparagraph (A) the following new subparagraph:

"(B) on the basis of the number of qualifying children (as defined in section 32(c)(3)) of the employee for such period, and".

(5) Paragraph (2) of section 3507(c) of such Code is amended—

(A) by striking "paragraph (1)(B)" and inserting "paragraph (1)(C)",

(B) by striking "by section 32" in subparagraphs (B) and (C) and inserting "by section 32(a)(1)",

(C) by striking "under section 32" in subparagraph (B)(ii) and inserting "under section 32(a)(1)",

(D) by striking "section 32(a)" in subparagraphs (B)(i) and (C)(i) and inserting "section 32(a)(1)",

(E) by striking "subsection (b)" in subparagraph (B)(ii) and inserting "subsection (b)(1)", and

(F) by adding at the end thereof the following new flush sentence:

"A separate advance amount table shall be prescribed for the credit under section 32(a)(2) in the same manner as provided under the preceding sentence, except that the applicable percentage under section 32(a)(2)(B) shall be substituted for 14 percent."

(6) Section 3507 is amended by adding at the end thereof the following new subsection:

"(f) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section."

(e) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years beginning after December 31, 1990.

(2) INCOME DETERMINATIONS.—The amendment made by subsection (c) shall apply to determinations made after December 31, 1989.

SEC. 6904. STUDY OF ADVANCE PAYMENTS.

(a) IN GENERAL.—The Comptroller General of the United States shall, in consultation with the Secretary of the Treasury, conduct a study of advance payments required by section 3507A of the Internal Revenue Code of 1986 (as added by section 6 (b)(1)) to determine—

(1) the effectiveness of the advance payment system, and

(2) the manner in which such system can be implemented to alleviate administrative complexity, if any, for small business.

(b) REPORT.—Not later than 1 year after the date of the enactment of this title, the Comptroller shall report the results of the study conducted under subsection (a), together with any recommendations, to the Committee on Finance of the United States Senate and the Committee on Ways and Means of the House of Representatives.

SEC. 6905. PROGRAM TO INCREASE PUBLIC AWARENESS.

Not later than the first day of the first calendar year following the date of the enactment of this title, the Secretary of the Treasury, or the Secretary's delegate, shall establish a taxpayer awareness program to inform the taxpaying public of the availability of the credit for dependent care and health insurance premiums allowed under section 21 of the Internal Revenue Code of 1986 (as amended by this subtitle). Such public awareness program shall be designed to assure that individuals who may be eligible are informed of the availability of such credit and filing procedures. The Secretary shall use public service and paid commercial advertising, direct-mail contact, and any other appropriate means of communication to carry out the provisions of this section.

SEC. 6906. DEMONSTRATION PROJECTS TO EXTEND HEALTH INSURANCE TO CHILDREN NOT COVERED BY PUBLIC OR PRIVATE HEALTH PROGRAMS.

Section 1115 of the Social Security Act (42 U.S.C. 1315) is amended by adding at the end thereof the following new subsection:

"(d)(1)(A) The Secretary shall conduct demonstration projects to evaluate and extend the provision of health insurance to—

"(i) children under the age of 19 who are not covered by other public or private health programs, and

"(ii) at the option of the organization described in subparagraph (B), the parents of such children who are not so covered.

"(B) Subject to the provisions of paragraph (2), the Secretary may enter into agreements to provide coverage described in subparagraph (A) through public and private cooperative arrangements sponsored by organizations, including (but not limited to)—

"(i) school based programs;

"(ii) programs operated under the auspices of nonprofit entities offering health insurance; and

"(iii) programs operated by nonprofit hospitals.

"(2) Any agreement entered into between the Secretary and any organization under paragraph (1)(B)(ii) shall provide—

"(A) that such agreement will be in effect for a period of 5 years, except that such agreement shall be terminated for failure to meet the requirements of this paragraph;

"(B) that the portion of the costs of any coverage program under the agreement to be funded from amounts provided by non-Federal sources shall not be less than the greater of—

"(i) the percentage (not less than 50 percent) specified by the Secretary, or

"(ii) if, at the time the agreement is entered into, such organization is conducting a program similar to the program covered by the agreement, the portion of such similar program funded by such non-Federal sources; and

"(C) that the coverage program provided by such organization shall not—

"(i) restrict enrollment in such program on the basis of a child's medical condition, or

"(ii) impose waiting periods or exclusions for preexisting conditions.

"(3) The Secretary in conducting demonstration projects under this subsection shall provide in any agreement that any organization described in paragraph (1)(B) may charge a premium to individuals enrolling in the coverage program provided by such organization.

"(4) The demonstration projects conducted under this subsection shall evaluate the effects of program coverage under any agreement on—

"(A) access to health services,

"(B) availability of insurance coverage to participating children and their families,

"(C) characteristics of participating children and their families, and

"(D) health care costs.

"(5) The Secretary shall publish no later than January 1, 1990, criteria governing the eligibility and participation of organizations in the demonstration projects conducted under this subsection.

"(6) For purposes of carrying out the demonstration projects described in this subsection there are authorized to be appropriated $25,000,000 for each of the fiscal years 1990, 1991, 1992, 1993, and 1994."

Subtitle J—Individual Retirement Accounts

SEC. 6921. SHORT TITLE.

This subtitle may be cited as the "Savings and Investment Incentive Act of 1989".

SEC. 6922. DISTRIBUTIONS FROM INDIVIDUAL RETIREMENT PLANS MAY BE USED WITHOUT PENALTY TO PURCHASE FIRST HOMES OR TO PAY HIGHER EDUCATION EXPENSES.

(a) IN GENERAL.—Paragraph (2) of section 72(t) (relating to exceptions to 10-percent additional tax on early distributions from qualified retirement plans) is amended by adding at the end thereof the following new subparagraph:

"(E) DISTRIBUTIONS FROM INDIVIDUAL RETIREMENT PLANS FOR FIRST HOME PURCHASES OR EDUCATIONAL EXPENSES.—The following distributions to an individual from an individual retirement plan:

"(i) FIRST-TIME HOMEBUYERS.—Qualified first-time homebuyer distributions (as defined in paragraph (6)).

"(ii) HIGHER EDUCATION EXPENSES.—Distributions to the extent such distributions do not exceed the qualified higher education expenses (as defined in paragraph (7)) of the taxpayer for the taxable year."

(b) DEFINITIONS.—Section 72(t) is amended by adding at the end thereof the following new paragraphs:

"(6) QUALIFIED FIRST-TIME HOMEBUYER DISTRIBUTIONS.—For purposes of paragraph (2)(E)(i)—

"(A) IN GENERAL.—The term 'qualified first-time homebuyer distribution' means any payment or distribution received by a first-time homebuyer from an individual retirement plan to the extent such payment or distribution is used by the individual before the close of the 60th day after the day on which such payment or distribution is received to pay qualified acquisition costs with respect to a principal residence for such individual.

"(B) QUALIFIED ACQUISITION COSTS.—For purposes of this paragraph, the term 'qualified acquisition costs' means the costs of acquiring, constructing, or reconstructing a residence. Such term includes any usual or reasonable settlement, financing, or other closing costs.

"(C) FIRST-TIME HOMEBUYER; OTHER DEFINITIONS.—For purposes of this paragraph—

"(i) FIRST-TIME HOMEBUYER.—The term 'first-time homebuyer' means any individual if such individual (and if married, such individual's spouse) had no present ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which this paragraph applies.

"(ii) PRINCIPAL RESIDENCE.—The term 'principal residence' has the same meaning as when used in section 1034.

"(iii) DATE OF ACQUISITION.—The term 'date of acquisition' means the date—

"(I) on which a binding contract to acquire the principal residence to which subparagraph (A) applies is entered into, or

"(II) on which construction or reconstruction of such a principal residence is commenced.

"(D) SPECIAL RULE WHERE DELAY IN ACQUISITION.—If—

"(i) any amount is paid or distributed from an individual retirement plan to an individual for purposes of being used as provided in subparagraph (A), and

"(ii) by reason of a delay in the acquisition of the residence, the requirements of subparagraph (A) cannot be met,

the amount so paid or distributed may be paid into an individual retirement plan as provided in section 408(d)(3)(A)(i) without regard to section 408(d)(3)(B), and, if so paid into such other plan, such amount shall not be taken into account in determining whether section 408(d)(3)(A)(i) applies to any other amount.

"(7) QUALIFIED HIGHER EDUCATION EXPENSES.—For purposes of paragraph (2)(E)(ii)—

"(A) IN GENERAL.—The term 'qualified higher education expenses' means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of—

"(i) the taxpayer,

"(ii) the taxpayer's spouse, or

"(iii) the taxpayer's child (as defined in section 151(c)(3)) or grandchild,

at an eligible educational institution (as defined in section 135(c)(3)).

"(B) COORDINATION WITH SAVINGS BOND PROVISIONS.—The amount of qualified higher education expenses for any taxable year shall be reduced by any amount excludable from gross income under section 135."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to payments and distributions after December 31, 1989, in taxable years ending after such date.

SEC. 6923. ACTIVE PARTICIPANTS ALLOWED DEDUCTION FOR 50 PERCENT OF CONTRIBUTIONS TO INDIVIDUAL RETIREMENT PLANS.

(a) GENERAL RULE.—Paragraph (1) of section 219(g) (relating to limitation on deduction of active participants in certain pension plans) is amended to read as follows:

"(1) IN GENERAL.—If (for any part of any plan year ending with or within a taxable year) an individual or the individual's spouse is an active participant, the amount allowed as a deduction under subsection (a) for such taxable year shall be the sum of—

"(A) 100 percent of the amount which would have been allowable for such taxable year if each of the dollar limitations contained in subsections (b)(1)(A) and (c)(2) were reduced (but not below zero) by the amount determined under paragraph (2), plus

"(B) 50 percent of the excess of—

"(i) the amount which would have been allowable for such taxable year without regard to this subsection, over

"(ii) the amount determined under subparagraph (A)."

(b) DISALLOWANCE OF DEDUCTION FOR INTEREST ON LOAN INCURRED TO MAKE IRA CONTRIBUTION.—Subsection (h) of section 163 (relating to disallowance of deduction for personal interest) is amended by adding at the end thereof the following new paragraph:

"(6) INTEREST ON LOAN INCURRED TO MAKE IRA CONTRIBUTION.—In the case of any interest which is paid or accrued on indebtedness incurred for purposes of making a contribution on an individual retirement plan—

"(A) for purposes of this subsection, such interest shall be treated as personal interest (and the provisions of paragraphs (3) and (5) shall not apply), and

"(B) such interest shall not be treated as investment interest for purposes of subsection (d)."

(c) CONFORMING AMENDMENTS.—

(1) Subsection (o) of section 408 is amended by striking paragraphs (1), (2), and (3) and inserting the following:

"(1) IN GENERAL.—Qualified nondeductible contributions may be made on behalf of an individual to an individual retirement plan.

"(2) QUALIFIED NONDEDUCTIBLE CONTRIBUTIONS.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'qualified nondeductible contribution' means the portion of any contribution for a taxable year beginning after December 31, 1990, to an individual retirement plan which is not allowable as a deduction under section 219 solely by reason of subsection (g)(1) thereof.

"(B) YEARS BEFORE 1991.—The term 'qualified nondeductible contribution' includes any contribution to an individual retirement plan for any taxable year beginning before January 1, 1991, which was a designated nondeductible contribution (as defined in this subsection as in effect on the day before the date of the enactment of the Savings and Investment Incentive Act of 1989).

"(C) TAXPAYER MAY ELECT TO TREAT DEDUCTIBLE CONTRIBUTIONS AS NONDEDUCTIBLE.—If a taxpayer elects not to deduct any contribution which (without regard to this subparagraph) is allowable as a deduction under section 219, such contribution shall be treated as a qualified nondeductible contribution.

"(3) TIME WHEN CONTRIBUTION MADE.—In determining for which taxable year a contribution is made, the rules of section 219(f)(3) shall apply."

(2) Paragraph (7) of section 219(f) is amended by striking "408(o)(2)(B)(ii)" and inserting "408(o)(2)(C)".

(3) Sections 408(o)(4) and 6693(b) are each amended by striking "designated nondeductible" each place it appears (including in any heading) and inserting "qualified nondeductible".

(4)(A) The section heading for section 6693 is amended by striking "designated" and inserting "qualified".

(B) The item relating to section 6693 in the table of sections for part I of subchapter B of chapter 68 is amended by striking "designated" and inserting "qualified".

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to contributions for taxable years beginning after December 31, 1990.

(2) DENIAL OF INTEREST DEDUCTION.—The amendment made by subsection (b) shall apply to indebtedness incurred after the date of the enactment of this Act, in taxable years ending after such date.

Subtitle K—Amendments Related to Financial Institutions Reform, Recovery, and Enforcement Act of 1989

SEC. 6931. TREATMENT OF TRANSACTIONS IN WHICH FEDERAL FINANCIAL ASSISTANCE PROVIDED.

(a) IN GENERAL.—Section 597(b)(2) is amended by striking "to reflect such treatment" and inserting "in connection with such assistance".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply as if included in the amendments made by section 1401 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

SEC. 6932. QUALIFIED STATE HOUSING AGENCY BONDS.

(a) IN GENERAL.—Section 141(f) (defining qualified bond), as redesignated and amended by section 6641, is further amended—

(1) by striking "or" at the end of subparagraph (E),

(2) by striking the period at the end of subparagraph (F) and insert ", or", and

(3) by adding at the end thereof the following new subparagraph:

"(G) a qualified State housing agency bond."

(b) QUALIFIED STATE HOUSING AGENCY BOND DEFINED.—Subpart A of part IV of subchapter B of chapter 1, as amended by section 6641, is further amended by inserting after section 144 the following new section:

"SEC. 145. QUALIFIED STATE HOUSING AGENCY BONDS.

"(a) IN GENERAL.—For purposes of this part, the term 'qualified State housing agency bond' means any bond issued by a State housing agency as part of an issue, but only if—

"(1) 95 percent or more of the net proceeds of such issue are to be used—

"(A) to acquire single-family residences or residential rental projects from—

"(i) the Resolution Trust Corporation,
"(ii) the Federal Deposit Insurance Corporation,
"(iii) the Federal Housing Authority,
"(iv) the Department of Veterans Affairs, or
"(v) any other agency of the Federal Government, or

"(B) to finance the disposition of single-family residence or residential rental projects owned by any entity described in paragraph (1), and

"(2) such issue meets the requirements of—
"(A) subsection (b), and
"(B) subsection (c) or (d), whichever is applicable.

"(b) LOCATION REQUIREMENTS.—An issue meets the requirements of this subsection only if the single-family residence or residential rental project, the acquisition or disposition of which is provided by such issue, is located within the jurisdiction of the State housing agency issuing the bond.

"(c) RESIDENCE REQUIREMENTS.—An issue meets the requirements of this subsection only if the disposition of a single-family residence provided by such issue meets the requirements of subsections (d), (e), and (f) of section 143.

"(d) PROJECT REQUIREMENTS.—An issue meets the requirements of this subsection only if the disposition of a residential rental project provided by such issue is to a purchaser with respect to whom the project is a qualified residential rental project as defined in section 142(d).

"(e) STATE HOUSING AGENCY.—The term 'State housing agency' means any agency authorized to carry out this subsection."

(b) CLERICAL AMENDMENT.—The table of sections for subpart A of part IV of subchapter B of chapter 1, as amended by section 6641, is further amended by inserting after the item relating to section 144 the following new item:

"Sec. 145. Qualified State housing agency bond."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to bonds issued after the date of the enactment of this Act.

Subtitle L—Coordination With Budget Act

SEC. 6941. COORDINATION WITH BUDGET ACT.

Any transfer of outlays, receipts, or revenues pursuant to this title (including section 6209, 6504, 6509, 6631, or 6632) is a necessary (but secondary) result of a significant policy change for purposes of section 202 of the joint resolution entitled "Increasing the statutory limit on the public debt" (Public Law 100–119), approved September 29, 1987.

22-661 (464)