S. Hrg. 102-451

TAX SIMPLIFICATION BILLS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON TAXATION

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

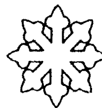
ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

S. 1364, S. 1394, and H.R. 2777

SEPTEMBER 10 AND 12, 1991



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

51-226 WASHINGTON : 1992

S361-27

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-037609-2

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TAX SIMPLIFICATION BILLS

TUESDAY, SEPTEMBER 10, 1991

U.S. SENATE,
SUBCOMMITTEE ON TAXATION,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:11 a.m., in room SD-215, Dirksen Senate Office Building, Hon. David L. Boren (chairman of the subcommittee) presiding.

Also present: Senators Moynihan, Baucus, and Symms.

[The press release announcing the hearing follows:]

[Press Release No. H-35, Aug. 2, 1991]

FINANCE SUBCOMMITTEE SCHEDULES HEARING ON TAX SIMPLIFICATION BILLS, OTHER PROPOSALS WILL BE DISCUSSED

WASHINGTON, DC—Senator David Boren, Chairman, announced Friday that the Senate Finance Subcommittee on Taxation will hold hearings on tax simplification proposals.

The hearings will be at *2 p.m. on Tuesday, September 10 and 2 p.m. on Thursday, September 12, 1991* in Room SD-215 of the Dirksen Senate Office Building.

Boren (D., Oklahoma) said the hearing will focus on a range of tax simplification proposals, including S. 1394, introduced by Senate Finance Committee Chairman Lloyd Bentsen (D., Texas) and Senator Bob Packwood (R., Oregon), ranking Republican on the Committee; the identical House companion, H.R. 2777, introduced by House Ways and Means Committee Chairman Dan Rostenkowski (D., Illinois) and Congressman Bill Archer (R., Texas), ranking Republican on Ways and Means; and S. 1364, the pension simplification bill introduced by Senator David Pryor (D., Arkansas) and Bentsen.

Witnesses may also discuss other tax simplification proposals, he said.

Boren also said the Subcommittee also is requesting written comments regarding tax simplification.

"A number of proposals have been offered in an effort to streamline America's tax laws. The testimony at these hearings and the written comments we receive will be very helpful as we examine those proposals more closely," Boren said.

"We will also be interested in receiving testimony or written comments concerning any other tax simplification proposals that should be brought to our attention," he said.

OPENING STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM OKLAHOMA

Senator BOREN. We are meeting this afternoon to begin the first day of the Subcommittee on Taxation's hearing on Tax Simplification Proposals. The main topic of discussion will be the provisions of S. 1394, the Tax Simplification Act of 1991, which was introduced by Chairman Bentsen and Senator Packwood.

Simplification, as we all know, means different things to different people. However, I think almost everyone agrees the Tax Code has become bogged down in complexity.

In Oklahoma I hear the same message from wage earners, independent businessmen, tax practitioners alike, the Code appears to be out of control in regard to complexity.

The Bentsen/Packwood Bill represents a challenging attempt to simplify some of the most complicated areas while remaining both revenue and policy neutral. Specifically, the bill addresses problems in the areas of partnerships, foreign taxes, alternative minimum tax calculation, Subchapter S corporations, long-term contracts, and estate and gift taxation. The bill also directs the IRS to develop a simplified tax form for individuals who itemize.

I strongly support this much needed provision and I want to commend Chairman Bentsen and Senator Packwood for its inclusion.

Of particular interest to me are the partnership provisions in the bill, especially as they affect the oil and gas industry. The oil and gas industry is badly in need of outside capital and outside investors. I have heard from hundreds of small investors bitterly complaining about the complexity of the K-1 partnership forms. The paperwork burden alone threatens to make these sort of investments uncompetitive.

Fortunately, S. 1394 allows for simplified reporting requirements. I commend the authors of the bill for this provision. But I am concerned that certain parts of the bill may have unintended consequences or affects on oil and gas investment.

For example, the bill may require investors to pay for simplification by restricting their depletion deductions. The oil and gas industry faces a regressive punitive tax structure as it is. I believe that further burdens on investment in our domestic oil and gas industry would be unnecessary and unwise.

I hope the committee will consider these matters carefully in light of the testimony which we'll hear today.

One proposal that certainly meets my definition of simplification but was not included in the bill is a ban on retroactive regulations. The IRS practice of issuing retroactive regulations is confusing and unfair and I've joined with Senators Pryor, Baucus and others in introducing legislation that would prohibit this practice.

I hope the committee will agree that we can do much for the simplification effort by also adopting that provision when the committee considers all of these proposals.

I look forward to the hearing, the testimony on these issues and others from the administration witnesses and our guests who bring so much expertise to our Subcommittee hearing today.

We'll try to move as expeditiously as we can. Other members are expected to come in and out during our proceedings.

Let me just mention that we will first hear from Kenneth Gideon, Assistant Secretary of the Treasury for Tax Policy, who is already before us at the witness desk; then from Fred T. Goldberg, Commissioner of the Internal Revenue Service, from Commissioner Goldberg; and then we will hear a panel which is specifically directed at the issue of the provision on partnerships which is included in this bill.

So, Mr. Gideon, we welcome you to the hearing today and we would welcome your opening comments.

STATEMENT OF HON. KENNETH W. GIDEON, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. GIDEON. Mr. Chairman, I am pleased to present the views of the Administration on tax simplification proposals currently under your consideration. My testimony today will address S. 1394, the "Tax Simplification Act of 1991," and S. 1364, the "Employee Benefits Simplification and Expansion Act of 1991."

In addition, in accordance with your invitation to testify, I urge your favorable consideration of other proposals not included in these two bills, specifically in the area of payroll tax deposits, the earned income tax credit and pension coverage and portability.

The Administration strongly supports simplification of our tax laws within the fiscal constraints of last year's budget agreement. Properly conceived and executed simplification can reduce the costs of tax compliance and administration, enhance both voluntary compliance and tax enforcement efforts and improve taxpayer morale.

When simplification efforts are successful, we believe there should be efficiency gains as well. Simplification is not viable, however, as a revenue losing proposition.

I particular want to commend Chairman Bentsen and Senator Packwood for their sponsorship and support for the bipartisan simplification bill, S. 1394. That bill and its House counterpart, H.R. 2777, were produced through the cooperative efforts of the committee staffs which deal with tax matters, the Treasury Department and the Internal Revenue Service.

We recognize that a number of modifications to the introduced legislation have been suggested by commentators. While I have not addressed these suggestions in my written testimony today, we will work with the committee and the staff to adopt meritorious suggestions.

Before turning to S. 1394 and S. 1364 I would like to describe the three additional proposals that we think will simplify and improve the tax law while meeting with the constraint of revenue neutrality.

The Treasury Department shares your interest in simplifying current employment tax deposits. We have previously indicated that the payroll tax provisions of H.R. 2775 would achieve simplification.

Senator Baucus has made a similar payroll tax simplification proposal in S. 1610. That proposal, like H.R. 2775, would require semi-weekly deposits. It would differ from H.R. 2775, however, in that small employers would be required to make monthly rather than quarterly deposits. The threshold treatment for treatment as a small employer would be $18,000 of quarterly liability and the minimum amount of permitted safe harbor underpayments would be $250.

S. 1610, like H.R. 2775, would further the goal of simplification. However, in its current form S. 1610 would result in significant revenue loss over th five-year budget period. These revenue losses could, however, be offset under S. 1610 if the threshold for monthly depositor status were lowered and the $250 safe harbor reduced for monthly depositors.

The Administration believes that S. 1610, if modified to make it revenue neutral, and H.R. 2775 merit serious consideration.

Senator BOREN. What is the recommended revenue estimate now in terms of revenue loss under S. 1610 as now written?

Mr. GIDEON. It is in our written statement, Mr. Chairman. Let me see if I can find it and give it to you.

It's at $2.2 billion as a loss if small employers are allowed to underpay each monthly deposit by $250 or $.6 billion in revenue loss if they're not allowed to use the $250 safe harbor.

But the point is, it is clear that by adjusting the threshold and that amount you could get to a revenue neutral proposal.

Senator BOREN. Thank you.

Mr. GIDEON. Let me turn now to the earned income tax credit. This credit is a refundable tax credit available to low income workers with children. The EITC consists of a basic credit which is adjusted for family size, a health insurance credit, and a supplemental credit for workers with a child under the age of one, the so-called "young child" or "wee tots" credit.

The 1990 Act increased the basic credit rate and added the family size adjustment, the health credit and the young child credit. Several interaction rules that are described in more detail in my written statement prevent a taxpayer from receiving full benefit of the health insurance credit or the young child credit or other tax provisions.

We propose that the interaction rules that are described in the testimony be repealed. To offset the revenue losses due to this repeal the basic EITC percentage would be reduced by 5/100 of a percentage point and the phase out rates would be reduced by 4/100 of a percentage point.

To offset the revenue losses due to repeal we are proposing a very small reduction in the basic credit rates. I think we have computed that for any single individual the maximum loss of credit would be about $3.71 or something thereabouts. So by this fairly minor change we think we can reduce the complexity of the current credit computation a great deal.

Finally, let me raise the issue of pension simplification coverage and portability. We're pleased that the committee is seriously considering simplification of the tax laws relating to pensions. The Administration has concluded that improvements in pension coverage and pension portability can be achieved as part of the tax simplification effort. We developed proposals to simply the law governing retirement plans, to expand pension coverage and to increase pension portability within the constraint of revenue neutrality.

In total, our proposals do not lose revenue as the estimates attached to my written statement demonstrate. The proposals in specific are described in some detail in the statement.

Let me move now to a brief comment on S. 1394. There is a very lengthy appendix attached to my testimony that goes through the bill provision by provision and presents the views of the Administration. We generally support the bill, although some adjustments will be required to achieve revenue neutrality before enactment.

The Office of Tax Analysis estimates that in its current form the bill is nearly revenue neutral. It loses $89 million in fiscal year 1992 and $47 million over the 5-year budget period.

Certain of the proposals in S. 1394 will achieve significant simplification, but with significant revenue cost. In these instances we've qualified our support as being subject to an acceptable revenue offset.

Let me say just a word about the Senate bill in the pension area. We are encouraged by the similarities in the Administration's pension proposal and the other proposals that are before the committee. These proposals all target the same basic areas where simplification is needed and areas where increased coverage should be indicated.

Our review indicates, however, that S. 1364 in its current form would lose significant revenue over the 5-year budget period. The Administration must oppose pension legislation that would lose revenue.

In addition, as noted in detail in our written statement, we have substantive policy concerns about certain provisions of the bill. We believe, however, that simplification of the employee benefit provisions of the Code can be achieved within the parameters of the budget agreement.

Mr. Chairman, that in summary form concludes my written statement and I would be pleased to answer any specific questions that you may have at this time.

Senator BOREN. Let me ask a question the partnership provision. Many oil and gas partnerships have said that qualified or simplified reporting will not be helpful to them if they have to give up percentage depletion to get it. This is a comment that we are getting. I am sure you have probably gotten similar feedback from them.

What is Treasury's position on modifying the large partnership reporting proposal to allow electing oil and gas partnerships to continue to use percentage depletion?

Mr. GIDEON. Well, the problem that we have is more basic because the structure of the Internal Revenue Code is that percentage depletion is an item computed outside the partnership. I think that we are willing to study proposals that these groups might submit. But I think that they should recognize as well the general approach here, which was to come up with simplified internal computations so that the partnership itself could make the computation as opposed to the partners.

If they think they have a way to do that that would be acceptable to them on a kind of rough justice basis I think we would be pleased to talk to them and see if we can work something out.

Senator BOREN. Well, I am glad to hear that because I think that is a major problem here and a stumbling block, because the trade off would be a very difficult one if there were a loss of some of the depletion that people are now able to get.

Mr. GIDEON. Well, frankly, that is one of the reasons oil and gas partnerships were excluded from the proposal—we did not want to be in the position of proposing that they had to give up something. On the other hand, if they think it is worth coming up with a simplified computation method of their own and they would like to put it in, I think it is clear that we would like to talk to them about what that might be.

Senator BOREN. Right.

One of the other concerns I have heard about the proposed simplified reporting system for widely-held partnerships arises from the fact that net capital losses would not throw through the partners, but would be suspended at the partnership level until they could be applied in future years against the capital gains. In effect, individual partners would lose the benefit of the rules allowing the use of the $3,000 on net capital losses to reduce ordinary income each year. I understand this was done to keep from having to add two boxes to the new 1099-K Form.

Mr. GIDEON. Well, maybe six boxes.

Senator BOREN. I don't know.

But do you think it is a good idea to give up the $3,000 offset to avoid another box or two on the form? Is there a way we can do this without having to suspend the capital loss?

Mr. GIDEON. I think I would certainly be a lot more interested in something that would let us get to an acceptable result without increasing the number of reporting items, because reducing the number of reporting items is frankly what a good part of this is about and what makes simplified reporting possible for these kinds of entities.

Having said that, again, if people have specific suggestions about how those modifications might be achieved within the parameters of the simplified proposal we would obviously be interested in hearing from them.

Senator BOREN. What about the, I mentioned in my opening remarks, the proposal that Senator Baucus and Senator Pryor and Senator Daschle and myself and others on the committee have made that tax laws, the regulations would not have a retroactive effect, but a perspective effect only? What is the administration's view on a bill of this kind?

Mr. GIDEON. Well, I think that we would like to know a lot more about the specifics of it. But reacting to the proposal generically I think we would oppose a provision of that sort.

The reason has to do with what is the effective date of the law. So often a regulation is simply stating the interpretative detail, if you will, of a law that has been enacted by the Congress. Are we really going to place ourselves in a position so that your action, when you enact the law, is not effective until we take some further implementing action down line?

I think in general that is not a good idea and I think you would not want a stricture of that sort.

Having said that, I think, Mr. Chairman, those who are familiar with my record in my job will recognize that I do not like retroactivity very much and we struggle mightily to avoid it whenever possible. But I think adopting an iron clad rule that under no circumstances ever would you have it, I think the committee would discover would lead to some fairly serious problems of revenue administration.

Senator BOREN. What about revisions of regulations in terms of retroactive affect?

Mr. GIDEON. Well, I think that, again, that is a case that really ought to be judged case-by-case. I again would point to our record— you know, we've been very chary with the use of that authority. I think that, to be fair, we heard people here, we heard people on the

outside, and I think that you can expect to see us be circumspect on that front in the future.

Senator BOREN. Well, I certainly think you have tried to be sensitive in that area and I commend you for it.

I would hope maybe that you might take a look. This is not the subject of today's hearing, but to look at the proposal we have made because the complaint that I get so often is that people cannot make—we are always saying we must have long-range investment planning in this country and that we are not long-range enough in our thinking.

I think one of those elements of uncertainty that always causes people sometimes to hang back from major investment decisions is the fear that later retroactively there will be some change in the tax law or in the way the tax laws are being interpreted by regulation that will change something that is profitable into something that is not profitable; and, therefore, people hold back because of this uncertainty.

So I think if there's a way of doing it—I understand what you are saying. There may be some circumstance when it becomes necessary from the point of view of justice and fairness. But any retroactivity in itself I think by definition has some harmful affect by creating this uncertainty in our society.

So we would welcome any suggestions you might have as ways in which we might address this, other than just on a case-by-case basis. Maybe there are certain categories of regulations and certain kinds of affects that simply should not be retroactive as opposed to the whole category.

Mr. GIDEON. Well, as I say, we have attempted to exercise our authority, hopefully wisely and certainly sparingly.

Senator BOREN. Thank you very much, Mr. Gideon. I believe that is all the questions I have. There may be some additional.

Mr. GIDEON. Thank you, Mr. Chairman.

Senator BOREN. We will put your entire statement and the appendix in the record; and there may be some additional questions that members may want to address to you in writing. We will hold the hearing record open for that purpose.

We thank you very much for taking time to be with us today.

Mr. GIDEON. Thank you.

[The prepared statement of Mr. Gideon appears in the appendix.]

Senator BOREN. Our next witness is Commissioner Fred T. Goldberg, Commissioner of the Internal Revenue Service.

Commissioner, we welcome you to the hearings and we would value any comments that you might make about the pending legislation.

STATEMENT OF HON. FRED T. GOLDBERG, COMMISSIONER, INTERNAL REVENUE SERVICE

Commissioner GOLDBERG. Thank you, Mr. Chairman. It is a pleasure to be here today. I would like to begin by commending you and your colleagues for taking on this difficult, but all important issue.

I am convinced that the greatest challenge our tax system faces during the 1990's is to reduce the burden of complying with our tax

laws. The administration and transaction costs our system imposes on the American public are simply unacceptable. We are needlessly consuming billions of hours and dollars of our citizens' time and money maintaining records, preparing forms, structuring their transactions and financial affairs, and dealing with government agencies. Time and money that would be far better spent on family, friends, and productive ventures.

I am equally convinced that the burden and complexity of our tax system are eroding voluntary compliance. I fear that the combination of laws, rules and IRS procedures are pushing taxpayers to the point where it may become too difficult, too expensive and too time consuming for taxpayers to comply. When they stop complying they stop paying their fair share.

There are many causes for the burden and complexity faced by taxpayers. I want to emphasize from the outset that many of these factors have nothing to do with the tax laws as such. We cannot hide behind the veil of blame it on Title 26. The IRS must step forward and accept responsibility for making the system work better for the American public.

We have endless opportunities to simplify tax administration and reduce the burden on taxpayers, opportunities that do not require substantive tax law changes. We can and should be held accountable for our efforts.

At the same time, while we must shoulder a great deal of responsibility, it is clear that existing tax laws are a major cause of needless complexity and burden. In my view, a long-term legislative effort to simply compliance is essential to preserving the health of our system.

I believe you and your colleagues are taking a meaningful first step down this road. I applaud your foresight and your leadership.

Now before turning to pending legislation I would like to offer a number of general observations. They are based on my experience as a private practitioner and as Chief Counsel, as well as my current role as Commissioner.

First, the common wisdom is that simplification requires hard choices among competing policy agendas. While simplifying the law is difficult, it requires great care and tough decisions. The alleged hard choices are often illusory.

Some suggest that the price of simplification is a reduction in revenue, others fear that simplification will be used as a cover for tax increases. While it is clear that simplification can lose or raise revenue, it is equally clear that meaningful simplification can be achieved in ways that are revenue neutral.

Others suggest that the price of simplification is uncertainty. To the contrary, simplification is the one true prerequisite for certainty. The 1980s were devoted to a well meaning effort to provide certainty through detailed laws and regulations. With the benefit of hindsight, I am convinced that the quest was doomed to failure. Each new rule spawns its own measure of uncertainty, unintended consequences, and the need for special exceptions. We have generated thousands of pages of laws, regulations and rulings over the past 10 years and we have created a system that is rife with uncertainty.

Finally, the suggestion is made that the price of simplification is greater inequity. I submit, Mr. Chairman, that the complexity imposed by current laws is hardly fair or equitable. Providing equity for this particular taxpayer or that particular taxpayer through a special provision may appear fair from that taxpayer's perspective, but the net result is to impose inequity on all other taxpayers who must understand and deal with that provision.

No matter how careful, well intentioned and skillful we may be, our efforts do fine tune rules to deal with special circumstances are sure to visit unintended inequities, costs and burdens on other taxpayers.

Now there is a suggestion that simplification is a nice rally and cry, but that there is no true constituency. I think the common wisdom is wrong. I am convinced that there is overwhelming support for genuine and broad-based simplification. All we have to do is open our ears beyond the Beltway. It starts with 120,000 IRS employees who day in and day out see a system that is too difficult and too complicated to meet the needs of the American taxpayer. It moves on to tens of thousands of practitioners and millions of taxpayers who are frustrated beyond measure by a system that has lost touch with the real world. These interest groups are not represented by high-priced lobbyists, but we ignore them at our peril. Their disenchantment threatens our tax system and threatens public confidence in the institutions of our government.

Now in approaching legislative and regulatory simplification efforts I think there are four points to keep in mind. First, it is a long-term endeavor. There is no silver bullet, no magic solution to achieve our end. We have to be patient. We have to accept small progress. If we are diligent and we persevere the impact in the aggregate can be dramatic.

Second, we must embrace rough justice and beware of the purists. By background and training so many of us tend to chase the theoretically complete answer. We want to resolve every question, address every loophole, deal fairly with every special circumstance. We are sure to fail and leave the American public with an unworkable and unadministerable system.

Third, we must always remember that a primary cause for complexity is constant change—124 public laws since 1977, thousands of Sections have been amended, the Code has doubled in size. Now the law will change over time and should. The point is not to resist all change, the point is to recognize that the very fact of a law change imposes a burden on taxpayers, an accumulative effect of incessant "micro modifications" can make that burden unbearable.

Finally, simplification is always on the agenda. We cannot have a simplification agenda today and then get on to high issues of policy tomorrow. Whenever laws or regulations are adopted or revised we should always pose questions, such as: What are the costs of implementation and compliance? Are there less burdensome and more administrable ways to achieve our overall objectives? We must pursue these matters with as much intensity and as much real concern as the more traditional policy issues relating to impact on economic incentives, competitiveness and horizontal and vertical equity.

Now I would like to comment briefly on a number of specific legislative proposals. But rather than focus on the abstract, technical concepts, the aggregate revenue issues of the legislation itself that have been covered by Assistant Secretary Gideon and will be covered by other witnesses today, I would like to approach the issue from a somewhat different perspective.

What are we trying to accomplish? What are the real world implications of the issues we are wrestling with? I believe that when we look at the numbers, when we look at the potential impact, we will find that the road you have started down will have a truly profound impact on the American taxpayer.

I am not going to comment on everything. I am going to limit myself to a few proposals. I would like to take a minute to mention the administration's proposal on the earned income tax credit. I am absolutely convinced that by eliminating the interactions we will dramatically improve the administration of the earned income tax credit and make that system infinitely more workable for the intended beneficiaries.

I would like to mention first some administrative provisions, two in particular. One permits us to enter into joint cooperative agreements on a reimbursable basis with the States. It does not sound like very much, but it is terribly important, whether you are a low income individual filing a State return and a Federal return or a multi-national company dealing with the Federal Government and all 50 States. The issue is the same—the burden that the governments of this country are placing on your shoulders. And by permitting us to enter into joint agreements we are confident we can reduce that burden.

To give you two examples: one, we could permit the joint electronic filing of individual tax returns. The taxpayer would file once, and pay one fee; we would distribute the data to the States and be done with it. Another is a national wage reporting system. The requirement to report repeatedly to the Federal Government and to State agencies on the most fundamental issue of wages is driving businesses up the way. The notion that we can combine that into a single national wage reporting system where the government provides a single form that is filed once with the information then distributed among government agencies would dramatically reduce the burden on taxpayers.

The second provision is to allow payment of taxes by credit cards. Some of us were skeptical at the outset. But it is clear that the taxpayers and practitioners of the country are convinced it is a good idea. It is how we pay bills in this country and it is time the IRS signed up. It is absolutely necessary to make electronic filing work for balance due taxpayers. It is a very effective way to deal with certain types of accounts on an installment basis.

Now I would like to turn to the payroll tax deposit rules and I would like to commend you, and I would like to commend your colleagues in the House for taking on this issue.

I believe you have in front of you an outline of my testimony. On page 4 it sets out some data. The payroll tax deposit system in this country accounts for 80 percent of all revenues collected. Approximately 5.1 million employers which we hope is every employer in

the country, deposited close to $850 billion through this system during 1990.

Now the current deposit rules you have are: daily—accumulate $100,000 or more; eighth-monthly—accumulate $3,000 but less than $100,000; monthly—accumulate $500, but less than $3,000; a quarterly accumulation of up to $500, 5 percent safe harbor for under deposits; make up of shortfall required within 15-45 days; all with no advance warning.

Now what are the net results of all those rules? [Laughter.]

Commissioner GOLDBERG. More than 1.5 million employers are assessed penalties every year, so close to a third of the employers in this country are penalized every year. Now, of course, 21 percent of those penalties are abated and 61.6 percent of those dollars are subsequently abated. But when you are penalizing a third——

Senator BOREN. What did you say? Could you say that last a little more slowly? One-third are assessed a penalty?

Commissioner GOLDBERG. Pardon me, sir.

Senator BOREN. You said one-third are assessed the penalty. How much was abated?

Commissioner GOLDBERG. One-third are assessed penalties and about 20 percent of those penalties are subsequently abated based on reasonable cause or mistakes in recordkeeping.

Senator BOREN. Right.

Commissioner GOLDBERG. That does not mean taxpayers are doing wrong. That does not mean we are doing wrong. It means we have a system that flat out does not work.

Payroll tax deposit cases account for more than $30 billion of our $100 billion accounts receivable inventory. That means more than $30 billion are owed on trust fund cases. $13 billion of that amount is viewed as not collectible.

Now there are lots of reasons for the problems with this system, but we are absolutely convinced that uncertainty and complexity are primary causes. We have not found, despite our diligent efforts, any business in this country that thinks in eighth-monthly increments. Monthly, weekly, but not eighth-monthly.

The accumulation rules require you to keep track effectively on a daily basis your account in terms of your liability. You can move among the four systems. You can move among quarterly, eighth monthly, monthly, during any given quarter with no advance notice.

Now the proposal in S. 1610 would retain the daily regime for $100,000 depositors, would provide a Tuesday/Friday after payroll date for taxpayers with over $18,000 per quarter; and a monthly system for the rest, with effectively a safe harbor on a quarterly basis for small businesses. It would also provide a three month lead time before moving to more accelerated requirements and a 1-year look back rule.

Senator BOREN. Let me ask you a question there.

Commissioner GOLDBERG. Yes, sir.

Senator BOREN. We have had comments from a number of small business groups expressing their concern about H.R. 2775, concern that as many as 40 percent of them, small businesses that now deposit monthly might have to make payroll deposits now every payroll.

Commissioner GOLDBERG. Mr. Chairman, let me comment on that; and hopefully this is a reasonable view of the new IRS. The original proposal reflected in the House bill was a recommendation that we had helped put together on the theory that it achieved other benefits.

After looking at the proposal in S. 1610, which would have the affect of moving taxpayers from an eighth-monthly or to a monthly system, we believe the approach set forth in the Senate bill is preferable, and would urge you to pursue that route. And it is a matter of listening.

We have no IRS stake in this. Our role is to find that system that works best for the American taxpayer. I am convinced that if we go down this road we will reduce the number of penalties asserted; we will reduce the cost to the business community. If you can imagine a world where the Internal Revenue Service is notifying taxpayers of the need to change systems before the fact, rather than penalizing them after the fact; if you can imagine a world where the Internal Revenue Service is contacting a taxpayer who may be behind within days or weeks with an offer to help, rather than getting to that taxpayer years later when they are so far in the ditch they'll never get out; it is a very different world; and it is a world that, with this legislation and a commitment by us to change the way we do business, we can achieve.

With respect to pension simplification, very briefly, along with private savings and Social Security, the pension system is essential to providing for the well-being of our senior citizens. You look at demographics, you look at life expectancies, and it is clearly a terribly important issue.

Data on page 6 of my outline sets forth statistics provided from a number of sources that paint a picture. Only 18 percent of small employers maintain pension plans. Less than 25 percent of those employed by small businesses are covered. While a higher percentage of large employers maintain pension plans only two-thirds of employees employed by those large employers are covered.

Among the legislative proposals is a provision to provide a truly simplified plan for companies that employ fewer than 100 employees. Under this provision, well over 95 percent of the employers in this country can elect a truly simplified system if they choose to. One that is on short forms; does not require the continued cost of actuaries, accountants, lawyers and other experts; and permits meaningful tax-deferred savings for all involved. It is not a panacea, but it is a terribly important step in the right direction.

There is another side to the pension system and that is the pension recipient—the tens of millions of individuals in this country who are or will be receiving pension benefits. Now the outline summarizes some of the current rules. Only lump sums can be rolled over and funds must be distributed to the beneficiary to achieve that rollover. Lump sum distributions are eligible for 5 and 10-year averaging. There is a $5,000 death benefit exclusion. The computation of the taxable portion of pension distributions requires ten pages of text, 65 pages of actuarial tables and 2 worksheets. About 15 percent of the W-2Ps sent to pensioners provides no helpful information in computing taxable income.

The net results of these distribution rules in our opinion are clear. There are terrible transaction costs, enumerable traps for the unwary, savings disincentives, administrative difficulties and widespread over- or underpayment of taxes by senior citizens.

Now a number of proposals pending before the Congress suggest the repeal of the five and ten year averaging options; repeal of the $5,000 death benefit exclusion; simplified basis recovery; permit the rollover of periodic distributions and direct plan-to-plan rollcver distributions.

Some are going to say that repealing those options is unfair. And repealing that death benefit is a little bit unfair. But I submit, Mr. Chairman, that a system that the people of this country cannot understand, and under which they cannot figure out what their tax liability is to save their lives, is what unfairness is all about.

When they have to take that money out and then go find another bank to put it in instead of simply saying "roll it over", when they have to figure out if I get periodic distributions I just blew my chances to keep on saving, that is what is unfair. And a proposal that makes the hard choices of eliminating some options, of going to a rough justice regime, will indeed eliminate the traps for the unwary. It will indeed provide additional savings incentives. It will repeal illusory options, replace uncertain and complex rules with simple and administrative provisions, will enable employers to provide 4.5 million senior citizens with the information necessary to determine their tax liability, and it will replace 65 pages of tables, 12 pages of worksheets, and taxing examples with one-third of one page of instructions.

On page 8 of my outline, there is a brief outline of the household employer reporting rules. Right now if you have a household employee and you pay them more than $50 a quarter, which may well be that kid cutting your grass, you are required to file five Federal forms, make five payments that do not coincide with any other payment or tax obligation, and probably do a corresponding amount of filing and paying with the States.

Well, the proposal is real simple: attach a schedule to your 1040 and adjust your withholding or estimated tax payments, and you are done. That is meaningful simplification for hundreds of thousands of taxpayers. And coupled with the legislation that would permit us to enter into joint agreements with States, we can combine that reporting and payment mechanism so it is simplified or eliminated at the State level as well. Those of us who are accustomed to receiving bills from our States in the average amount of $2.78 a quarter will appreciate that this is meaningful simplification and meaningful savings to State governments.

The large partnership rules, you mentioned those, they are covered on the outline at page 9. I think the numbers are what are most revealing. There are 1.65 million partnerships in the country and about 18 million partners or investment units; 3,000 of those 1.6 million have 250 or more partners. Those 3,000 partnerships have more than 9 million investors. So you are talking about a universe of 3,000 partnerships that involve more than 50 percent of the individual-partnership investments in the United States.

The problem is that current law subjects those large partnerships to all of the same reporting and audit rules as small partner-

ships. The result is staggering and unworkable complexity for partners, for partnerships and a system that is essentially unadministerable from our perspective.

The proposal would permit in effect the replacing of partnership returns that can be 10, 20, 30 pages long with a nine-line form and permit the adjustment of any issues between the Internal Revenue Service and the partnership at the partnership level. This is truly meaningful simplification for the taxpayers of this country.

Then there is the foreign tax credit. It doesn't sound like a big deal. But the amount of investment in foreign funds by individuals and the number of individuals investing in foreign funds has grown dramatically over the past decade. Those individuals are subject to the same foreign tax rules in effect as multi-national companies. They have their Forms 1116. They have their 32-line forms. They have their pages of instructions.

The proposal simply says, if you have less than $200 of foreign tax credit, take it. Life is too short to worry about anything else.

Now that is a big deal. There is 640,000 folks claiming foreign tax credits. This proposal would help out 175,000 of them, more than a fourth of them. The proposal is limited to those who will receive a report and who have only passive investments. If you applied that $200 floor to all individuals with foreign tax credits more than 375,000 taxpayers would be freed of that obligation.

One other proposal I would like to mention involves the expanded access to simplified income tax returns. We absolutely concur in your judgment that we must expand access. We are committed to pursuing that avenue as aggressively as we can. Starting in 1988, strategic initiatives in terms of distributing proofs of tax forms to the public before going final, to focus groups, and town meetings to solicit public input, have resulted in change.

The Form 1040A now permits senior citizens to use that form instead of the more complex 1040. At the recommendation of our citizens, separate booklets are now available for Form 1040-EZ filers. In the last filing season, 15 million taxpayers used 1040As, 13 million used 1040-EZs. We are experimenting with other initiatives. The 1040-EZ-1 we tested in the State of Texas last year and are testing more broadly this year allows those with the simplest forms to provide a minimum amount of information and we compute the rest.

We are working actively with a number of groups, including the staff of the Senate Finance Committee, on a 1040 Form that would be simplified for the large number of individuals whose itemized deductions are limited to home mortgage interest deduction, income taxes and charitable contributions.

We believe we are vigorously pursuing all of these efforts and do not believe that we need the statutory prod to continue. We urge you to pursue vigorous oversight to be sure we are living up to the promise of form simplification and maintain the close working relationships with your staffs.

One quick comment on effective dates. All of these changes have to operate in the real world. I would urge you to be sensitive as I think you were last year, to the time that is required to implement whatever happens in terms of the printing of forms and instructions, to States that need to come into conformity, and to software

houses that need to redesign their computer programs. And to the extent you feel that some of these changes need to be implemented for the 1992 filing season, particularly the earned income tax credit change, those changes really need to occur by the end of the month.

That concludes my testimony. Again, I want to congratulate you on the road you are going down and the effort you are making.

Thank you very much.

Senator BOREN. Thank you very much, Commissioner. We appreciate your testimony. We will put your full statement into the record.

[The prepared statement of Commissioner Goldberg appears in the appendix.]

Senator BOREN. I appreciate also your comments in regard to payroll tax deposits that you made earlier. Because I think the last thing we want to do is push more people into this eight times per month reporting period.

Let me just ask one brief question, and then I want to turn to Chairman Bentsen. The bill, as you know, provides that under Subchapter S, which I do not believe we have touched upon yet, that the Subchapter S corporation is deemed to have a single class of stock if it confers identical voting distribution liquidation rights on its shareholders.

In other words, nonconforming distributions would not create another class of stock if shareholders had the right to eventually have the distribution made pro rata.

One of the earlier regulations that were issued last fall which interpreted the single class of stock requirement in a very strict way would have found more than one class of stock if there had been a nonconforming distribution in the 3-month period.

Now I know those regulations are being reworked and have been reworked. On August 8 we issued new proposed regulations which would abandon this approach to some degree, but would continue to leave room for the IRS to find certain arrangements might create different voting liquidation and distribution rights.

I wonder if you have had a chance to look at the language of the proposed statute here as compared with your latest action on regulations. Do you find it in any way in conflict or do you interpret them as being consistent with each other?

Commissioner GOLDBERG. I believe they are consistent, Mr. Chairman. I have learned that I must follow a certain script since I am the Commissioner not the Assistant Secretary. But I note here that Mr. Gideon supports your legislation and, therefore, I conclude that they are compatible. [Laughter.]

Senator BOREN. Your logic is overwhelming. [Laughter.]

Senator BOREN. Well, Commissioner, I thank you for the comments you have made, the enthusiasm that you are bringing to the task and your obvious personal commitment to the cause of simplification.

I am going to turn now to the Chairman of the full Committee who has joined us, and of course is the principal author of this legislation and your comments of commendation to the Committee and to the leadership of the Committee apply most directly to him for his efforts. This has been a cause of his for a long time to try to

simplify the Tax Code and bring relief not only to average taxpayers, but especially to average taxpayers, but to others in order to encourage investment in this country and orderly transaction of our business.

I would turn to Chairman Bentsen for any comments that he might like to make or any questions that he might like to ask.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. Thank you very much, Mr. Chairman.

Let me say to you, Commissioner, I have been really impressed and delighted with the way you have moved on simplification on regulations. I am very appreciative of that.

I think the need for simpler tax laws is self-evident. If they get overly complicated it leads to disrespect for the law and, frankly, we do not collect as much reserve.

The tax simplification proposals that you have seen in our legislation, were introduced by myself and Senator Packwood. It was bipartisan. On the House side the tax simplification proposals were introduced by Chairman Rostenkowski and Mr. Archer. Then we, along with other staffs, worked with Treasury and with the IRS. We are appreciative of their cooperation and support.

During these negotiations, however, I put these ground rules on the staffs. They could not be making policy and changing policy. They had to be budget neutral. But in spite of those limitations I think you have seen some significant things proposed and I am very pleased to hear the comments that you have made concerning them.

I would also like to hear about any more simplification proposals you think we can consider to get rid of some of the confusion and some of the conflicts. Anything you can do in that regard would be most helpful to us.

I must say, Commissioner, I helped write these tax laws and I would not dare try to make out my own income tax return. I would like to be able to achieve that at some point in the future. But I am also pleased with the expanded access provision on simplified income tax returns. And trying to do that and hearing your agreement with it, it is essential to us that we continue to have the cooperation of your staff in that regard or we cannot accomplish what has to be done in the way of further changes of the law.

So we are very pleased to have your contributions and your comments. Please tell us additional simplifications we can make, apart from the constraints of policy and neutrality. If your suggestions cost us money we will try to figure out how to pay for them.

Commissioner GOLDBERG. Mr. Chairman, I think we can do so much more than we recognize without costing any revenue. I appreciate your comments.

I think that you personally have led a lot of us down the road we need to go. This may be inappropriate, but I would like to take a minute to say some thanks to Sam and Van, your staff, because I think we can go as far as we want to go if we have the commitment to do it.

If making life work better for the American people is something we always think about, and we understand that most of them out there do not have lawyers and accountants and professionals and that it has to work in the real world or it isn't worth doing, if we apply that notion and we think about that question every day, there is no end to the progress we can make.

I think that, as I said before, there is so much we as an agency can and should do without changing the law. It is real easy to blame the Congress, just like it is real easy to blame the IRS. We can fix it. And we have to be pushed by you and your colleagues through the oversight process to make us pay attention to what matters to the American people.

In terms of specific legislative suggestions, I think that if you look at the combination of proposals, if you can meaningfully fix the payroll tax deposit system, including that for household employers; if you can meaningfully fix problems for large partnerships; if you can meaningfully simplify the pension rules for small employers and for 30 million pension recipients; and if you can do the other more targeted fixes that you are talking about doing, I believe you will have accomplished far more in one legislative effort than any of us dreamed possible.

It does not mean it is over, but I think it is a remarkable start. I, again, express my respect for what you are doing.

The CHAIRMAN. Thank you very much.

Thank you, Mr. Chairman.

Senator BOREN. Thank you very much, Senator Bentsen.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Commissioner, I apologize. I was not here when you earlier spoke.

As I understand it, I think you made some reference to the payroll tax deposit provisions in the bill I have introduced; and as I further understand it you referred to them favorably. Is that correct?

Commissioner GOLDBERG. Yes. I referred to it before as S. 1610. I believe it is also known as the Baucus bill. [Laughter.]

But, yes, that is correct, Senator.

Senator BAUCUS. You are a quick learner, Mr. Commissioner. [Laughter.]

Commissioner GOLDBERG. Believe me.

As I said, the IRS should not have any stake in this. We want a system that works best for the employers of the country. Our initial judgment was that the certainty we were providing and giving more taxpayers the opportunity to go on a quarterly system was going to be a better way to go. Having listened to taxpayers, having looked at the legislation proposed, it is now clear to us that permitting taxpayers to move to a monthly system, which is what S. 1610 does, is on balance a better way to proceed and that is the way we would urge you to go.

Senator BAUCUS. Do you think there is a way to work with the safe harbor provisions to not only protect the integrity of the system, but also find a revenue neutral way of resolving?

Commissioner GOLDBERG. As Assistant Secretary Gideon testified, it is clear that we can find appropriate thresholds that will move

some number of taxpayers to a monthly system, and can achieve the other structural changes that are so important in terms of certainty, such as look back rules instead of "gottcha rules." I am confident that we can get to a place that will be of great benefit to the small business community.

Senator BAUCUS. I appreciate that. As you well know, small businessmen just hate the present provisions; and I know the Service is not enamored with them either.

Commissioner GOLDBERG. I think we share the loathing. Yes.

Senator BAUCUS. I hope we can find a solution. Because we are doing a lot of people in this country a great service if we can.

Commissioner GOLDBERG. I agree.

Senator BAUCUS. Thank you.

Senator BOREN. Thank you very much, Commissioner. And again, thank you for the attitude that you are bringing to the job and the task. It is something that is widely appreciated on this committee.

Commissioner GOLDBERG. Thank you for your support.

Senator BOREN. Thank you very much.

Our next witnesses consist of a panel. We will now particularly focus our attention on the issue of partnership taxation as covered in this legislation.

John J. Flavio, Jr., executive vice president and chief financial officer, TENERA, Berkeley, CA, on behalf of the Coalition of Publicly Traded Partnerships; Mr. William Morris, Rogers & Wells, on behalf of Investment Program Association, Washington, DC; Ms. Denise Bode, president, Independent Petroleum Association of America; Mr. Sean Brennan, director of taxes, Mesa Limited Partnership; and Mr. James Aughinbaugh, general tax manager of Oryx Energy Company of Dallas.

We welcome all of you to this hearing and we will be interested to hear your comments on the simplification provisions in regard to the information that must be provided and then given by those investing with limited partnerships, particularly also your assessment of whether or not the provision as now written would require the loss of the partnership of some of the present depletion allowances and deductions.

I think what we will do is just go right down the line here and begin with Mr. Flavio. Because of the size of the panel, I would appreciate it if we could hold our comments. If you could summarize your comments certainly to not more than 5 minutes, preferrably to less than that, perhaps to 3 minutes, because I think we can profit most from having an interchange and having you hit the high points.

We will receive the full testimony of each of you and place your full statements into the record.

Mr. Flavio?

STATEMENT OF JOHN J. FLAVIO, JR., EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, TENERA, L.P., BERKELEY, CA, ON BEHALF OF THE COALITION OF PUBLICLY TRADED PARTNERSHIPS

Mr. FLAVIO. Good afternoon, Mr. Chairman, and members of the Subcommittee. My name is John Flavio and I am the executive vice president and chief financial officer of TENERA, L.P., a publicly traded partnership providing engineering and management services to electric utilities and industrial clients.

I am testifying today as the Chairman of the Board of the Coalition of Publicly Traded Partnerships, a trade association representing publicly traded partnerships or PTPs. The Coalition strongly supports the efforts of this committee to simplify reporting for large partnerships, eliminating what has been one of their greatest problems in raising capital, the fear and loathing of the K-1 form on the part of investors.

This has been a particular problem for PTPs as we attract small investors who are less sophisticated than those investing in non-traded partnerships and who are thus more deterred by complexity.

The Coalition endorses S. 1394 overall. But there are some areas that we believe need improvement or clarification. In addition, the Coalition believes that the bill should address two areas of the Tax Code that add unnecessary complexity by establishing different and inconsistent rules for PTPs.

Let me begin with those two provisions. They are the separate passive loss rule of Section 469(k), which states that passive income from a PTP can only be offset against passive loss from the same PTP and vice versa, and the special UBIT rule in Section 512(c)(2) which states that tax exempt partner share of PTP income will be treated as unrelated business income without the 512(b) exceptions allowed other partnerships for income such as interest, dividends and rents.

The Coalition was disappointed to find that the bill continues these provisions without change. By treating PTPs differently from other partnerships these provisions add unnecessary complexity to the law. They discriminate not only against publicly traded partnerships, as opposed to non-traded partnerships, but also against small investors, the very taxpayers this bill is trying to help, as opposed to wealthier investors.

PTPs attract small investors to a greater extent than non-traded partnerships because the cost of the PTP units is lower than that of interests in other partnerships and the liquidity of the units provides a ready means of retrieving their capital if necessary.

As explained further in my written statement, there is no policy reason to justify this complexity and discrimination. The way a partner's share of PTP income is treated under these two rules is not only discriminatory but it is inconsistent.

Section 469(k) treats the PTP investor like a limited partner by making him go through the passive loss regime; and if the calculations result in a net loss, suspending that loss. If the result is net income, however, it then turns around and treats it as portfolio

income, as if it were a corporate dividend. Is it any wonder that PTP investors are confused?

Then in Section 512(c)(2) the Code does another turnabout and says to tax exempt investors that the income is not portfolio income after all. It is trade or business income from a partnership and must be taxed as unrelated business income. There will, however, be no look through to the source of the income at the partnership level to see if qualifies for an exception, as is done with other partnerships.

There is no consistent theory unifying these methods of taxing PTP income. Legislation that retains this sort of irrationality cannot truly be termed simplification.

There are two ways that Congress could resolve the problems posed by these provisions and bring consistency to the treatment of PTP income. The first would be to treat PTPs the same as other large partnerships by repealing Sections 469(k) and 512(c)(2).

A strong argument can be made that once a PTP earns partnership classification by meeting the income requirements of Section 7704 it should then be treated as a partnership for all purposes of the Code, rather than have corporate-like treatment in some areas and partnership treatment in other areas.

Alternatively, Congress could separate PTPs out from other partnerships on a consistent basis by treating the partner's distributive share of net ordinary income as dividend income for both purposes. Under this alternative the PTP would net the income and loss items included under paragraphs one and two of the new Section 772(a), passive income and loss, and portfolio income and loss, but not capital gain, and report the result to its partners.

If the result were a net loss, it would be suspended as it is now. If net income resulted, it would be treated by the partner as dividend income for passive loss and UBIT purposes. Distributions would continue to be treated as tax deferred return of capital. The result would be major simplification for PTP investors who would no longer have to wade through the Form 8582 and its attendant instructions and worksheets.

Tax exempt investors, including individuals investing through IRAs, which are the bulk of tax exempt investments in PTPs, would no longer need to be concerned about exceeding the $1,000 income threshold and filing the Form 990.

I would like to move on to the due date of furnishing information. The due date for providing K-1s or whatever the new name will be to partners is an item of great concern. Section 107 of the bill requires large partnerships operating on a calendar year, as most PTPs do, to provide information returns to the partners by March 15 rather than the April 15 deadline.

No provision is made for late filing. This is a serious oversight and we urge you to correct it.

The Coalition sympathizes with the drafter's desire to provide partners with information well before they have to file their own returns. We make every effort to do this. After all, our investors can sell their units if they do not like the way we treat them.

I guess I am out of time. Thank you very much.

Senator BOREN. The bell seems louder than before the recess. [Laughter.]

[The prepared statement of Mr. Flavio appears in the appendix.]

Senator BOREN. Mr. Morris?

STATEMENT OF WILLIAM MORRIS, ROGERS & WELLS, ON BEHALF OF INVESTMENT PROGRAMS ASSOCIATION, WASHINGTON, DC

Mr. MORRIS. Thank you, Mr. Chairman. My name is William Morris. I am with the law firm of Rogers & Wells. I appear here today in my capacity as general counsel to the Investment Program Association.

On behalf of the IPA, I would like to publicly commend Chairman Bentsen and Ranking Minority Member, Senator Packwood, for their effort in initiating tax simplification legislation, along with the Treasury and the Internal Revenue Service who have labored long and hard on this issue. I especially want to thank you and the other members of your Subcommittee for taking the time to hold these hearings today. They are an extremely important step in the legislative process.

I would like to pick up on the compelling statement made by Commissioner Goldberg on behalf of tax simplification. While we endorse the proposals that are incorporated in the bill, we think that there is one very important additional simplification item that needs to be added.

I believe you have before you a series of forms that indicate the modifications and additional simplification that we would hope to achieve. For investors who receive $1,000 or less from a particular partnership, we propose that they be able to list that income on Schedule B just as they now list interest and dividends.

This would simplify their burden enormously. They would not have to fill out a series of complicated schedules and attachments they must now include with their tax return.

We also suggest that the capital gains and losses which each of the investors may have from these partnerships be reported on Schedule D. Credits of $300 or less could simply be shown, as we've indicated, on the line for credits on the Form 1040, which on this year's form was line 44 under "general credits."

We suggest that losses of less than $1,000 be permitted to be suspended at the partnership level, so that individual investors would not have to go through the horrendous calculations that have to be made in completing Form 8582, which you will see is the last form attached to the package.

We also propose that the definition of large partnership be set at 500 partners, as opposed to 250 partners; 500 partners is the level generally used for securities purposes in establishing what is a large publicly-offered partnership.

The Commissioner indicated that approximately 3,000 partnerships with over 9 million individual partners would be covered under the proposal at the 250 partner level. We believe that at the 500 partner level, there would be about 2,500 partnerships and over 8 million individual partners covered, thereby still achieving significant simplification for many, many people; and hopefully eliminating some of the complexities and concerns that have been expressed by partnerships in that 250 to 500 partner range.

We would also like to point out, one of the changes proposed in S. 1394 is that tax exempt interest would lose its character unless a partnership had more than 50 percent of its assets invested in tax exempt obligations.

We think there is really no sound policy reason for pursuing that approach. We think tax exempt interest should retain its character as tax exempt interest. An example of a problem arises in the case of a low income housing partnership that is required to maintain reserves to ensure the maintenance of the property. In that case an effort is made to invest those funds in tax exempt bonds because the investors in those transactions clearly are not expecting to receive taxable income. We think there really is no policy reason not to permit the flow through of tax exempt interest.

The next point that was just mentioned by Mr. Flavio is the issue of the due date for furnishing the 1099-K, or as we would prefer to call it the K-99, so that it is not confused with 1099's. A problem arises for us in connection with a partnership that holds interests in a series of other partnerships. For example, we have seen at least one partnership holding interests in 80 operating partnerships.

In order to make it possible for that partnership to provide timely distribution of information it has to have some grace period after the initial due date for the furnishing of information from the first partnership. We think that a 10 or 15 day grace period would help ensure timely distribution of accurate information.

Senator BOREN. Let me ask this question. Others of you might want to address this. It has already been raised by our first witness, this whole question of the reporting date. Because I understand really you're usually giving investment information earlier, around this time anyway.

If we were to go ahead and change it to March 15, but allow some grace period, and also some reasonable provision in regard to penalties for incorrect filing so that we stay at reasonable levels, would that ease your feelings about changing that date somewhat to March 15?

Mr. MORRIS. Yes. If we had some additional grace period within which to furnish the information. It is in our interest to furnish that information as early as possible.

Senator BOREN. Yes. Right.

Mr. MORRIS. Most of our investors would love to have it by January 31.

Senator BOREN. Sure.

Mr. MORRIS. If we could get it to them by January 31 we would. Our problem is that where we have large partnerships that have interests in other partnerships, we just cannot get that information out even though we press those partnerships for timely information and try to get it out as early as possible.

Senator BOREN. Maybe there is room here for some compromise between the April 15 and March 15 by allowing some reasonable grace period and also making sure that any provision on penalties for incorrect filing, inadvertent errors, are reasonable and not penal.

Mr. MORRIS. That is extremely——

Senator BOREN. Excuse me. I took part of your time by getting into the questioning. So why don't you go ahead and complete what you wanted to say.

Mr. MORRIS. Thank you, Mr. Chairman.

I just have three other points I would like to mention very quickly. One is we strongly support the concept of reporting both capital gains and losses to partners on an annual basis.

Senator BOREN. Right.

Mr. MORRIS. And not suspending capital losses at the partnership level. We also think that there is a need for change with respect to adjustments that are made for partners for deficiencies for prior periods. We strongly support the notion of passing adjustments through in the current year as a major simplification.

However, we would like to ensure that interest and penalties are also flowed through to the limited partners because the limited partners and not the partnership are the tax paying entities. To create a regime under which the partnership is a tax paying entity creates severe problems. A partnership is a conduit.

The other item that we are concerned about is the case of a significant deficiency, of let's say $5,000 or more for individual limited partners. We think that there needs to be a special provision covering a situation where partnership units have been transferred and the owner of the partnership interest in the year to which the deficiency relates may not be the owner of that interest in the year in which the adjustment is made.

We think that where the adjustment is significant there has to be some protection for that successor investor and that we should be able to go back to the investor who held the interest during the year to which the adjustment relates. Otherwise, it will require an act of Congress to provide relief in some horror case; and we think there is some flexibility needed.

And lastly, we think that partnerships for which a principal activity is the buying and selling of commodities (not held as inventory), options, futures or forwards with respect to commodities should be treated in the same fashion as large partnerships holding oil and gas assets which are permitted to be excluded from the large partnership rules. We believe the treatment is appropriate for commodity pools, because of the unique way in which their assets are marked to market.

Thank you very much, Mr. Chairman.

Senator BOREN. Thank you very much.

[The prepared statement of Mr. Morris appears in the appendix.]

Senator BOREN. Mr. Brennan?

STATEMENT OF SEAN BRENNAN, DIRECTOR OF TAXES, MESA LIMITED PARTNERSHIP, IRVING, TX

Mr. BRENNAN. Chairman Boren, and members of the Subcommittee on Taxation, my name is Sean Brennan. I am the director of taxes for MESA Limited Partnership of Dallas, TX.

By way of background, MESA is an independent producer of domestic oil and gas. We converted to a publicly-traded partnership in 1985. Upon conversion we recognized $250 million in taxable income.

Currently, MESA is one of the largest partnerships in the United States, with in excess of 125,000 partners.

My remarks this afternoon focus primarily on an amendment that MESA would like to see incorporated into the simplification bill. This amendment would provide an election for large partnerships to report unrelated business income "UBI" and pay unrelated business income tax on behalf of their tax exempt partners. We believe that this amendment would simplify and enhance compliance and is in accordance with the criteria that we understand was used when this legislation was drafted.

Under the current law, UBI reporting is troublesome for all involved. IRAs and other custodial tax exempt accounts often invest in widely-held partnerships. For example, MESA has approximately 24,000 tax exempt investors. Of that 24,000 in excess of 20,000 are IRAs and other custodial accounts.

Although generally unknown by these small tax exempt investors, investments in widely-held partnerships create unrelated business income. Any investment which generates $1,000 of gross UBI income, irrespective of whether or not there is net taxable UBI income, requires that these accounts file an annual tax return, Form 990-T with the IRS. In addition, to make that filing, these accounts are required to apply for and receive an employer identification number from the IRS, which otherwise is generally not needed for these accounts.

On top of the complexities faced by IRA's, the current UBTI rules provide a significant disincentive for investment in PTPs by large institutional tax exempt entities.

MESA's proposed amendment would provide a widely-held partnership, as defined under the bill, an election to file a single composite UBI return on behalf of its tax exempt partners. Although we are working with the tax writing staff on the details, our general suggestions are as follows:

The election would be made on an annual basis at the time the partnership's tax return is filed. The UBI attributable to the tax exempt partners would be calculated and included at the partnership level in a single return.

The taxes would then be paid using a single rate, which would be set so as to approximate the general effective tax rate under current law. Since the partnership would be calculating and filing this return, any adjustments to UBI, including additional tax, interest and penalties would be payable by the partnership.

MESA believes that this proposal, if included, would create a significant number of benefits to all the parties involved. First, IRAs and other retirement accounts would no longer be subject to current complicated administrative compliance requirements and specifically would no longer need to file an annual form.

Second, we believe the IRS would achieve a significant reduction in the number of filings, as well as recognize enhanced compliance with the current rules on top of a centralized audit system in which to administer the current rules. In addition to the revenue enhancement brought about by enhanced compliance, we believe there would also be reduced IRS administrative costs.

Thirdly, the partnerships would generally benefit because significant current barriers to institutional tax exempt investment would

be removed. We believe this ultimately would result in making additional capital available to such critical industries as domestic real estate and domestic energy.

Mr. Chairman, MESA and I thank you and the entire Subcommittee for holding these hearings on Senate Bill 1394.

Senator BOREN. Let me ask you this one question. Under the current law the tax exempt organization is allowed an annual $1,000 deduction against its unrelated business taxable income from all sources.

I wonder how would you or any partnership know whether all the partners would be entitled to take all or part of the $1,000 deduction in that they might have multiple investments in other partnerships, other non-related business income? How would you go about that problem?

Mr. BRENNAN. Mr. Chairman, I don't believe the partnerships really would be able to know. I would propose the use of some intermediate rate that reflects the current revenues being generated, or some other rate, lower than the maximum rate, which approximates the affect that multiple exemptions are available to the partners.

This is something that in a similar situation MESA has done with respect to non-resident partner reporting for various States. We have a similar concept where we go in and file a single return on behalf of our non-resident partners and pay a flat tax at an agreed upon rate with the States.

Senator BOREN. So what would be the revenue offset of any possible loss from a multiple claim? That's how you would do that?

Mr. BRENNAN. Well, right now we believe there is significant non-compliance with the filing requirements altogether. To aggregate and actually get the UBI being generated into a return and taxed at virtually any rate we believe would enhance revenues.

Senator BOREN. Thank you very much.

[The prepared statement of Mr. Brennan appears in the appendix.]

Senator BOREN. Mr. Aughinbaugh?

STATEMENT OF JAMES R. AUGHINBAUGH, GENERAL TAX MANAGER, ORYX ENERGY COMPANY, DALLAS, TX

Mr. AUGHINBAUGH. Mr. Chairman, thank you for the opportunity to appear before you today. My name is Jim Aughinbaugh and I'm the general tax manager for Oryx Energy Co., which is the managing general partner for Sun Energy Partners, limited partnership. Sun Energy is a large oil and gas partnership.

My testimony will address the large partnership audit procedures and the matching provisions proposed in the Tax Simplification Act of 1991.

Large partnership audit provisions: Oryx opposes these for three reasons.

First, we believe that these provisions would be unfair to partners. These provisions would transfer prior year's tax liabilities to current partners of the partnership, including partners who have just joined the partnership. The current partners will be required to pay the old tax liabilities directly out of their own pockets.

Second, the proposed audit rules would decrease the marketability of interest in large partnerships. A partnership interest could carry with it a large but unknown tax liability. Potential investors would not want to purchase these interests.

Third, the proposal would actually increase complexity. The proposals create different audit procedures for different partnerships and for different partners. More rules and procedures mean greater complexity. This is not simplification.

We believe the current audit rules should be retained for all partnerships. If additional change is necessary to facilitate administration of the tax laws by the IRS we suggest that consideration be given to the possibility of eliminating partner participation in large partnership audits so that any resolution of an issue at the partnership level could automatically bind the partners. This would allow the IRS to directly bill the persons who were partners during the year subject to the adjustment.

Matching provisions: The Act includes two provisions that attempt to facilitate matching of items reported on the tax return of large partnerships with the items reported on the tax returns of its partners.

These two provisions are the mandatory consistency requirement and the magnetic media reporting requirement. Oryx opposes both of these provisions because matching is not feasible in the case of oil and gas partnerships and the proposals will require costly system changes and administration without achieving the desired results.

Mandatory consistency in filing: The Act would require a partner of a large oil and gas partnership to file consistently with the partnership's return. Oil and gas partnerships are not subject to the proposed simplified reporting rules for large partnerships.

Therefore, they will continue to pass through as many as 30 or 40 items of income and expense to their separate parties. Many of these items will be treated differently at the partnership and the partner level.

For example, a partnership's tax return allocates intangible drilling and development costs among the partners in accordance with their sharing ratios. A partner that is an integrated oil company, however, is permitted to deduct only 70 percent of the IDC passed to him. The partnership's tax return and the partner's tax return would not match in this case.

Other items that would be treated differently on the tax returns of the oil and gas partnership and its partners include depreciation, passive income or loss subject to the passive activity rules, and tax items calculated with reference to the tax basis of partnership property when the partnership has made a Section 754 election.

These examples illustrate that a partner in many cases cannot file consistently with the tax return of the partnership. Yet the proposal requires a partner to do so or pay a penalty, even if to do so would perpetuate a known error.

Currently law requires partners to file consistently with the partnership's tax return or notify the IRS of any inconsistency in filing. We believe the current law should be retained in the case of large oil and gas partnerships that are not subject to the simplified

reporting rules. The notice of inconsistent treatment now required is more than adequate to alert the IRS of any discrepancies.

Reporting on magnetic media: The Act authorizes the IRS to require all large partnerships to file by magnetic media to permit the IRS to match the tax returns of large partnerships with the tax return of their partners. This provision, if adopted, would require us to develop additional systems to allow us to report on magnetic media. Developing and administering these systems would be costly.

The only justification advanced by the IRS for this requirement is the desire to facilitate matching. Yet as just discussed, matching often is not possible in the case of oil and gas partnerships.

Mr. Chairman, I would be pleased to answer any questions you may have.

Senator BOREN. Thank you very much.

First let me say that we are appreciative to you and your staff for working with the staff of the committee on many of the technical points that you have raised. I know we have been able to resolve some of them, and obviously not all of them from your testimony. But your testimony will be very helpful to us as we go back over some of these proposals in detail.

I would be curious to know your reaction to the proposal made by Mr. Morris in his statement, that in terms of the liability, you've talked about this problem in terms of the liability of partners for previous years, those that have been partners only recently, let's say. We might modify the current year's partners maximum liability for some adjustment relating to prior tax years with some sort of a cap on the amount of liability that would be charged.

How do you respond to that suggestion?

Mr. AUGHINBAUGH. I think it is a step in the right direction.

Senator BOREN. But you would just like not to see any liability whatever?

Mr. AUGHINBAUGH. I would like to see the original partner have the liability.

Senator BOREN. Have the liability as opposed to those of the current partners?

Mr. AUGHINBAUGH. Right.

Senator BOREN. Thank you very much. I appreciate your testimony.

Mr. AUGHINBAUGH. You are quite welcome.

Senator BOREN. We are pleased to welcome Denise Bode, President of the Independent Petroleum Association of America. I believe, is this your first appearance before the committee as the President of the IPAA?

Ms. BODE. Yes, it is.

Senator BOREN. Is is a little hard for me to operate up here because she used to be back behind me here as a member of my staff in the ancient past. But we welcome you and would value your comments on behalf of IPAA.

STATEMENT OF DENISE A. BODE, PRESIDENT, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, WASHINGTON, DC

Ms. BODE. Thank you very much. As I said, my name is Denise Bode. I am president of the Independent Petroleum Association of America. I welcome the opportunity to comment on behalf of our National association which represents 5500 independent crude oil and natural gas explorers and producers in 33 States with oil and natural gas production.

The IPAA includes among its members a number of publicly-traded master limited partnerships besides the significant number of smaller partnerships in which our members maintain interests.

IPAA does support the concept of simplified reporting to the extent that new requirements reduce the number of items required to be separately reported to partners. Yet primarily because oil and gas partnerships that elect the simplified reporting benefits under the Act are subject to the loss of percentage depletion benefits, the Act will significant reduce the attractiveness of oil and gas investments held in partnership form.

Minimum tax reform is also of paramount importance. Much of the complexity that is prevalent in oil and gas partnerships has resulted from the impact of the minimum tax laws. The oil and gas industry is subject to numerous adjustments for purposes of the minimum tax resulting from the treatment of drilling costs, percentage depletion and equipment depreciation.

The need to separately state these items would be eliminated for the majority of investors if the different treatment of these items was modified.

Domestic producers should be allowed to use their long established, ordinary and necessary business deduction, such as drilling costs, and the allowance for the depletion of the resource. We want to be treated equally, just like any other small business.

At a time when investment in domestic petroleum resources in a perilous decline due to problems with oil and natural gas price volatility and a lack of capital, current tax law only serves to exacerbate the problem.

For instance, due to price volatility and the complexity of the minimum tax, a potential investor may not know if he made a wise decision to drill until almost a full year after the drilling date. Given the risks an investor must undertake, he needs little additional aggravation in the form of punitive and regressive tax provisions.

The IPAA feels that the Congress would best advance the goals of tax simplification and wise energy policy by not penalizing these legitimate business deductions under the minimum tax.

On simplified reporting and percentage depletion the simplification bill provides that the simplified reporting requirements would not apply to large oil and gas partnerships unless the partnership makes an election to apply these requirements.

IPAA supports this elective treatment in view of the fact that drilling costs and percentage depletion must often be separately stated to comply with other provisions of the Internal Revenue Code. However, a partnership electing the simplified reporting requirements must forego the benefits of percentage depletion and

can only deduct cost depletion. The loss of percentage depletion benefits would severely reduce the attractiveness of oil and gas investments held in partnership form.

The IPAA recommends that there should be no limitations on the allowance of percentage depletion deductions by large partnerships electing simplified reporting. In order to advance the goals of simplified reporting, depletion could be computed at the partnership level, except for those partners otherwise excluded from the simplified provisions.

With regard to proposals affecting assessment of deficiencies with respect to widely-held partnerships, the bill provides for a number of changes in the audit procedures of widely-held partnerships apparently arising out of the recommendation in the Department of Treasury study that audit procedures should be changed.

However, we question the need for changes in this area based on the Treasury Department's conclusion that a significant amount of unreported partnership income exists from widely-held partnerships. The Treasury study is notable in that it offers no factual evidence to back up this conclusion. However, the approach adopted in the bill is a major policy change, would severely damage the ability of partners to resell partnership interests and would impose an unfair burden on partners by subjecting them to tax on income they have never received.

The IPAA is opposed to the changes in the partnership audit procedures contained in the bill. If changes must be made, we recommend that changes apply to publicly-traded partnerships only and those partnerships that are not publicly-traded and were formed for the purposes of conducting a single business venture must be exempted from the new rules.

With regard to magnetic media filing and the advance of the due date for furnishing information to partners, we have also furnished written comments concerning the magnetic media filing requirement and the advance of the due date for furnishing information returns to partners.

In brief, we recommend that only the oil and gas partnerships that have elected the simplified reporting provisions should be subject to magnetic media reporting. In addition, we believe that more flexibility should be provided to partnerships to extend the due date for filing partnership returns and sending information returns to partners if reasonable cause exists for a later filing.

We appreciate the opportunity to testify and I would be pleased to answer any questions that you may have.

Senator BOREN. Thank you very much.

[The prepared statement of Ms. Bode appears in the appendix.]

Senator BOREN. Let me ask, would the rest of you concur with what Ms. Bode has just said in terms of the audit provisions as now written or not, in terms of this problem of reliability?

Mr. FLAVIO. I would like to respond. I would say that we feel a little bit differently about that, that we do not think it would put partners at a significant disadvantage, just like a corporate security owner who buys his security, who may have a tax problem down the road. So we do not see that it would be at a disadvantage.

Senator BOREN. Do others of you want to comment?

Mr. BRENNAN. I would like to comment in that with respect to MESA it is a valid point, although an argument could be made that a tax liability is no different than any other liability that a partner would buy into currently.

Our biggest concerns right now with the audit and the administrative proposals is the fact that in terms of retaining current policy, most of the significant limitations on utilizing current deductions and, operating losses are retained under the proposal, such as passive losses, basis limitations, at risk, et cetera.

However, when it comes to imposing interest and penalties, the assumption is made that the deductions were utilized immediately at a maximum rate.

Senator BOREN. Right.

Mr. BRENNAN. So our major concern is not so much the new partner buying in as much as it is the mismatch that you are paying interest on items of deductions——

Senator BOREN. In terms of the assumption on the basis of penalties.

Mr. BRENNAN [continuing]. That may not have been realized by anyone.

Senator BOREN. Would you all agree that is a problem?

Mr. Morris, did you want to add a comment on that?

Mr. MORRIS. I guess our concern is that there is sort of a balancing of interest here. One of the difficulties that is faced currently is going after thousands of limited partners for very small amounts of additional tax; and under existing law you have to have a separate procedure with respect to each individual.

Senator BOREN. Right.

Mr. MORRIS. So we felt that it really is a major step forward to come up with some sort of a mechanism for making those adjustments where there are small items.

Our concern is with a situation where an individual gets stuck with a large deficiency that was never anticipated.

Senator BOREN. Right.

Mr. MORRIS. We think it is extremely rare that it would happen, but we would hate to see a horror case occur where it would take actually additional legislation to correct it.

Senator BOREN. That is the reason you want to see some sort of a cap.

Mr. MORRIS. Right. We would like some sort of a protection in there against a horror case.

Senator BOREN. Mr. Aughinbaugh, I gather you would agree with what Ms. Bode said, go further than the cap from your previous comments.

Mr. AUGHINBAUGH. Yes.

Senator BOREN. Ms. Bode, let me ask one last question on the position of the IPAA. If a way were found to allow for use of the simplified procedures without the loss of percentage depletion, would the IPAA then be in favor of the legislation?

Ms. BODE. Oh, definitely. In fact, that is what we have been saying, is that we think that it can be fixed so that you can exclude those partners who they are concerned about, who are, for example, subject to the depletable quantity limitations.

Senator BOREN. Right.

Ms. BODE. That you can exclude those folks and still allow those people who are now appropriately able to use percentage depletion to continue to use percentage depletion.

Senator BOREN. To continue to do so.

Ms. BODE. To continue to do so.

Senator BOREN. Well, I am very hopeful we can do that. Because it would be a shame to deny and make it really uneconomic for those who now get some benefit from percentage depletion, given the economics of the oil and gas industry, strictly the independent sector, to have to give up percentage depletion in order to have the advantages of simplification.

I would turn to Senator Baucus. Any questions of this panel?

Senator BAUCUS. No questions, Mr. Chairman. Thank you.

Senator BOREN. Senator Moynihan has joined us.

Senator MOYNIHAN. No questions, Mr. Chairman.

Senator BOREN. Thank you very much.

Well, I thank the panel for being with us. There may be some additional questions that we want to address to you and I assure you we will put your full statements into the record as if presented to us today.

Mr. FLAVIO. Thank you very much, Mr. Chairman.

Mr. BRENNAN. Thank you.

Senator BOREN. I apologize as I call up the next panel, Mr. Robert Perlman, vice president, tax, customs and licensing, Intel Corporation, Santa Clara, CA, on behalf of the Tax Executive Institute; Mr. Robert Mattson, Assistant Treasurer, IBM, on behalf of National Association of Manufacturers; Mr. William Dakin, Senior Tax Counsel, Mobil Corp., on behalf of the National Foreign Trade Council; and Mr. Murray Scureman, Governmental Affairs of the Amdahl Corp. on behalf of the Coalition on the PFIC Provisions.

Let me say that I apologize to the members of the panel. I have to go now to chair another committee, another meeting, and let me say also that I look forward to hearing the comments of our next panel as well. Mr. Fred Corneel, Mr. Mike Roush, who I know has worked with us on our proposal on retroactive regulations on behalf of NFIB, Ellen Nissenbaum, and Lloyd Plaine on the estate and gift tax provisions that are a long interest of mine.

But I want to assure you that I will read the testimony of each of these two panels and I appreciate the fact that my colleague, Senator Baucus, has agreed to help me because of these pressures of schedules to complete the hearings.

We will proceed under the rule as we were just operating. And, obviously, with so many to make comments, we would appreciate it if you could summarize your testimony in 3 to 5 minutes, hitting the high points in an informal way. We will put your full statements into the record. Then that will enable us to focus on the principal points that you wish to make.

So we will begin with Mr. Perlman and I will turn the chair over to my colleague, Senator Baucus.

Senator MOYNIHAN. Mr. Chairman, may I have a statement in the record on the passive foreign investment company provisions that Mr. Scureman will give testimony on?

Senator BOREN. Without objection, we will include your statement in the record.

Senator MOYNIHAN. Thank you.

[The prepared statement of Senator Moynihan appears in the appendix.]

Senator BOREN. Mr. Perlman.

STATEMENT OF ROBERT H. PERLMAN, VICE PRESIDENT, TAX, CUSTOMS AND LICENSING, INTEL CORP., SANTA CLARA, CA, ON BEHALF OF TAX EXECUTIVES INSTITUTE, INC.

Mr. PERLMAN. Thank you, Mr. Chairman. I am Bob Perlman, vice president of tax, licensing and customs for Intel Corp. in Santa Clara, CA. I am here today in my capacity as Senior Vice President of the Tax Executives Institute.

TEI is a professional association of corporate tax specialists that place special emphasis on the administrability of the tax law. Our 4,700 members do not interact with the tax laws as consultants or advisors, but rather work in the tax departments of the 2,000 largest companies in North America.

Our members deal with the Code's complexity day-in and day-out and they are responsible for ensuring their company's compliance with the laws. They know first hand the hidden cost that complexity imposes on international competitiveness. While U.S. companies are becoming more efficient and productive their tax departments are requesting additional resources to do such things as multiple depreciation and inventory calculations and hundreds of separate foreign tax credit basket computations. Senior management often has a difficult time reconciling this need with other hard decisions they are forced to make. TEI commends the Committee for recognizing the need for simplicity. We believe the introduction of S. 1394 and the scheduling of these hearings are positive signs of Congress's commitment to simplification.

We recognize that the simplification process is an incremental one, and that the bill cannot be all things to all people. Nevertheless, we would be less than candid if we did not express our disappointment as to the overall scope and tenor of S. 1394.

TEI strongly urges the Committee to step back and view simplification not only as an end unto itself, but as a necessary step to ensuring the continued ability of U.S. companies to compete abroad. It would be a mistake to consider issues strictly on revenue grounds. It would also be a mistake to ignore problems caused by the Tax Reform Act of 1986.

For example, S. 1394 does not address the overwhelming requirement of the 1986 Act that a separate foreign tax credit "basket" be created for each so-called 10/50 company. There has, however, been almost universal agreement, including that of the Treasury, that something must be done to relieve taxpayers and the IRS of the burden of dealing with potentially hundreds or thousands of separate foreign tax credit calculations.

To side-step the problem, as the bill does, is to lose a golden opportunity for real simplification. Fortunately, S. 936—which was introduced by Senator Baucus—would create a single basket for all 10/50 companies or at the taxpayer's election a look-through rule for such companies. We strongly support this provision.

We also recommend that Congress deal forthrightly with the tremendous unnecessary complexity spawned by the application of the uniform capitalization rules to foreign corporations. Again, while S. 1394 ignores the problem, S. 936 would provide meaningful relief from the administrative and compliance burdens placed on U.S. companies operating abroad at minimal cost.

Mr. Chairman, there are two other foreign provisions I wish to comment on. The first relates to the translation of foreign taxes. The 1986 Act changes to this area were, quite frankly, unnecessary and unworkable. As drafted, the bill would work no simplification but would merely authorize the Treasury to issue regulations which would provide at best modest relief.

TEI recommends that the Committee take up the issue directly and provide a return to prior law or a statutory-year-of-accrual rule. Such a rule is provided for in S. 936, and would make it possible for taxpayers to comply with the law and for the IRS to audit that compliance.

The other provision almost belies the title of the bill. The proposed changes to the Code's anti-deferral rules are anything but simple. The passive foreign corporation or PFC proposal was prompted by concern about the overlapping of three or four different sets of rules, most notably the Subpart F and PFIC provisions.

The PFIC rules were originally intended to patch a perceived hole in the Subpart F wall. Rather than acting as a repair, however, the PFIC rules have eclipsed Subpart F and established a more onerous regime. The easiest, simplest way to address the problem would be a single sentence in the PFIC rules: "These rules will not apply to controlled foreign corporations subject to Subpart F."

Regrettably, the bill does not take that approach—or the alternative approach of modifying or eliminating the assets or gross income tests. Instead, this bill would create an entirely new structure layered on top of the existing provisions. The proposal is not only complicated, but would further erode the Code's time-honored principal of deferring current tax on foreign earnings where no abuse is involved.

We urge the Committee to carefully consider whether the PFC rules can truly be squared with the goals of the simplification initiative.

Mr. Chairman, I encourage the committee to seize the initiative and to work expeditiously to effect real tax simplification in the same vein as the Commissioner is taking the initiative on his part.

Enactment of a bill such as S. 936 will not only underscore Congress's commitment to the concept of simplification but will pay dividends in terms of U.S. productivity and competitiveness far beyond the five-year budget window.

I will be happy to respond to your questions. Thank you.

Senator BAUCUS. Five minutes, bing. Wow! That timing is perfect.

[The prepared statement of Mr. Perlman appears in the appendix.]

Senator BAUCUS. Mr. Mattson?

STATEMENT OF ROBERT N. MATTSON, ASSISTANT TREASURER, IBM CORP., ARMONK, NY, ON BEHALF OF NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. MATTSON. My name is Bob Mattson. I am assistant treasurer of the IBM Corp. responsible for the company's worldwide tax operations. I appreciate the opportunity to be here today to present NAM's views on the pending legislation for simplifying the U.S. Tax Code.

NAM commends Chairman Bentsen for his leadership in introducing a primary tax simplification bill, S. 1394. NAM also applauds S. 936 introduced by Senator Baucus which would substantially simplify the rules governing international activity by U.S. based companies without materially affecting their U.S. tax liabilities. NAM urges the committee to include the provisions of S. 936 in the tax simplification bill.

The first goal of tax simplification should be to maintain the existing corporation tax rates. The U.S. corporate tax rate has resulted in substantial benefits to U.S. global companies. A major, reason for this, and often overlooked, is that the benefit from a reduced U.S. corporate tax rate is that it encouraged other countries to significantly lower their tax rates.

The 1986 tax rate reduction, unquestionably the most positive tax policy achievement of the last decade should under no circumstances be reversed.

A dramatic change in the 1986 Tax Reform Act was the layer upon layer of complex rules that were directed at U.S. corporations' activities outside the United States. Many of these provisions did not raise revenue, but were enacted because of the fear that in some way the lower U.S. rate operating in conjunction with the foreign tax credit had to be back stopped by a set of complex protective rules.

After examination of these rules, most experts agree that the level of complexity is unwarranted. It is important to note that similar costs are not borne in other countries by their taxpayers and our competitors.

What was imposed on America's global companies in the 1986 Tax Reform Act included nine multiple complex separate limitation basket calculations of the foreign tax credit.

Furthermore, the "10/50" basket, which affects our joint ventures that we have to deal with around the world, can result in hundreds, if not thousands of separate limitation calculations, depending on the form of joint venture operations abroad and it interferes greatly with those operations.

It also requires complex allocations of numerous categories of domestic expenses and burdensome translation of foreign taxes. The member companies of NAM have experienced an increased burden of the cost of data collection, an increase in the tax return preparation time, increased costs to deal with the dazzling maze of intricate compliance steps in meeting the rules, and increased compliance personnel requirements.

I would like to refer to the chart on my left and I would visually try to give you a picture of what is happening to show how much complexity and burden there is. At first our company, as most

multi-nationals and most global companies do, has to send a tax instruction package out to over 129 countries. Companies in those countries and their personnel have to prepare all this information. We have to try to explain to them the U.S. Tax Code so we can get the information back.

This generates over—

Senator MOYNIHAN. That would mean companies overseas?

Mr. MATTSON. Overseas. Personnel of companies overseas. Germans, French, Japanese, Ghanians, throughout the world.

This generates over 3,000 separate tax reports prepared by the countries and sent back to the U.S. parent. There are 31 different reports under the current tax law that a country entity has to prepare.

Dividend analysis information is obtained from country entities, with amounts remitted, dates of payment, exchange rates for currency translation, and withholding tax information. Each individual income tax payment by the foreign entity has to be converted into U.S. dollars as of the tax payment date.

Tax reports received from the foreign entities must be examined, cross checked—3,000 or more of these—and verified for accuracy. These require time-consuming and extensive analyses. Data inputs and calculations of earnings and profits adjustments are verified prior to input, in our case we input it into a massive software program which we acquire from Price Waterhouse, their international tax management system, with numerous modules.

We have to develop in our company numerous Lotus software models to calculate deemed foreign tax credits related to dividends from each entity. Overall basket information is controlled by the U.S. model, Lotus models, and then backed up by this Price Waterhouse system. And this is a small fraction of the work that has to be done.

This information has to be imputed into Form 1118's, over 200 pages in our return. Hundreds of separate Form 5471's, over 1,500 more pages have to be prepared. The company employs 25 tax professionals, plus about 5 part-time college students, working over 8 months, often requiring overtime to accomplish the above tasks.

The Internal Revenue Service then comes in and spends 2 to 3 person years just skimming the surface of all of this work.

In conclusion, one of the most disturbing myths burdening American tax policy today is that tax simplification will result in lost revenue. In many cases simplification will actually increase revenue by reducing unnecessary costs of compliance.

This concludes my prepared statement and I would be glad to address any questions.

Senator BAUCUS. Thank you, Mr. Mattson.

[The prepared statement of Mr. Mattson appears in the appendix.]

Senator BAUCUS. Mr. Dakin, you are next.

Mr. DAKIN. Thank you.

STATEMENT OF WILLIAM G. DAKIN, SENIOR TAX COUNSEL, MOBIL CORPORATION, FAIRFAX, VA, ON BEHALF OF NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. DAKIN. I am William Dakin. I am senior tax counsel to Mobil Corp. and I am appearing on behalf of the National Foreign Trade Council, which is a group of some 500 U.S. companies engaged in international trade.

It is we who are the people who have to collect the data, keep the records, and make the calculations required by the tax law. Simplifying the foreign provisions of the Code is a high priority for the NFTC and its member companies.

I would first like to give recognition to the professional staff for the highly fine job that they have done in the technical preparation of this bill. It is clear that a lot of hours have been put in and a lot of hard thought has been given.

Given the constraints of no revenue impact and no policy changes, narrowly defined, it would be very difficult to come up with substantial kinds of simplification.

I am going to first discuss why it is that we feel that the proposals in S. 1394, while technically very well drafted, do not appear as a practical matter to accomplish much simplification for many U.S. multi-national taxpayers. One of the proposals would be quite helpful, another would be harmful.

Then I would like to discuss briefly S. 936, the Foreign Tax Simplification Act of 1991, which we believe would reduce compliance costs without much revenue impact.

To simplify the written submission, the anti-deferral provisions of the Code simply define when U.S. taxpayers are going to be taxed on income that is earned by foreign corporations, either currently as it is earned or later when it is distributed to them as dividends.

Now what the bill does in this area is to try to simplify the overlapping provisions that now apply by essentially taking the rules that apply to individual investors and applying them across the board to all taxpayers, including very large foreign subsidiaries of U.S. multi-nationals.

As Commissioner Goldberg pointed out in his testimony regarding the foreign tax credit, it is not always readily apparent that rules that are appropriate for small individual taxpayers are appropriate for very, very large foreign corporations engaged in trade or business.

We think that the drafters of Subtitle A deserve credit for doing a good technical job of the task that they set for themselves and we think that their proposals could well be helpful to individual investors and to closely-held businesses.

The reason that we do not think that they would be terribly helpful to large publicly-traded U.S. multi-nationals is that many of the rules that would be repealed or consolidated do not apply to publicly traded companies and therefore since they already do not apply repealing those rules does not appear to us to accomplish much simplification for them.

We would all like to solve the PFIC problem. In our opinion, a simpler way to do it, without adding new complexities and without

adversely affecting competitiveness would be to exempt controlled foreign corporations from the new PFIC rules because they are already adequately covered by the Subpart F rules.

An exemption for controlled foreign corporations would not solve the problem for non-controlled foreign corporations, but it would be a very constructive step. So we would recommend relying on Subpart F to tax the foreign subsidies of U.S. multi-nationals and use the approach in the bill of combining the foreign personal holding company rules and the PFIC rules to provide a simplified way of taxing the non-business income of individuals.

We strongly support the proposal to extend Section 1248 of the Code, which says that when you sell stock in a foreign corporation the gain on that sale is treated as a dividend to the extent that it is the equivalent of distributing that company's retained earnings. That is a helpful step which we strongly support.

We do not support the proposal to repeal Section 960(a)(3) of the Code. That is a provision that if income has already been taxed to a U.S. taxpayer under Subpart F, then when that income is subsequently distributed it is not taxed a second time; it is treated as a distribution of previously taxed income. But if additional foreign taxes have been paid on that income, the U.S. taxpayer is entitled to claim them. We think that that is a sound provision and should be retained.

The National Foreign Trade Council, in common with many business organizations, has submitted lots of recommendations on simplification. Five of those generally supported ideas are incorporated in S. 936 which was introduced by Senator Baucus on April 25.

We commend S. 936 to the committee because it would provide genuine simplification and workload reduction for U.S. companies engaged in international trade. It addresses the compliance problems which U.S. companies actually face. The proposed solutions seem to us to be practical. They enjoy very broad-based business support and we would urge that they be incorporated in any simplification bill which the Committee may report out.

Thank you very much for the opportunity to testify. I would be happy to take questions later.

Senator BAUCUS. Thank you, Mr. Dakin.

[The prepared statement of Mr. Dakin appears in the appendix.]

Senator BAUCUS. Mr. Scureman?

STATEMENT OF MURRAY SCUREMAN, VICE PRESIDENT, GOVERNMENT AFFAIRS, AMDAHL CORP., SUNNYVALE, CA, ON BEHALF OF THE COALITION ON THE PFIC PROVISIONS, ACCOMPANIED BY THOMAS A. O'DONNELL, COUNSEL TO THE COALITION ON THE PFIC PROVISIONS, BAKER & McKENZIE, WASHINGTON, DC

Mr. SCUREMAN. Thank you, Mr. Chairman. My name is Murray Scureman and I am vice president of government affairs for the Amdahl Corp. I am here today representing a Coalition of 17 companies to discuss the negative impact that we are all experiencing as a result of the overbreadth of both the current and proposed PFIC provisions.

Joining me here at the table is Tom O'Donnell, the counsel for the Coalition.

Amdahl is a $2.1 billion California-based high technology company and was an entrepreneurial success story in the early 1970s when our founder raised nearly $50 million to develop the industry's first large scale IBM compatible mainframe computer, shipping that first machine to NASA in 1975.

In 1976 we had our first international sale and in 1978 we opened a plant in Ireland to service the international business, which by last year had grown to nearly 50 percent of our revenues.

Amdahl's situation is typical of the PFIC problem. Although we have been profitable from the beginning it was clear that the U.S. market alone would not be sufficient to support both the operational drains on investments and the cost of R&D investment necessary to fund the development of future systems.

Aggressive expansion outside the U.S. then led to the building of a plant within the EC in order to be competitive in that marketplace. Ireland was chosen as the plant site for a number of reasons, obviously including favorable Irish tax treatment.

As an American high technology start-up company that was only in its third year of profitable operation, building a plant in a high tax country such as Germany was simply out of the question. The economics of remaining competitive depended upon our ability to generate substantial profits to be reinvested in our expansion abroad.

The current PFIC provisions threaten these financial assumptions at a time when American companies are having their greatest difficulty remaining competitive. With the advent of EC-92 we could be facing even more competition from the Europeans and the Japanese who are investing in the EC at a furious rate and are not burdened by anything comparable to PFIC.

The distortion in this case is created by the "ASSET" test, which states that a corporation is a PFIC if 50 percent or more of its assets measured by value are passive. Much has already been said about the mechanics of the ASSET test. Let me say here that we strongly recommend that CFCs not be subject to the asset test as proposed in the legislation introduced by Senators Moynihan and Packwood.

I would now like to share with you a few business examples where the asset test forces companies in the Coalition to engage in expensive and time-consuming activities to avoid accidental PFIC status.

The first example is that compliance with PFIC demands that each subsidiary in each foreign country conduct quarterly appraisals of the fair market value of all of their assets, including plant equipment and all tangible assets supporting the operation.

If the results of that effort fall short of the 50 percent non-passive asset mark then expensive appraisals of the intangible assets must be conducted evaluating such items as goodwill and technology. In addition, this effort will undoubtedly result in lengthy and costly disputes with the IRS because of the difficulty in agreeing on the value of assets, particularly intangibles.

The second example is that companies must set up systems to monitor asset status in advance of the quarter's end, to ensure that normal business activities, such as the receipt of accounts receiv-

ables or the normal taking of deposits on orders, do not trigger PFIC status.

The third example is a case where one of our Coalition members decided against selling off an unprofitable division, for which he had negotiated a fair price. The reason is that the sale would have converted active assets into passive cash assets triggering PFIC status, an ongoing situation he could not afford.

The last example is a case where another one of our members lost business in Europe because the threat of PFIC prevented him from establishing a financial subsidiary within the EC, whose assets would have been primarily passive.

I think the Subcommittee would agree that tax laws should not restrict the options available to American businessmen trying to compete in the international marketplace, particularly at a time in history when the U.S. is having serious difficulty with foreign competitors who do not face similar burdens.

We urge the Subcommittee to adopt S. 1654, the Moynihan/Packwood proposal. Thank you. I would be pleased to answer any questions.

Senator BAUCUS. Thank you, Mr. Scureman.

[The prepared statement of Mr. Scureman appears in the appendix.]

Senator BAUCUS. I wonder if you could amplify a little bit on why EC-92 might further complicate the American competitiveness, at least from the point of view of the PFIC rules.

Mr. SCUREMAN. Yes. One of the things that we are all looking at is what kind of investments are going to be necessary, what do we have to do to our plant in Ireland in 1992 to prepare for the additional competition that we are anticipating. The problem is that we have been accumulating profits to be used for that purpose, reinvesting in our passive and active assets getting close to each other, which will then, trigger PFIC status. If we become a PFIC, of course, then there is substantial taxation that would be directed away from EC-92.

Senator BAUCUS. But under American tax law currently, can U.S. parent corporation, U.S. multi-national transfer certain passive assets quickly? Some accumulate passive assets, cash for example, which may trigger PFIC with its adverse consequences. Is there a way to get around that?

Mr. SCUREMAN. Well, the problem you run into in our business, we are speaking of in high technology now, is that it takes often several years worth of profits from the Irish operation in order to accumulate enough reserves to make possible a substantial investment in plant and equipment; or to open a leasing division, which we are considering.

There are a number of different things you might want to do with the cash.

Mr. O'DONNELL. Senator, if I may answer?

Senator BAUCUS. Sure.

Mr. O'DONNELL. It is possible to avoid PFIC status through doing some rather complicated restructuring. In particular, by taking a company like the Irish company Amdahl has, dropping its operating assets into a second-tier subsidiary, which is a tax-free transaction, and then leaving the so-called passive assets in an upper-tier

company which is paying full tax under Subpart F, PFIC status can be avoided for operational assets.

When the time comes to reinvest you can drop the cash back into the operating company for reinvestment. The problem is that this kind of restructuring includes complication and expense to comply with foreign law. In the case of Ireland you have to set up a Bermuda company that operates as a branch in Ireland; you have to issue all kinds of stock certificates. It is a very, very expensive proposition to go through this little restructuring in order to avoid the PFIC status.

This is the sort of compliance problem that we just do not think makes any sense.

Senator BAUCUS. Mr. Perlman, do you want to add to that?

Mr. PERLMAN. Yes, Senator.

My company has a factory in Singapore that became a PFIC because it was saving its cash to increase capacity and do research in future years.

Now if you look at the fact that we are competing with the Japanese and other Far Eastern manufacturers, making the same product right across the street from us; we are both in Singapore, we are both in Malaysia, we are both in the Philippines. They get tax sparing. We are not even asking for tax sparing; we are just asking to leave us alone and do not take a factory and turn it into a passive company—which it is not—when it is accumulating its assets for reinvestment.

So we are in effect at a double disadvantage with competitors from other countries that have tax sparing arrangements.

Senator BAUCUS. I appreciate that. But help us who are championing these changes, if you could tell us now what some of the potential abuses are that the earlier PFIC rules were designed to prevent and why in your judgment we should not be concerned about those potential abuses.

Mr. PERLMAN. I believe, Senator, that the original rationale for PFIC was to close down offshore mutual funds that were structured in such a way as to walk through the ownership requirements of Subpart F so that true passive income would not be subject to Subpart F, and would end up in the big basket when it came home.

I do not recall any company rearing up and saying, please do not close that loophole. That was one of these things that lasts until it is found out and then it is dead. But in closing that loophole, in all the active companies, such as factories and sales offices that happen to have $200,000 in the bank, but lease their office space. They become PFICs as well.

It was absolutely beyond the scope of the original intention of the PFIC proposals, which was to close down offshore mutual funds.

Senator BAUCUS. Any other comments on that?

Mr. SCUREMAN. Yes. I would like to just add that from the very beginning, all of our passive profits were fully taxed under Subpart F because all of the members of our Coalition are controlled foreign corporations.

What has happened is that the PFIC provisions have now gone way beyond passive income and now our active operations may be endangered as well.

Senator BAUCUS. Senator Moynihan, I know has a bill to help remedy this and I think it is a good idea, frankly. Before I turn to him, though, I have just a few seconds left.

I would like to ask your views, I guess, Mr. Perlman, you spoke to this, on the 10/50 provisions. What is the rationale for the different treatment between non-controlled corporations and the requirement that 10/50 companies have to set up these baskets and so forth on the one hand and controlled that do not have to on the other? What is the potential rationale for that difference?

Mr. PERLMAN. Senator, I would like to yield to Mr. Dakin who has far more experience in that area than I.

Senator BAUCUS. Okay.

Mr. Dakin?

Mr. DAKIN. When an American business operates overseas through a controlled foreign corporation, the fact that it has control over the foreign subsidiary generally enables it to get data and information required to comply with the Internal Revenue Code.

But when a U.S. corporation has a minority position in a foreign corporation it does not have control—the rationale for the 10/50 basket was that it may not have sufficient clout to get the kind of data that it would be able to get if it controlled the foreign subsidiary; and, therefore, they set up a separate basket, a separate limitation on the foreign tax credit for each separate company in which you owned less than 50 percent or which was not a controlled foreign corporation because there were not other U.S. investors who owned enough to tip over the 50 percent mark.

In our experience, the kind of businesses that foreign companies in which you own a minority stake do, are in no way different from the kinds of business in which the companies that are controlled foreign corporations are operating. There is no basis that we can see for distinguishing between a dividend from a controlled corporation and a dividend from a non-controlled foreign corporation so far as the quality of the income or the character of the income is concerned.

If there were reasonable look through rules so that you could put that dividend in one of the appropriate remaining eight baskets we would suggest that that ought to be close enough. If that kind of position is not acceptable, if there has to be some sort of a separate basket at all, then we would say, well, put them all just in one basket, but not separate baskets—in the case of Mobil we have some 275 of these. We have to calculate this for some 275 companies each year.

Senator BAUCUS. The essential point is that we expect the 10/50 companies, the quality and the character of the income is as good as would be with a controlled foreign company.

Mr. DAKIN. We own a 25 percent stock interest in a Japanese corporation that operates a refinery in Japan. If we got a dividend from that company we would put it in the general limitation basket. We own a 50 percent interest in a shipping company in Saudi Arabia. If we got a dividend from that company, we would put it in the shipping basket. It is no different from the refinery income or the shipping income or any other kind of income that U.S. companies earn.

Mr. MATTSON. Could I comment, Senator?

IBM until around 1985 only ran 100 percent owned foreign controlled corporations. We did not want to get into joint ventures. We find today that our survival is based on joint venture and alliances. We are forming over 100 outside the United States every year. U.S. tax laws, make these more punitive and more difficult to enter into. The survival of American companies outside the United States depends on getting technology that is being broadly based outside from the Japanese, the Germans, and the Europeans. Even as the Eastern Europe evolves we need joint venture and U.S. tax law should not be more punitive. It should give us the flexibility to operate.

These rules are more punitive and there are many areas in the tax law that do not have the modernization of the way American companies are operating in joint ventures. This whole area needs to be looked at.

Senator BAUCUS. That is a very important point and I appreciate that very much.

Senator Moynihan?

Senator MOYNIHAN. Yes.

Mr. Chairman, I would like to say that I need the help of my colleagues in this matter or I will spend even more time in purgatory than I have already got coming because this comes under the heading of unanticipated consequences.

Back in 1986 by general agreement Senator Packwood—I was assigned the passive foreign investment company rules. That was designed to improve my standing on Wall Street and it did. [Laughter.]

Senator MOYNIHAN. But there were off-shore investment arrangements which were allowing whole sectors of our citizenry to hold mutual fund investments tax-free.

So we stopped that. And we ought to have done, and we did. But we never intended to put factories into the mix with off-shore mutual funds. And we certainly didn't want to have to go through the process that Mr. O'Donnell described of getting a blind pig in the Cayman Islands and moving it up to Bermuda and slipping it over and dropping it down. [Laughter.]

It is probably good for every one of the people at this table, but it is not good for the economy. [Laughter.]

Senator MOYNIHAN. I think we have a very impressive set of statements from Mr. Perlman, Mr. Dakin, Mr. Scureman about the PFIC rules—Mr. Mattson you would not want to just join in with solidarity from IBM?

Mr. MATTSON. Well, while we do not experience significant PFIC issues you are absolutely right that an investment company and an operating company are two different animals. You put very restrictive rules on a manufacturing operation, a technology operation, and a high service operation. We have a service operation where we had to retain certain pension funds in one of our major operating companies. We were very close to falling into a PFIC trap because of that. We had to devise some very unique activities to get out of that and keep away from it.

This was our normal manufacturing and marketing activity in a single country. So that the PFIC rules, as you said, were never intended to hit controlled foreign corporations that are operating.

And, in fact, all you have to do is have some operating capital waiting to build a building or waiting to put it into research and development and you are a PFIC and you are literally being injured in competing outside the United States.

So operating companies, controlled foreign corporations, ought to be clearly exempted from PFIC.

Senator MOYNIHAN. Or you give a big Christmas party and your goodwill goes up and bang you go down and you are in PFICs. [Laughter.]

I just think that is a sensible thing and we are dealing with people who make things, which kind of helps, you know.

Sir, I have to be at a conference committee on the House side; and so will excuse myself.

Thank you very much, gentlemen.

Mr. MATTSON. Thank you, Senator.

Senator BAUCUS. Thank you very much, gentlemen.

One question back on PFICs. There are various ways to skin this cat. One is change the assets test as suggested by Senator Moynihan. And I introduced a bill, as you all know, to change the 75 percent gross income to gross receipts. There are other suggestions. I am just curious as to balancing everything out here which proposal or combination do you think makes the most sense here.

Mr. PERLMAN. If I might start, Senator. First, I would like to commend both you and Senator Moynihan for introducing bills not only in the PFIC area, but in many areas, that address the real problems that are getting under the skin of American industry today. I think I speak for the whole panel when I commend you for that.

The PFIC problem, at least in my experience, has become more of an issue to operating companies through the asset test rather than the income test. It is the question that Mr. Mattson and myself both referred to when you have income and you store it in cash getting ready to rebuild, when in fact it is nothing but your depreciation flow coming back in cash waiting to replace the assets and all of a sudden you wake up one morning and find out you are a PFIC.

I think your bill makes some progress in the area. I do not believe it goes far enough. I think to really resolve the PFIC problem as it affects American multi-national companies we either need to eliminate the asset test or to take the simplest way and just say that PFIC does not apply to controlled foreign corporations covered by Subpart F.

Senator BAUCUS. Okay. I appreciate that.

Thank you gentlemen, all, very much for your testimony. I have no further questions. I very much appreciate what you have said, what you have come up with and I think your testimony will go a long way to help this Committee make these changes.

I must say, I do not know when we are going to have a tax bill, whether this year or next. It is very fluid. But I for one think that we should pass these provisions quickly and there will have to be others on down the road, because I just think American competitiveness or lack of competitiveness or at least the efforts to be more competitive requires a stronger look and a more indepth look at

our foreign tax provision so that we have at least a level playing field.

Thank you very much.

Mr. MATTSON. Thank you, Senator.

Mr. PERLMAN. Thank you, Senator.

Mr. DAKIN. Thank you, Senator.

Mr. SCUREMAN. Thank you, Senator.

Senator BAUCUS. Our next panel is Mr. Fred Corneel, senior partner of Sullivan and Worcester of Boston, MA, on behalf of Fidelity Investments; Mike Roush, director for Federal Government relations, for the NFIB; Lloyd Plaine from Washington, D.C.; and Ellen Nissenbaum, legislative director for the Center on Budget and Policy Priorities in Washington, DC.

Fred, why don't you begin.

STATEMENT OF FRED CORNEEL, SENIOR PARTNER, SULLIVAN & WORCESTER, BOSTON, MA, ON BEHALF OF FIDELITY INVESTMENTS

Mr. CORNEEL. Thank you very much, Senator.

My name is Fred Corneel. I am an attorney in Boston. I make my living advising family businesses and owners of family businesses and also organizations that function as trustees of family businesses. I would like to submit two proposals that I think would substantially simplify living with Subchapter S.

These companies are not Mobil Oil or IBM, but those that have them love them. The first proposal is to permit discretionary family trusts to own S Corporations. Right now that is just not permitted. That prohibition against ownership of an S Corporation by a discretionary trust makes it very difficult to do good estate planning for the owners of these businesses.

I would say the standard modern estate plan is that something goes to the surviving spouse, if there is a surviving spouse, and the balance goes to a family trust. The family trust is for the benefit of the wife and the children, and the grandchildren, not only those that are now born and maybe those that may come along later on, and there is not a fixed percentage for each member of the family. It is for the entire family group and it is left to the discretion of the trustee to allocate income and allocate principal where it is needed among the family members, having regard to their needs, to their financial responsibility and to their other resources.

This kind of discretion in the trustee makes it possible to be flexible and therefore to accommodate changing needs as they come along. The way in which it works now when you work for owners of an S corporation you do one estate plan for all of the assets except the S stock and you provide that those assets go into a discretionary family trust. For the S stock you have to do something different because that is not a permitted ownership and that makes for complicated estate planning.

It also makes for bad estate planning because it may be that when the plan is made the S Corporation stock is half the assets. But by the time the owner dies it may be a quarter of the assets, it may be 80 percent of the assets. And what made sense for 50/50

division does not make sense when it changes. So people make all kinds of complicated arrangements.

Now in my written testimony I refer to a letter ruling where one individual set up 24 trusts under 17 separate trust instruments, one of which had 8 separate shares, all in trying to accommodate what is pretty normal estate planning to the prohibition of Subchapter S.

This idea of permitting discretionary trusts to own shares in an S corporation is not a new idea. Other people have made the same proposal but it ran against the constraints that Senator Bentsen mentioned. Either those proposals involve policy changes in Subchapter S or they were not revenue neutral.

I have discussed this proposal with a good many accountants, lawyers, clients, people in government and so on, trying to devise something which really does live within the Subchapter S limitations which the earlier proposals for trust ownership did not. Each potential current beneficiary counts as a separate shareholder, each one has to be a qualified shareholder under Subchapter S and we make the trust that is going to be paying taxes on the income allocated to it, pay taxes at the highest individual rates so that the discretion cannot be used to channel income to a lower bracket taxpayer.

I honestly believe that Congress would make a substantial contribution to simplifying the transfer of ownership of family businesses from one generation to the next if it agreed to make these changes, permitting ownership by a discretionary trust, but do it in such a way that the principles of Subchapter S are safeguarded.

The second proposal is very simple. The Subchapter S simplification bill that is now pending permits a Subchapter S corporation to have a C corporation as a subsidiary. I think that is a useful proposal. I would supplement it in one way. That is to say that if dividends are paid by the C subsidiary to the S parent corporation that they should not be subject to the penalty provisions which now apply to excess passive investment income received by an S corporation.

So those are the two proposals. I would very much appreciate your consideration.

Senator BAUCUS. Thank you, Mr. Corneel.

[The prepared statement of Mr. Corneel appears in the appendix.]

Senator BAUCUS. Mr. Roush?

STATEMENT OF MICHAEL O. ROUSH, DIRECTOR FOR FEDERAL GOVERNMENT RELATIONS, SENATE, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, WASHINGTON, DC

Mr. ROUSH. Thank you, Mr. Chairman. It is a pleasure to be here today to be able to talk about the subject of simplifying the Tax Code on behalf of the 550,000 small business owner members of the National Federal of Independent Business.

After tax reduction, tax simplification is probably the most often heard rallying cry for small business owners in the public policy arena. What for some people is merely an interesting administra-

tive, legal, or economic exercise in efficiency, it is for small business owners a matter of vital and daily concern.

What do I owe the government? How do I figure it out? When do I have to pay it? And what happens to me if I screw up? Are among the practical and important questions that small business owners ask themselves about their taxes.

But they also ask themselves more fundamental but related questions about the tax laws. Are they understandable? Are they consistently applied? Are they fair? And are they in at least some sense simple?

When the answers to the practical questions are ambiguous and the answers to the fundamental questions are negative or unclear, is when we can most clearly see that the welfare of a country does depend on its laws and on how well they are written. Because compliance with and respect for the tax laws particularly, measureably decline if they are not clear, fair and simple.

While there are a number of areas of the Tax Code, such as pension law, estate taxes and the definition of independent contractors, that I would urge the committee consider simplifying at some point, today the one and perhaps most important area of the Tax Code, because it affects every business owner in the country, that I am urging the Senate to simplify is the Federal tax deposit system.

As you know, every employer is required to withhold their employee's share of FICA and income taxes and to deposit those amounts together with the employer's share of FICA in one of 15,000 financial institutions authorized to act as Federal depositories.

Mr. Chairman, the system for making these deposits is, so to speak, where the rubber meets the road in our tax system. In 1988 5 million employers made of 73 million deposits, totaling $627 billion. It was at that time more than two-thirds of all Federal revenues. This is where small business owners deal most often and most directly with the Federal Government.

Unfortunately, these dealings have not been particularly happy ones. About a third of all business owners in the country are penalized each year for some error, usually a timing error, in dealing with the Federal tax deposit system, amounting to $2.6 billion in penalties in 1988.

We, and many others, including the GAO, the IRS, the Chairman of the Ways and Means Committee, and yourself, I believe, are convinced that the large number of penalties in this area are primarily due to the complexity of the deposit rules themselves.

They are too complex to describe in any detail in my allotted time this afternoon. Suffice it to say that there are four rules, four deposit schedules and a number of exceptions to the rules. The problem boils down simply to the fact that when and how often an employer is supposed to deposit his withholdings changes with how much money he has accumulated to deposit at any given point in time, leading to situations where an employer does not know when to deposit, consequently being penalized for missing a deposit date that can occur as often as eight times in a month.

The solution to this is to simplify the deposit rules, reduce the number of deposit schedules and allow the triggering mechanism, in this case the accumulated withholdings, to be based on some

past period of time rather than ongoing accumulations, so as to bring some certainty and continuity to the employer's deposit schedule.

Your bill, S. 1610, accomplishes the necessary simplification in an eloquent and direct manner. We urge its adoption by the Congress and we hope all of your colleagues will support it. I will emphasize that the Federal tax deposit system affects every employer in the country. Consequently, its simplification is what we are urging at this time and I would be happy to answer any questions.

Senator BAUCUS. Thank you very much, Mike.

[The prepared statement of Michael Roush appears in the appendix.]

Senator BAUCUS. Next, Lloyd Leva Plaine.

STATEMENT OF LLOYD LEVA PLAINE, WASHINGTON, DC

Ms. PLAINE. Mr. Chairman, I appreciate the opportunity to appear before the Subcommittee today. I am Lloyd Leva Plaine an attorney practicing estate and gift tax law at the law firm of Sutherland, Asbill & Brennan. I am a partner in charge of the estate planning practice at that firm.

I will address two provisions of the Tax Simplification Act, S. 1394 and H.R. 2777, dealing with estate and gift tax or income taxation of estates and trusts.

The first one I would like to discuss is the treatment of revocable trusts under Section 441. Revocable trusts, as you know, are very broadly used in estate planning for legitimate nontax reasons. They are valuable in case of future disability of the grantor to avoid a court appointed guardianship or conservatorship. They are valuable in case of death—to the extent that they are funded with property at the time of death, that property can avoid a probate administration and its inherent delay and costs.

They are not used for tax reasons because all of the income with respect to the property in the revocable trusts is still included on the income tax return of the grantor of the trust and all of the property in the trust at the death of the grantor of the trust is still included in the estate of that grantor.

Unfortunately, there are certain differences in tax treatment during life between the outright ownership of property and property that is owned in revocable trusts. There are differences in the income tax treatment during life.

Secondly, there are differences after death in the income tax treatment between property that is in an estate and property that is in a revocable trust, that is a trust that was revocable during life.

The goal, I believe, of Section 441 should be to achieve total tax parity in the inter vivos situation between the outright ownership of assets by an individual and ownership by a revocable trust. In the post mortem situation there should be tax parity between property owned in an estate and owned in a trust that was irevocable during life.

The Section 441 is helpful, but I believe too narrow. It would achieve parity only for certain revocable trusts under certain cir-

cumstances. I do not really see any policy reason for not having complete parity.

In the testimony are detailed suggested changes and two attachments, one of which contains draft statutory language that was submitted on June 5, 1991. These were prepared by individual members of the Estate and Gift Tax Committee of the Tax Section and Real Property, Probate and Trust Section of the ABA.

Several of those suggested changes are (1), I believe the Act should cover revocable trusts where there is more than one creator of the trust. That is common in community property States, such as the State of Texas. It is also common in some non-community property States. I believe it is important to be sure that these provisions to give tax parity also apply even if the grantor is incapacitated.

There are a number of other provisions I think are important. The parity should apply, inter vivos as well as post mortem. I believe if the approach taken in the bill is retained that it is important to have cross references in other parts of the Code because the provision as proposed as in Section 7701, the definitional provision. If there are not cross references I am afraid people will be caught unaware.

The second provision of the bill, Section 502, deals again with lack of parity here in the estate tax between assets held in a trust and assets held outright by an individual. Specifically, if an individual owns assets outright and gives them away within three years of death and does not retain any strings over those assets, those assets will be out of that individual's estate for purposes of Federal Estate Tax.

On the other hand, if that individual had assets in a revocable trust, for example, and within three years of death gave those assets away directly from the revocable trust, and retained no strings over those assets, under present law those assets could be brought back into the individual's estate.

It is important in that area to also have tax parity and Section 502 does do this. It does correct the provision and we appreciate that. I believe it needs some clarification and expansion. When I say expansion I really mean clarification because I think some of the ways that we suggest that it should be expanded were items that were intended to be covered.

Two other items that I would like to mention. One is in Title IV of H.R. 2775, which is another simplification bill. There is a provision that overrules a decision in a case called Alexander dealing with the marital deduction. I am in favor of that provision overruling Alexander. I would just like to raise the issue as to whether the language in the provision goes farther than is necessary. I want to be sure that normal pecuniary formula marital deduction bequests are not caught by this provision.

There are other suggestions for tax simplification that start on page 8 of the testimony. I will not go into those right now since the time is limited, but I would appreciate it if those could be examined, because I think there are other areas that should be addressed at present in the estate and gift tax area and in the area of income taxation of estates and trusts.

Thank you. I would be happy to answer any questions.

Senator BAUCUS. Thank you very much.
[The prepared statement of Ms. Plaine appears in the appendix.]
Senator BAUCUS. Ms. Nissenbaum?

STATEMENT OF ELLEN NISSENBAUM, LEGISLATIVE DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES, WASHINGTON, DC

Ms. NISSENBAUM. Thank you, Senator. I am Ellen Nissenbaum, the legislative director of the Center on Budget and Policy Priorities. The center is a nonprofit organization that conducts research and a wide range of issues affecting low and moderate income Americans, including tax policy and the earned income credit. In fact, the center now coordinates a nationwide public education campaign on the earned income credit.

My testimony concerns the need to simplify the earned income credit and to do so in the very immediate future as Commissioner Goldberg testified today. In fact, we are delighted that the administration highlighted simplifying the credit as one of the top priorities for simplification.

I do not need to take much time before this committee to stress the importance of the credit. This committee has been very helpful in recent years in expanding and improving on that credit. The earned income credit is pro-family, pro-work and help offset the regressive effects of Social Security and Medicare payroll taxes on low wage working families with children.

The Congress last year took landmark action to expand the earned income credit, including the creation of a new health insurance credit and a young child supplement. Unfortunately, however, the outstanding work of this committee and the Congress is now in severe jeopardy. Several technical aspects of last year's EIC provisions have complicated the credit much more than was realized at the time.

So just when the support provided by the credit is set to expand the earned income credit threatens to turn into something of a nightmare for the 12 million low income families that now receive it.

The complexities loom so large that many eligible families could fail to complete the proper paperwork and could lose the benefits they have earned if action is not taken in the immediate future. The good news is the matter can be addressed and without increasing the deficit.

Until now an eligible family simply needed to file a 1040 or 1040-A to receive the credit. And, in fact, the IRS would even calculate the credit for the family if they so chose. Starting with tax returns for 1991 however eligible families will have to file a new Schedule EIC for the first time. Those that do not file it may in fact lose their benefits.

Unfortunately, the form has really turned into a maze. If, Senator, you turn to the back of the testimony you'll see the new form released in draft form by the IRS in June. The form as you will see is quite complicated and I am not sure that many of us even here today could complete it without the help of a commercial preparer.

Yet this is the schedule that 12 million low income families, many with limited education, will have to file next year. I cannot

overstate our concern about the consequences of the new schedule. In fact, both the American Bar Association and the American Institute of CPAs testified during hearings on simplification on the Ways and Means Committee on the need to simplify the earned income credit.

The complexities created by the new schedule could not come at a worse time. Due to the recession the principal wage earner in many families will be unemployed for part of 1991 and will have an annual income that will qualify them for the earned income credit. This is about $21,000. Yet, these families will now face difficulties in obtaining their earned income credit.

I should note we have been working closely with the IRS on the form and that the Service is doing its utmost to simplify the form within the constraints of the law. But the real problem is with the statute itself. It is hard to imagine there are many parts of the Tax Code for which the need for simplification is really greater.

We believe that the earned income credit deserves priority consideration when simplification is taken up. One remedy, in fact, recommended by Assistant Gideon today would be to remove two complex and unnecessary new provisions from the EIC provision of the Code.

The first stipulates that a family may either choose the young child supplement for a child under the age of one, or the dependent care credit, but not both. That means that families would have to figure out whether the dependent care credit or the young child supplement would have greater value. Yet few families would be able to do this themselves and the IRS will not make that calculation for the family.

There is no compelling reason for this restrictive rule since the young child supplement and the young child credit serve very different purposes and few families will be eligible for both credits anyway.

The Joint Tax Committee recently estimated the cost of repealing this restriction at just $41 million over 5 years and the small cost could easily be offset by changing the earned income credit phase in-and-out rates by a small fraction as Mr. Gideon noted in his testimony.

Similarly, the restrictive rule stating that a filer must choose between a health insurance credit a medical deduction should be dropped. The number of families who itemize their deductions that have medical expenses over 7.5 percent of AGI and who would also qualify for the health insurance credit is really minuscule. So, too, is the number who would qualify for both a self-employed medical deduction and the health insurance credit.

Repealing these restrictions affect such a tiny number of filers that the cost is just $38 million over five year. Yet all income credit families filing the 1040 Form will be confronted with the additional complexities as a result of the rule. Repealing these two interactions would improve EIC administration and simplify the filing process. There now appears to be a growing bipartisan accord on the need to repeal these rules and to do so quickly. Over the long run other reforms may be needed to simplify receipt of the credit.

Finally, in conclusion, I would like to emphasize the urgency of addressing this matter in time for the 1991 tax filing season. If this is not done 12 million low income working families will face an extremely complex form next winter, with a likely result that many may fail to receive the payments they have earned, while many may make errors on the new schedule.

We urge speedy consideration of this request and look forward to working with you. Thank you.

Senator BAUCUS. Thank you, Ms. Nissenbaum.

[The prepared statement of Ms. Nissenbaum appears in the appendix.]

Senator BAUCUS. Listening to you just struck me that over the years as the budget deficit increased, you know, the Congress has imposed upon itself often a condition of revenue neutrality, whenever we enact any changes in the Tax Code it seems to me—it's true, we sit up here and mark up here and go to conference and as we true to achieve equity and forge compromises we make the Code more complex. Maybe we need some kind of a complexity neutral standard.

Ms. NISSENBAUM. It would be a great litmus test for new tax reviews.

Senator BAUCUS. Whatever it is we cannot make it more complex than it presently is. It would at least have to be a start so then we can start simplifying all of this.

Ms. NISSENBAUM. There is a real concern, Senator, that a number of families this year may in fact have to rely on commercial preparers to do their earned income credit and it seems to us unsound tax policy that we have set this up, and yet families will have to rely on preparers to receive their earned income credit.

Senator BAUCUS. Well, there is no doubt about it, I remember about 12, 14 years ago I was sitting at my kitchen table trying to figure out my tax return and I gave up. I felt un-American. Here is this person, law school graduate, that gave up. I just could not figure out my own income tax return.

Ms. NISSENBAUM. And of course many of these families have a real limited degree of education.

Senator BAUCUS. Exactly. This is wrong. It is too complex and the fault is with the Congress because we do make the laws and we do cause most of the complexity. The Service is partly at fault but I think the Congress is mostly at fault.

As I understand it your organization has distributed thousands of pamphlets, I guess, explaining the EIC. Have you also done the same with the health tax credit?

Ms. NISSENBAUM. Senator, the Center has for 3 years in a row conducted a public education campaign that involves the national Governors, the Catholic Bishops, and thousands of groups across the country. That has primarily focused on families that are eligible for the credit but do not have to file. We want to let them know they have to file to get the credit.

This year the campaign will distribute about 15,000 public education kits around the country. We will have two focuses. One is to make sure all eligible earned income families know that it is a two-step process this year, filling out the 1040 and then the new form. The second part of the new aspect of the campaign will be to let

families know about the health credit as well as the young child supplement.

To that end, we have begun to contact organizations ranging from employer-based groups, the children's hospitals, the American Academy of Pediatrics. We are reaching out to a broad based group of organizations at the State and local level, doctors and others, that can help inform families specifically about the health care credit and how they can take advantage of it.

We are particularly interested, for example, in families where the principal wage earner has a health policy, but it only covers that employee. And yet the policy allows him to buy more coverage for his children, his or her children. So the thought is that the credit may help those families in particular broaden their health insurance coverage to include their children.

Senator BAUCUS. I appreciate that and commend you for what you are doing.

Mr. Corneel, as I understand it you propose a system whereby the trust, I guess, the discretionary family trust basically——

Mr. CORNEEL. Yes, sir.

Senator BAUCUS [continuing]. would treat income and losses from Subchapter S investment separately from the trusts other income or losses.

Mr. CORNEEL. That is quite correct, yes.

Senator BAUCUS. Now what happens when a Subchapter S investment is a loss and there is no other income to offset that loss?

Mr. CORNEEL. It just sits there.

Senator BAUCUS. Does that create any concerns that we should be concerned with?

Mr. CORNEEL. Our feeling is that the need to simplify estate planning for owners of Subchapter S corporations by permitting flexible trusts to own the stock is so important that people who want that benefit ought to be willing to forego some of the income tax benefits that they might have with other arrangements.

We consciously say, for instance, this stays in the trust and you cannot combine the Subchapter S loss with the income of the individual or you cannot combine the Subchapter S laws with the income of the other portion of the trust that you referred to. It may very well be that there are some taxpayers who will say, look, that is too much of a price to pay. I do not want to have a discretionary family trust.

But I think if you tried to accommodate all of the income tax considerations together with a discretionary trust you would have a great deal of complexity. We really feel that here we do have simplicity by keeping it all in one basket.

When the time comes that the trust disposes of the Subchapter S shares, then anything that is locked up in that portion of the trust would pass over either to the other portion of the trust or to the beneficiaries who would receive the distribution. But while it is going on we intentionally mean to keep it separate, to keep it simple.

Senator BAUCUS. Mr. Roush, I appreciate your support basically for payroll tax and deposit reform. Could you tell me whether NFIB supports reduction of the safe haven threshold for deposits below the current 5 percent?

Mr. ROUSH. We do.

Senator BAUCUS. How far?

Mr. ROUSH. How far? Down to 2 percent or the greater of $250. Part of the reason for that is revenue; and part of it is that we think such a calculation is reasonable and a determination business owners can make of their withholdings. Revenues are a big concern and is the safe harbour level variable.

We think that for small businesses the dollar level is more important. That is, the $250. In fact, I would say in answer to the Treasury's concern about revenues that that 2 percent could go down to 1 percent and we could raise some revenues there to help make S. 1610 a neutral proposal.

Senator BAUCUS. But that's a good offset for the other reforms you think. I appreciate that.

Well, I want to thank all of the panelists very much for your testimony. You have helped us very much. I hope we can get the simplification bill passed very quickly.

The hearing is adjourned.

[Whereupon, the hearing was recessed to Thursday, September 12, 1991 at 2:00 p.m.]

TAX SIMPLIFICATION BILLS

THURSDAY, SEPTEMBER 12, 1991

U.S. SENATE,
SUBCOMMITTEE ON TAXATION,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:21 a.m., in Room SD-215, Dirksen Senate Office Building, Hon. David L. Boren (chairman of the subcommittee) presiding.

OPENING STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM OKLAHOMA

Senator BOREN. We will commence. I apologize. We had another meeting that lasted longer than it was supposed to, so it delayed our beginning this afternoon.

This afternoon we will continue the Subcommittee on Taxation's hearings on tax simplification efforts. Today we will hear testimony from the General Accounting Office, independent professional groups, and several business and industry representatives.

Today's topics will include payroll taxes, look back contracts, and alternative minimum tax calculation. I am especially interested in the comments on simplification of the AMT calculation. The current law requires two separate depreciation calculations for companies with AMT. This cumbersome procedure has placed a tremendous burden on companies paying AMT, and the committee should make every attempt to streamline the system.

I am also very interested in studying the negative effects of the AMT on the ability of American companies to compete for investment capital in the global marketplace. There have been a number of studies in this regard.

One of the areas that has concerned me most about the work of our committee over the last decade or more has been our failure to consider the impact of our own tax policy on our ability to compete with others in the international marketplace. If it takes three times as long to recover the cost of the capital investment in this country as it does in another country, I do not know how in the world we are going to compete. But that is a whole other subject, and I will not make my speech on that subject today since it is not really within the bounds of this hearing. However, it is something that our subcommittee intends to look at in the future: the impact of the AMT on costs of capital in this country and on the recovery through depreciation of capital investment costs.

It is estimated that 40 percent of large U.S. companies now fall under the AMT, and there is strong evidence that this tax system

is hampering U.S. corporations relative to their European and Asian competitors. So we will revisit that question.

But in the meantime I think it is highly appropriate that we look at ways in which we can at least try to simplify the procedure that is now in place, the burden that is now in place.

So I look forward to hearing all of our witnesses today. We will, as always, try to proceed with dispatch. We will put the full text of the statements of all the witnesses into the record. I would appreciate it if the witnesses could summarize their testimony within five minutes, hitting the major points that they would like to emphasize. Then we can pursue additional points in questioning.

Our first witness is Mr. Paul Posner. I would ask for him to come forward. He is the Associate Director of Tax Policy and Administration Issues of the General Accounting Office and is presenting testimony on behalf of the GAO. We appreciate your being with us today, Mr. Posner. We welcome your comments. As I indicated, we will receive your full statement for the record.

STATEMENT OF PAUL L. POSNER, ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY RALPH BLOCK, PROJECT MANAGER, AND MICHAEL BROSTEK, ASSISTANT DIRECTOR

Mr. POSNER. Thank you, Mr. Chairman. I want to introduce the gentleman on my left, Mike Brostek, is our Assistant Director; and Ralph Block, here on my right is our Project Manager and the person who has really spearheaded our work on payroll deposit reform.

Senator BOREN. We are happy to have all of you.

Mr. POSNER. We are pleased to be here today to discuss the bills, both the House bill, H.R. 2775, and the Senate Bill, S. 1610, which would simplify the payroll tax deposit system.

Currently five rules determine when employers must deposit their payroll taxes and in a report we issued in 1990 we said that the deposit rules are difficult to understand and comply with. And, moreover, we said that up to one-third of the Nation's employers are penalized each year for failure to follow these complex rules.

Now we believe that changes to these rules are urgently needed and that both the House bill and the Senate bill will ease the employer's task of understanding and complying with their payroll tax responsibilities. The proposal will also reduce the number of deposits that some employers will have to make.

But we believe that S. 1610, the proposal introduced here, would be the least burdensome to smaller employers. By way of background, the routine deposit of Federal payroll taxes is the lynch pin of the Federal tax system. But the current system, which is based on the voluntary compliance of over 5 million employers is distinctly unfriendly to the employers who must make these deposits.

As I said, about a third of the nation's employers are assessed a penalty each year and total the penalty revenue amounted to $2.8 billion in 1989. And about 70 percent of these penalties are assessed against small employers. We think that the complexity of the rules is the major factor causing this problem.

The deposit rules vary according to how much tax has been withheld and how often the pay days occur. Under the current rules, employers pay their taxes either quarterly, monthly or within three banking days following the end of one of the deposit periods.

Further, a statutory deposit rule requires employers with $100,000 or more in employment tax liabilities each pay day to deposit the next banking day. Now in our review of the system we found that many employers were assessed penalties because they had difficulty understanding these requirements. The rules specify different dates, depending on the amount of undeposited withholding taxes that an employer has. When employers' payrolls fluctuate, many employers struggle, trying to predict when their deposits are due.

They do not know ahead of time when their deposits are due. In other words, there is nothing saying at the beginning of a quarter or a year that this is the rule I am going to go by. The rules change based on how much accumulated deposits they have.

So the employers must constantly monitor the taxes that they have on hand from pay day to pay day and determine which of these rules are triggered. And 31 percent of the cases that we looked at, employers were faced with at least one change in their requirement during a given quarter.

In over half the cases, employers got caught who made timely deposits under the initial requirement, but were penalized when their employment taxes went up but they did not realize it; thus triggering a penalty.

Perhaps an even more telling indicator of how confusing these rules are is that IRS made errors 44 percent of the time when they had to manually assess and determine the penalty for employers.

Now to address these problems we recommended in our report that Treasury abandon the complicated eighth-monthly deposit rule system and adopt a simplified single deposit rule for all employers not affected by the statutory 1-banking-day requirement, in other words employers over $100,000.

We also suggested that the complex multi-tiered set of exemptions be replaced with a simplified rule for smaller employers exempting them from the deposit rules for the larger employers.

In addition, we recommended—regardless of any other changes made, and this is the most important thing in our view—that a look back rule be established, where employers would know with certainty their deposit rules at the beginning of the quarter. We believe again that this certainty would be the single most important thing we could do, even if we did not change the other rules. Give employers certainty ahead of time when their payments are due.

Finally we said that the changes to the rule should include repealing the safe haven provision which permits employers on the eighth-monthly rule to delay depositing 5 percent of the taxes that are due until the next month.

Now for some employers they have legitimate problems calculating their tax, but we think there are other ways to deal with that and that the 5 percent safe haven for some employers represents a maximum target rather than a legitimate exception to the rules.

Now in assessing the reforms in both bills, we apply four criteria. Would the burden experienced by employers, particularly smaller employers, be reduced? Are the proposed requirements easy to understand? Would the IRS administrative burden be manageable? And finally, would the cash flow to the government be maintained?

Based on our assessment, we believe both the House bill and the Senate bill, S. 1610, represent commendable approaches to bring fairness and predictability to the payroll tax system. We think that both of them are easy to understand and that the bills would undoubtedly reduce the number of penalties plaguing the system.

Both bills would replace the current eighth-monthly system with a system that just simply requires deposits to be made on Tuesday or Friday, depending on when your pay day is. We think employers should have little problem determining when to deposit their payroll taxes under this system.

Now each bill also provides an exception to the Tuesday-Friday rule for small employers so that they will not be burdened with having to make deposits every pay day.

Under the House bill, the exception level applies to small employers with quarterly liabilities of $3,500 or less. An estimated 52 percent of the employers, about 2.3 million of them, would be allowed to deposit quarterly under the House bill.

We think that the Senate bill provides a better exemption for small employers. This bill would exempt employers with quarterly liabilities of $18,000 or less, rather than $3,500 from filing Tuesday/Thursday.

These employers—instead of the House bill which provides they can file a deposit quarterly—these employers will be allowed to deposit on a monthly basis by the 15th of the following month. This threshold would permit all employers currently paying monthly to continue to do so. Plus, about 800,000 who now pay more frequently would be switched to a monthly system as well under this bill.

So the $18,000 level is a little higher than the current exemption level for small employers and there will be more small employers covered under this. In fact, $3.7 million employers, or about 83 percent of all employers, would be exempted from making deposits after the pay day on a Tuesday/Friday basis under the Senate bill.

Now, of course, the problem with increasing the exemptions is you get a concern about what affect this would have on the Federal cash flow if you slow down deposits for a large number of employers. We think that S. 1610 will nevertheless increase Federal revenues, although not as much as the House bill.

On the basis of data we developed from the first quarter of 1989, the H.R. 2775 would probably raise about $1 billion or over $1 billion in the initial year. This would result from accelerating payments of employers with over $3,500 in quarterly deposits who now pay monthly to a Tuesday/Friday system.

S. 1610 nevertheless will also, we think, raise several hundred million in the initial year. Although more employers would pay less frequently than they do now, we think the revenue affect will be positive because the Tuesday/Friday rule would accelerate payments for many employers above $18,000 in quarterly tax liabilities.

Now we understand that the Treasury the other day estimated a $2.2 billion revenue loss for the Senate bill, principally due to the extension of the safe haven for small employers. As I will discuss later, we do not feel that such haven provisions are advisable, particularly for small employers.

And as Treasury acknowledges, if the safe haven provision were deleted from the Senate bill, the bill could achieve revenue neutrality with slight changes in the small employer threshold. If the provision were retained, however, we still do not feel this would cause the overall bill to lose revenue.

One other advantage of the Senate bill is you have a monthly payment.

Senator BOREN. Let me stop you at that point. You say even if the safe haven is retained in the Baucus bill, which is at a 2 percent level, I believe—

Mr. POSNER. Right.

Senator BOREN.—reduced from the 5 percent level—

Mr. POSNER. Right.

Senator BOREN.—there would be a net gain of revenue, because there would be a pick up in terms of the number of employees that will be paying in the Tuesday/Friday period?

Mr. POSNER. That is right.

Senator BOREN. Do you have an estimate of what you think the net would be?

Mr. POSNER. We think about $300 million now.

Basically, the safe haven under current law is used very, very seldomly. About 19,000 employers out of 5.1 million use it right now. We have no reason to think that employers who are depositing monthly would even need the safe haven. They have enough time to get their accounting together and that kind of thing.

As I said earlier, one of the best features of both bills is that they both include this look back provision, where employers will know ahead of time what their obligations are. Under the House bill, employers would qualify for the exemption, the $3500 or less, if they had this level of deposits in each of eight preceding quarters; and employers would have to make this eight quarter determination prior to every quarter.

An employer who exceeds this $3500 threshold per quarter in any one quarter in the prior eight would have to go on a Tuesday/Friday system and again built eight consecutive quarters of liability under $3500 before again being qualified to be exempted.

S. 1610 we think has a much simpler and improved look back provision. Under S. 1610 before each quarter employers would only use the prior four quarters rather than the eight quarters of liability to determine if they can be exempted from the Tuesday/Friday speed up rule. We believe that seasonable variations in business taxes can be captured just as well with a four quarter as with an eight quarter period, with less burden to employers.

Now we think business paperwork requirements could be lessened even more if a look back rule were determined just once in a year rather than at the beginning of every quarter.

Getting to the safe haven provision, as I said currently Treasury does have an exemption to deposit rules for only employers on the eighth-monthly system. These are the larger employers above

$9,000 per quarter. It allows the employers who make these deposits to deposit 95 percent of their accumulated taxes within three banking days. The remaining 5 percent can be deposited in the following month.

The current provision exists to benefit large employers who could not determine their actual employment liability in time. Maybe they have dispersed locations or what have you. In our report we recommended the 95 percent safe haven be eliminated.

IRS studies show that less, as I said, than one-half of 1 percent of the nation's employers use it. Furthermore, studies by IRS and the Railroad Retirement Board indicate that some employers use a safe haven not because they have legitimate payment problems, but rather to delay depositing their full tax liability.

For example, one IRS study showed that 25 percent of the businesses that use a safe haven consistently deposited exactly 95 percent of their tax liability. For these employers, a safe haven represents a maximum payment target, rather than a means to ease legitimate payment calculation problems.

Now both bills do provide a statutory safe haven. Under the House bill it is 2 percent or $150; in the Senate bill it is 2 percent or $250. We understand the bills can be interpreted to extend the safe haven under the current law to all depositors, not just the larger ones covered under the speed up, but those under the eighth-monthly period or the Tuesday/Friday period too.

We do not think that this extension is warranted. Under the bill, for example the Senate bill, small employers are given at least two weeks at the end of the month to pay their taxes. This should be more than enough time for them to get their records together. They do not currently enjoy that safe haven now. We do not see any reason why that should be extended to them.

In general, we think, of course, both bills provide 2 percent instead of the 5 percent, so they are preferable to the way it is now. But we think that other administrative procedures, less prone to abuse, could be established in lieu of the safe haven, that would provide the needed flexibility to accommodate genuine hardship cases, but without the abuse.

We think IRS, for example, could grant waivers for depositing the liability to employers who submit evidence that they are having problems.

In conclusion, we think that both bills, the House and the Senate bill, would achieve a major simplification of tax rules for our Nation's employers. They would lessen the burden, particularly experienced by small employers, be simpler to understand, would not reduce the Federal Government's cash flow compared to current rules and should result in fewer penalties in the system.

Now we support the basic frame work in both, but we believe that S. 1610 would improve the frame work by further reducing the burden's experienced by the small business community.

That concludes my statement.

Senator Boren. Thank you very much, Mr. Posner.

[The prepared statement of Mr. Posner appears in the appendix.]

Senator Boren. On the question of the safe haven, I am sure you know there will be other witnesses today. I have read over the testimony of some of those who will be appearing—the U.S. Chamber

of Commerce and others—that indicates that they feel that any reduction in the safe haven, below the 5 percent, even down to the 2 percent level, would make it very difficult for the larger firms to have the flexibility they need.

Now you have indicated that a very small percentage use the safe haven. I forget. What was the percentage you indicated?

Mr. POSNER. It was 19,000 employers out of about 5.1 million.

Senator BOREN. All right.

Would nearly all of those be larger employers?

Mr. POSNER. They would have to be those that qualify currently to deposit on the eighth-monthly system. So it would be those with liabilities exceeding $9,000 per quarter.

I don't know. Do we have any data about that?

Mr. BLOCK. Around 1500 of them have quarterly liabilities of $1 million or more.

Senator BOREN. So do you think there is any justification for keeping the safe haven for those that have a very large problem in terms of the magnitude of the payment, or would you still argue that that would not be necessary?

I understand your argument about not extending it to those companies that do not now have it, especially since you are going to be moving a significant number from eight payments per month into monthly payment.

Mr. POSNER. Right.

Senator BOREN. Do you think we should at least consider the possibility that some of the larger firms that have to prepare the eight monthly reports should continue doing so?

Mr. POSNER. Well, we are not arguing that they may not have some legitimate problems. But we think those problems can be dealt with through basically a waiver process. When they submit their quarterly tax return, their 941, where they have to check now that they want to claim the safe have. We think that they would have kind of a reasonable cause explanation they would give as to why they are doing so, that could be reviewed by IRS, rather than just an automatic kind of grant, where we think it is really subject to abuse.

So I think we would still adhere to our position.

Senator BOREN. We know that there are some very small businesses that are now paying quarterly that I believe under S. 1610 will be brought under a monthly schedule.

Mr. POSNER. Right.

Senator BOREN. While certainly there is a positive shift in the large number of those that are paying eight times a month that would come into a monthly picture, there are some that would be disadvantaged by having to move from a quarterly into a monthly process.

Do you think there is any merit in our schedule keeping a system that has both monthly and quarterly so that we do not move those very small employers into a monthly payment period?

Mr. POSNER. This has been a tough one for us to wrestle with. I think ideally we would like one exception for all small employers. The problem is that these people with under $500 have less than the equivalent of one-half employee.

Senator BOREN. Right.

Mr. POSNER. You know, we can just imagine the kinds of businesses that they are and I think realistically we could understand keeping that quarterly exemption for them. They are not even in the deposit system. They send their payments with their tax return at the end of the quarter.

Senator BOREN. Yes.

Mr. POSNER. So they would now have to get started with dealing with banks and deposit slips and coupons.

Senator BOREN. I am not even sure that would not create increasing complexity for the government.

Mr. POSNER. It would create about—

Mr. BLOCK. It would definitely increase the cost because those businesses right now who are not making any deposits now would be making around 7 million deposits a year. Okay? And the IRS gets charged around 35 cents per deposits.

Senator BOREN. Right.

Would there be any revenue impact if we continued the quarterly system? I am sure there is some because you would get a little bit more cash flow on a monthly basis than you would by allowing those that are quarterly now to stay quarterly. On the other hand, as you have indicated, there will be some additional costs to the government in speeding that up.

Is there any way of quantifying?

Mr. BLOCK. It is about $2 million a year.

Senator BOREN. How much?

Mr. BLOCK. $2 million.

Senator BOREN. $2 million a year?

Mr. BLOCK. Yes, it would be that much.

Senator BOREN. And you say that even if we kept the bill, even with the safe haven at 2 percent, you still think it is a net of probably $300 million.

Mr. BLOCK. Yes.

Senator BOREN. Well, that is something that I would hope we would really consider. You say these firms average one-half of an employee?

Mr. BLOCK. Less.

Senator BOREN. Less than one-half of an employee?

Mr. BLOCK. Yes.

Senator BOREN. Well, I think that if we are talking about simplification and trying not to put additional burdens on a firm that really has a part-time situation that is essentially a sole proprietorship that solution is something that we really ought to try to accomplish.

I understand it loses a little of its symmetry. But in terms of the practical effect it would seem to me we ought to give some serious consideration to taking the other provisions of the bill, but leaving for these very small people that quarterly possibility.

Mr. POSNER. One thing that we were thinking that you might also want to consider is possibly requiring Treasury to look at this population, keeping them on the quarterly system, but do a market survey and figure out who these people are and whether they really would experience problems going to a deposit system.

Senator BOREN. Right.

Well, thank you very much. The testimony has been very helpful and certainly we appreciate the work which has been done by GAO and giving us advice and the staff advice as we proceeded on this matter.

Mr. POSNER. Thank you.

Senator BOREN. Thank you very much for taking the time to be with us.

Mr. BROSTEK. Thank you.

Senator BOREN. Our next panel consists of Mr. Albert O'Neill, chair-elect of the American Bar Association, Section on Taxation; and Mr. Robert M. Brown, chairman of the Tax Simplification Committee of the American Institute of Certified Public Accountants in Washington.

We always have felt that we help keep the professions in business by keeping things as complicated as possible. [Laughter.]

So it is refreshing to have two representatives of the learned professions here to advocate simplification today.

As I indicated, we do have other panels that will follow, so if you can summarize your testimony for us and hit the high points in approximately five minutes, I would appreciate it. Then we will open up for some questions.

Do you have a preference as to which one? We will proceed with Mr. O'Neill then.

STATEMENT OF ALBERT O'NEILL, CHAIR-ELECT, AMERICAN BAR ASSOCIATION, SECTION ON TAXATION, WASHINGTON, DC

Mr. O'NEILL. Thank you.

I am Albert O'Neill, chair-elect of the Section on Taxation of the American Bar Association. I speak here today on behalf of the American Bar Association, which is strongly on record in favor of tax law simplification. The Association applauds the committee for taking up this topic in this careful and deliberate manner.

As you may know, the section of taxation has more than 24,000 members throughout the country. I would dare guess that the desirability of tax law simplification may be one of the only items on which you could get anywhere near unanimity among the members. We certainly unqualifiedly support the concept of simplification. Indeed, we go further and support most of the specific provisions that are in the various bills before you.

We would like to particularly applaud the approach that is being taken here and hope that it will be a model for future action. Frankly, we look forward to the day when simplifications bills can become routine, continue to be staffed in advance, considered in a deliberative fashion by the committees and with a chance for public comment.

We recognize that if the process is to work, the bills will need to be kept free of extraneous provisions and the public will need to understand, as I am sure you do, that sometimes complex provisions in and of themselves can produce a lot of simplicity in operation. We will certainly do our best to advance these positions.

Turning to some specifics, we are particularly pleased with the provisions dealing with Subchapter S corporations. The removal of some of the traps for unwary, such as in the one class of stock

area, and the removal of some of the restrictions that frankly do not seem to have any basis in policy, for example the current requirement that S corporations cannot generally be members of an affiliated group, are all great steps forward. We think that these and other changes that are being proposed will certainly benefit the many small businesses that rely so heavily on the S corporation format.

Section 441 of S. 1394, which attempts to conform the treatment of revocable trusts more closely to that of descedents' estates, is certainly a step in the right direction.

In the foreign area, the changes in the Section 1248 rules are a very good improvement. The attempt to unify the anti-deferral rules, which are now scattered throughout the Code, is in most respects a very good first step. In general, in the foreign area as a whole, the changes that are being proposed are well crafted, particularly when one accepts the premise of attempting to simply existing laws without changing policy.

I think I should note here, however, that based on some past studies the Section of Taxation has done and the American Law Institute has done, we believe that the foreign area is one where there can be further simplification and rationalization, particularly if a few minor policy changes could be accomplished. We also believe that in the S corporation area and the revocable trust area there could be some further steps taken.

We are not intending to criticize here by these comments. But we believe so strongly in the simplification principle that we would hope that in its deliberations, the committee could come up with some type of informal procedure whereby the members could at least discuss some relatively minor policy changes and give some guidance for further simplification.

We believe the individual area, involving individual taxpayers, and particularly low-income taxpayers, provides fertile grounds for further simplification. We recognize that some of the leading candidates here for simplification, such as the deductibility of non-business interests, the "kiddie tax", the earned income credit and other provisions that affect low income taxpayers, to fully provide true simplification, may need some policy changes.

The low income taxpayers frankly do not have the ability to go out and hire a lot of experts to help them get through some of the complexities that exist today. So if they are going to get help, it needs to be here in this room.

In conclusion, I would note that the experts that compose the various committees of the Tax Section have been and are now working on detailed technical analyses and technical comments. These comments will be soon forwarded to you for your review. Our members are prepared to meet with you and members of the staff to go over the comments. Indeed, we stand ready to do anything that we can to keep this process moving forward and to help achieve the success we all seek.

Thank you.

Senator BOREN. Thank you very much, Mr. O'Neill.

So there will be some other specific proposals that you will be making to us in terms of other areas where we can achieve simplification?

Mr. O'NEILL. That is correct. As I say, we are looking to our committees, which really know these areas, to come up with detailed comments and analyses; and you will be getting those in the very near future.

Senator BOREN. I appreciate that very much. And as you know Chairman Bentsen, the Chairman of the full committee, has really been the captain of our effort in regard to tax simplification. He is very strongly committed to it. I know that he would welcome these additional suggestions from you as soon as you can get them to us and to the staff.

Mr. O'NEILL. Certainly.

Senator BOREN. I assure you they will be very seriously considered.

[The information appears in the appendix.]

[The prepared statement of Mr. O'Neill appears in the appendix.]

Senator BOREN. Mr. Brown?

STATEMENT OF ROBERT M. BROWN, CHAIRMAN, TAX SIMPLIFICATION COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC

Mr. BROWN. Thank you, Mr. Chairman, for the opportunity to testify today on this very important subject. I am Robert M. Brown, chairman of the tax simplification committee of the American Institute of Certified Public Accountants. I am also a partner in the Washington national tax practice of the international accounting firm of KPMG Peat Marwick.

We commend Chairman Bentsen for introducing S. 1394 and you, Mr. Chairman, for having this hearing here today. We strongly believe that this bill is an important step in an ongoing, orderly process to simplify the tax law. The AICPA urges that tax simplification be made a legislative priority. We have made the need to simply the tax law a priority for the past three years.

Complexity in the tax law has reached a point at which many tax practitioners and taxpayers believe that it is undermining our system of voluntary compliance. Taxpayers and tax practitioners are increasingly frustrated with the burden of trying to understand and comply with the tax laws.

The Internal Revenue Service is finding it increasingly more difficult to administer the tax law. Frequent change, the current legislative process, and the increasing complexity and magnitude of the Internal Revenue Code are serious concerns to us.

The cornerstone of tax administration in the United States is our voluntary compliance system. Voluntary compliance depends both on the ability and the willingness of taxpayers to comply. Complexity threatens to erode the system, because full compliance in many cases requires an unreasonable outlay of effort and resources.

The complexity leads some taxpayers to believe that the IRS will be incapable of discovering any noncompliance. Some have even developed the impression that understanding the tax laws serves only to increase the amount of taxes that they must pay. Some taxpayers even believe it is to their advantage to use less knowledgeable tax preparers to reduce their tax liability.

To maintain a voluntary tax system it is imperative that simplification be given a very high priority in all stages of the tax process, along with policy and revenue objectives. Defining what constitutes simplification is not easy. We have defined simplification in our work in terms of increasing the understandability and workability of the tax law. S. 1394 being considered here today accomplishes this.

The AICPA strongly endorses S. 1394. We encourage the Congress to enact it. We support most of the provisions of the bill, which we have detailed in our prepared statement.

In addition to the provisions in the bill in S. 1394, we recommend that the Senate Finance Committee give very serious consideration to simplifying the earned income credit. This credit, which is aimed at the group of taxpayers that are least equipped and least able to comply with complexity or deal with complexity, has always been far from simple.

The earned income credit now is composed of three separate credits. With respect to two of them, taxpayers must elect one after determining which is more beneficial. While we take no position on whether it is good tax or social policy to have these three separate credits, we believe something needs to be done to simplify this area of the law.

At a minimum we believe that the interactions should be eliminated. We welcome the opportunity to work with the committee and provide assistance as this bill is refined. Further, we would like to see additional areas which affect a large number of individual taxpayers considered for simplification.

We also will be submitting additional simplification provisions and suggestions to the committee in the near future.

Mr. BROWN. Let me add, since you have asked for specific comments in the alternative minimum tax, it happens to be an area that I spend a lot of time in. There are two provisions in S. 1394 that would simplify the alternative minimum tax. We strongly endorse both of those provisions. Currently corporations are subject to three separate systems—the regular system, the AMT, and the adjusted current earning system. We encourage the committee to look at ways of contracting at least the adjusted current earnings and the AMT systems together.

One of the two provisions addresses changes in ownership, which is probably the most complex part of the adjusted current earnings system of AMT. The bill would repeal the provision that requires, in certain cases where there is a change in ownership, corporations to revalue their whole balance sheet and have a whole separate system of calculating depreciation, gain and loss, inventories, et cetera. We recommend that this requirement be repealed retroactively. It has only been in existence since the beginning of 1990 and it is a particular burden to affected taxpayers.

The timing of this discussion is very appropriate, given that September 16, on Monday, is the extended due date for corporations to file their tax returns for 1990. This is the first year the adjusted current earnings provision is in effect and our phones have rung off the hook over the last two weeks with last minute questions and problems.

Thank you very much for this opportunity.

Senator BOREN. I appreciate those comments very much and certainly will share them with my colleagues on the committee; I am in agreement with you.

[The prepared statement of Mr. Brown appears in the appendix.]

Senator BOREN. I have just a couple of questions, first for Mr. O'Neill. I know that previously you sent us a proposal that would allow taxpayers to combine their personal investment interest and would allow a deduction to the extent of a taxpayer's investment income, plus a prescribed additional amount.

You have talked about the low and moderate income problem of simplification. How would you respond to complaints from low and moderate income taxpayers who do not have investment income and therefore would not benefit from that proposal?

Mr. O'NEILL. Well, I think that in part of that proposal, there was a first category that would permit continuing the policy we have today of allowing deductions for interest that is incurred on indebtedness securing principal or secondary residentces. So I believe that the taxpayers, to the extent they owned a residence, would be able to take advantage of some of those provisions.

Also, you cannot do everything with any single provision. One of our biggest concerns with the structure of the interest deductions today, as we pointed out in that submission, is that you have so many pots that a significant tracing problem is created. I would think—fortunately I do not have to prepare the returns—but I would think the current provisions drive return preparers "batty" because of the complexity and the tracings.

What we were trying to do was to come up with some system that would prevent having to do as much tracing that would otherwise simplify the operation of the system.

Senator BOREN. Do you know if it would result in any revenue loss, that proposal?

Mr. O'NEILL. No, sir. We did not—

Senator BOREN. You haven't sought revenue estimates on it?

Mr. O'NEILL. Right.

One of the things we did mention is that possibly some of the limits on the residential interest deduction could be slightly lowered.

Senator BOREN. Adjusted a little bit, or make it revenue neutral.

Mr. O'NEILL. To make it revenue mutual. But we defer to the experts on those areas.

Senator BOREN. Thank you very much.

I notice, Mr. Brown, on the AICPA statement that there is some misgiving about moving the date for furnishing the partnership information from April 15 to March 15. We heard something about this in our opening day of hearings as well. We get it from both sides, obviously.

There are others on the receiving end of this information who say we want it earlier because often we do not get it until the day our own tax returns are due. And I can understand the concerns of both.

Is there some fair compromise that we might reach between this April 15 and March 15 proposal that might be workable and might at least prevent some people from ending up not getting the information until the day their own taxes are due?

Mr. BROWN. In most cases, Mr. Chairman, the partners do receive informal information from the partnership so they can make their extension requests by April 15.

We think there is sufficient pressure now by partners on partnerships to provide information as early as possible. By mandating a March 15 deadline it would actually increase the burden on preparers far beyond what is necessary.

We suggest approaching it from a different side. In the case of many taxpayers involved in multiple partnerships, they typically extend their return anyway. They will not be filing on April 15. They will be filing on August 15, or, more likely, on October 15.

So our suggestion is to mandate that the K-1s be provided at least no later than September 15. That should give the partnerships plenty of time to get this out.

Our concern is if you mandate a March 15 deadline there will be too many occasions when the partnerships will have to amend their K-1s after they have been sent out.

Senator BOREN. Thank you very much.

Thank both of you very much for taking time to appear. We will, as I say, receive your full statements into the record. Also, we will look forward to receiving additional specific proposals that you may have on behalf of the organizations. Thank you very much.

Mr. BROWN. Thank you, again, for your efforts as well.

Mr. O'NEILL. Thank you.

Senator BOREN. Thank you.

Our next panel consists of Mr. Glenn Graff, chief financial officer and executive vice president of Linbeck Construction Company, Houston, Texas, on behalf of the Associated General Contractors of America; and Mr. Richard Shavell, C.P.A., construction tax manager, with Zelenkofske, Axelrod and Company, Ltd., Pennsylvania, on behalf of Associated Builders and Contractors.

We appreciate both of you being here with us today.

Mr. SHAVELL. Excuse me. Mr. Deviney is unable to attend. He is caught in a travel problem.

Senator BOREN. Right.

We thank both of you for being here. As I have indicated to our earlier panelists, we will receive your full statements for the record and would appreciate your highlighting your major areas of concern so that we can focus on those in an abbreviated period of time.

Mr. Graff, would you like to commence?

STATEMENT OF GLENN GRAFF, CHIEF FINANCIAL OFFICER AND EXECUTIVE VICE PRESIDENT, LINBECK CONSTRUCTION CORP., HOUSTON, TX, ON BEHALF OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Mr. GRAFF. Thank you, Mr. Chairman. Mr. Chairman, the Associated General Contractors of America is pleased to participate in this hearing on the Tax Simplification Act of 1991. AGC is a national trade association of more than 33,000 firms, including 8,000 of America's leading general contracting firms.

We want to express our appreciation to you, Mr. Chairman, to Senator Bentsen and to the committee for their commitment to tax simplification. The need to simplify the Tax Code is compelling.

Compliance today imposes prohibitive administrative costs and imposes an unmanageable paperwork burden.

Pervasive uncertainty about what rules mean and how to implement them undermines compliance. Lack of regulatory guidance is compounded by the backlog of new regulation projects. And lack of stability in the tax statutes and regulations thwarts long-range business planning.

It is no secret that tax compliance for small business is historically low, primarily because taxpayers simply cannot understand how to apply the perplexing maze of Federal tax rules.

As IRS Commissioner Goldberg told Congress recently, most noncompliance is unintentional. Much of it is due to the complexity of the tax laws.

The 1986 Act added a new provision in accounting for long-term contracts, the look back provision. The underlying premise for the look back provision is a mistaken assumption that construction contractors defer income from their long-term contracts. Contrary to this assumption, construction firms must recognize, not defer income, in order to satisfy banking and bonding relationships.

Construction is a highly competitive business with profit margins often of 1 to 2 percent. A construction firm cannot successfully bid on new work without adequate surety credit. Construction contractors must accelerate, not defer recognition of income in order to accumulate working capital and maintain access to maximum surety credit.

The look back provision has also been justified as a deterrent against the reporting of income. However, Internal Revenue Code Section 6662 already has stiff penalties for underpayment of income tax. There is no exception for underpayments attributable to the under reporting of profit on long-term contracts.

Mr. Chairman, we believe that every contractor not currently exempt from the look back provision will benefit from the proposed 10 percent look back tolerance factor and the creation of an annual interest rate. Even though a contractor would still be required to apply the first step of the look back calculation, the 10 percent de minimis rule and the change from a quarterly to an annual interest rate will reduce compliance costs.

Our own company recently completed an analysis of the post completion costs for all of our contracts over the past ten years to which look back would have applied had it been in effect. Of the 116 contracts which had post-completion costs, 70 of the contracts had post-completion costs of less than 10 percent of the contract profit.

During this same 10 year period there were only three contracts with post-completion revenues. The experience of our company and many others indicates that the look back rules result in more interest refunds to taxpayers than in interest payments to the government. One AGC member recently filed for a look back interest refund of $257,000.

The simplification bill also modifies current statutes and proposed regulations of S corporations by clarifying that a corporation is treated as having only one class of stock if all the outstanding shares of the corporation confer identical rights to distribution and liquidation proceeds.

The proposed clarification would essentially refute recent proposed IRS regulations that would determine that an S corporation has a second class of stock if distributions to shareholders differ in timing or amount. The penalty for finding a second class of stock is termination of the S election.

The simplification bill extends the authority of the Internal Revenue Service to waive the effect of an inadvertent S corporation termination and to also waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents.

Under current law a small business must elect S corporation status no later than the fifteenth day of the third month of the taxable year for which the election is effective. The IRS cannot validate a late election. But the consequences of an inadvertent late election can be enormous to the taxpayer.

Rules affecting S corporations are of great importance to the construction industry. Surveys have indicated that two-thirds of AGC members are S corporations.

AGC is pleased to support the Tax Simplification Act of 1991 and we hope that our comments have been of value to the committee in its review of tax simplification.

Thank you.

Senator BOREN. Thank you very much, Mr. Graff.

[The prepared statement of Mr. Graff appears in the appendix.]

Senator BOREN. Mr. Shavell?

STATEMENT OF RICHARD R. SHAVELL, C.P.A., CONSTRUCTION TAX MANAGER, ZELENKOFSKE, AXELROD & COMPANY, LTD., JENKINTOWN, PA, ON BEHALF OF ASSOCIATED BUILDERS AND CONTRACTORS, INC.

Mr. SHAVELL. Good afternoon Mr. Chairman, and members of the committee. My name is Richard Shavell and I am pleased to be here today on behalf of the Associated Builders and Contractors and the Associated Specialty Contractors, Inc. I am a construction tax manager with Zelenkofske, Axelrod and Company, Ltd. in Jenkintown, Pennsylvania.

Mr. Chairman, we commend the committee on its efforts to address the complexities of the Internal Revenue Code and we support S. 1394 and other needed simplification legislation.

What I would like to discuss is a provision in the Tax Code that imposes a complex and costly administrative burden on small construction contractors without any benefit to the contractor or the government because the provision is revenue neutral.

This same provision causes contractors to perform thousands of computations which in some cases the result is a zero liability. Typically, the contractor pays more in compliance costs than result under this provision. Of course I am speaking of the same look back method that Mr. Graff just spoke of, which is found under Section 460(b) of the Internal Revenue Code.

And although Section 411 of this proposed bill will provide relief for larger contractors by establishing a 10 percent de minimis rule, this proposed 10 percent de minimis rule alone will not reduce look backs complexity for small contractors.

We hope that our proposal to exempt small contractors from look back can be considered by this committee, if not in this bill, then in the context of tax policy at the earliest opportunity.

Let me briefly explain how the small contractor falls into look back compliance and reasons why a small contractor exemption is justified. Under the 1986 Tax Act, small contractors, those contractors with average annual gross receipts of under $10 million, were exempt from look back because they could use the completed contract method, the cash method, or any method they wanted for regular tax purposes.

Look back compliance was only for the larger contractors who reported under the percentage of completion method. However, under the alternative minimum tax all contractors must use the percentage of completion method. Because they must use percentage of completion for AMT purposes contractors must also perform the look back computations for alternative minimum tax. This is a double hit.

Senator BOREN. Right.

Mr. SHAVELL. Supporting our recommendations to exempt the small contractor from the look back method are the following facts: First, the administrative burden is immense to the small contractor. For example, complex computations must be performed annually for AMT purposes even though there may be no result, no liability, and no refund. The current de minimis rules and the proposed 10 percent de minimis rules provide insufficient relief to the small contractor.

Also, simplified methods that are currently available provide limited, if any, relief to the small contractor. Included in our written comments is a detailed memo that was prepared at the request of the Treasury Department that amplifies this point.

Senator BOREN. So you are saying that virtually all of these small firms are going ahead and making this computation even though they do not fall under the minimum tax?

Mr. SHAVELL. That is correct. The rules read that they have to do these computations.

Second, the look back method is not a "watch dog" on the construction industry as intended. The look back method was originally implemented to prevent manipulation of the estimates required under the percentage of completion method. Most small contractors do not fully understand the look back method, and if they do not fully understand it, it is not going to affect how they develop their estimates when they are computing percentage of completion income.

The true "watch dog" on the construction industry are the surety and banking requirements imposed on the small construction contractors that force them to aggressively report higher income, thus accelerating their tax liabilities not deferring it as was originally believed by the tax writers.

Third, there is no abuse by small contractors in reporting under the percentage of completion method as evidenced by the fact that the look back method has not resulted in a windfall to the Treasury. In fact, the IRS acknowledges that the look back method is revenue neutral.

Fourth, the small contractor is now forced to face not one, but two acceleration mechanisms in the Tax Code. Both the alternative minimum tax and the look back method are accelerations of tax and interest that will reverse in the following year or years.

And fifth, this exemption that we are asking for will not cause a major change in the alternative minimum tax system. We are not asking to exempt small contractors from the percentage of completion under AMT. All we are asking for is that they not be subjected to look back in addition to alternative minimum tax.

In conclusion, we are pleased that the committee recognizes the burdens of the look back method and has addressed this issue in the tax simplification bill. It is the hope of small construction contractors that relief can be provided that is relevant to their way of doing business. A small contractor exemption from the look back method is sound policy and fair because it has no positive impact for either the taxpayer or the government. This exemption is not just warranted, but desperately needed.

We thank you.

Senator BOREN. Thank you very much.

[The prepared statement of Mr. Shavell appears in the appendix.]

Senator BOREN. Mr. Graff, you have indicated that in your company you thought that the simplification changes in the look-back provision would save 15 to 20 percent in administrative costs.

Mr. GRAFF. That is correct.

Senator BOREN. Do you think that the other companies would be in a similar situation? Would your situation be fairly typical in terms of administrative cost savings?

Mr. GRAFF. I believe we would be fairly typical for the companies in excess of the $10 million limit.

Senator BOREN. Yes.

Mr. GRAFF. Yes.

Senator BOREN. You have heard Mr. Shavell's proposal on behalf of Associated Builders and Contractors to exempt the small contractors from the look back rule on the minimum tax. Do you have any comment on that proposal?

Mr. GRAFF. Of course, I agree very much with what he has said. It was our understanding that that was probably not an appropriate topic for these hearings so we have not commented on it. But in order to put it in perspective, when you are talking about a $10 million contractor, and we have subsidiaries that are in that range, you are talking about a company that may have a manager, two estimators and two people in the office.

Senator BOREN. Yes.

Mr. GRAFF. And when they have to comply with these burdensome rules it is a tremendous burden on them.

Senator BOREN. Thank you very much.

Mr. Shavell, I gather from your testimony that you believe that providing this exemption on look back would be revenue neutral and that there may be some IRS data that might support that conclusion.

Can you go into that a little more? Why do you think it would be revenue neutral?

Mr. SHAVELL. The data I referred to was in August of last year at the hearings for the regulations under the look back method. The

IRS at that time stated that the look-back method was revenue neutral.

Additionally supporting neutrality are various surveys that indicate that the amounts refunded to and paid by taxpayers are insignificant. We have also computed and supplied charts to the Treasury Department that shows different levels of revenue, different levels of misestimation because that is basically what we are talking about, and different profit levels and what the resultant impact is. The impact is insignificant in relationship to the revenue and the tax at the lower levels of revenue.

In the case of small contractors, of course, we are only talking about AMT. AMT is a reversal mechanism which is basically an acceleration of tax. If you pay tax this year under AMT you are going to get it back in the future. The same thing with look back interest. All that is being done under look back is—and I guess to get into this, it would be better if I just stepped back and explained the three steps under the look back method.

There are three steps. The first step requires the contractor go through computations, contract by contract by contract, and redetermine the percentage of completion based on final facts as compared to the estimates that were used in the prior year or years when that contract was undergoing. As a result of the accumulation of all this information under step one the contractor has determined how much income was under or over reported in a prior year under the percentage of completion method.

Keeping it a simple situation, by definition the contractor has infact paid all the tax under the percentage of completion method. The only question is when. So if I under reported last year I had to over report this year. When I go through the computation of the tax, what happens is that if I over reported tax last year I under reported tax this year. What happens with the interest? The exact same thing.

So it is merely a reversal and that is why the results have to be revenue neutral. Over a period of time the results will constantly come up to zero. If you looked at a five-year period or a three- year period at those contracts opened and closed in the period, there must be a zero result.

Senator BOREN. Thank you very much.

I appreciate both of you being with us today; we will share your full testimony with the entire committee, and we appreciate the support that you are giving to our efforts for tax simplification.

Thank you both for being with us.

Mr. GRAFF. Thank you, Mr. Chairman.

Mr. SHAVELL. Thank you very much.

Senator BOREN. Our next panel consists of Matthew P. Fin, senior vice president and general counsel for the Investment Company Institute of Washington; Mr. James Mack, vice president for government affairs, the National Machine Tool Builders Association, on behalf of the Invest to Compete Alliance; and Mr. Benson Goldstein, manager, Tax Policy Center, U.S. Chamber of Commerce. We welcome all of you here.

Again, I would ask if you could to summarize your testimony and hit those major areas of concern, particularly in the areas of

change or addition that you think should be made to this pending legislative proposal.

Mr. Fink, we will begin with you.

MATTHEW P. FINK, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, INVESTMENT COMPANY INSTITUTE, WASHINGTON, DC

Mr. FINK. Thank you, Mr. Chairman. I am Matthew Fink, senior vice president and general counsel of the Investment Company Institute, which is a national association of the mutual fund industry. We greatly appreciate the opportunity to testify today in very strong support of the portions of S. 530 which would simplify and modernize the taxation of mutual funds by repealing the so-called 30 percent test.

That test requires that a mutual fund seeking to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code receive less than 30 percent of its gross income from the sale or other disposition of securities held for less than 3 months.

While this restriction may have been consistent with a prudent investment philosophy in 1936, 55 years ago when the provision was put into law, the securities markets of today are very different than the securities markets of 1936. What may have been prudent 55 years ago in 1936 may not be prudent today. And repeal of the 30 percent test would advance the goal of tax simplification in three very important ways.

First, if the provision is repealed the people who run mutual fund portfolios would not be forced to engage in tax motivated transactions which are inconsistent with the best interests of fund shareholders.

Just to give you two examples: today, with the 30 percent test in effect, in times of heavy market volatility, a surge in stock prices might make the sale of certain securities advisable. But if the securities have not been held for 3 months, the 30 percent test could prevent the fund from selling them.

Additionally, a fund manager might today receive a very attractive tender offer to buy some securities held by the fund but would have to turn down the tender offer because following it would lead the fund to breach the 30 percent test.

In short, today the costs associated with tax motivated transactions are borne by millions of mutual fund shareholders.

A second reason we support S. 530 is that, repeal of the test would provide the typical mutual fund shareholder, who is of moderate income, with the same tax treatment that our law provides to wealthy direct investors who are not subject to the 30 percent test. Repeal will also provide comparable tax treatment for mutual fund investors with investors in other pooled investment funds like bank common trust funds, bank collective investment funds, insurance company separate accounts, et cetera, none of which are subject to the 30 percent test.

And finally, the legal complexities and administrative burdens that are imposed on funds today would be reduced if the 30 percent test was repealed because they would no longer have to do recordkeeping and compliance monitoring.

In short, we think the test should be repealed and we applaud S. 530. I would be happy to respond to any questions.

Thank you.

Senator BOREN. Thank you, Mr. Fink.

[The prepared statement of Mr. Fink appears in the appendix.]

Senator BOREN. Mr. Mack?

STATEMENT OF JAMES H. MACK, VICE PRESIDENT FOR GOVERNMENT AFFAIRS, NATIONAL MACHINE TOOL BUILDERS ASSOCIATION-THE ASSOCIATION FOR MANUFACTURING TECHNOLOGY, ON BEHALF OF THE INVEST TO COMPETE ALLIANCE, WASHINGTON, DC

Mr. MACK. Thank you, Mr. Chairman. We appreciate the opportunity to support the simplification of the corporate alternative minimum tax or, as it is affectionately known around this table, the AMT.

The complex depreciation calculations that the current AMT requires of American business, both large and small, are a complicated and time consuming administrative burden not carried by our foreign competitors. Our written testimony outlines this complex process which must be conducted by all taxpayers, whether they end up under the AMT or not.

In 1989 House legislation was introduced that would have simplified the corporate AMT and would have corrected several structural defects related to the depreciation of capital equipment. That legislation would have collapsed the two-tiered AMTI and adjusted current earnings or ACE structure into one calculation and it would have eliminated the costly retroactivity problem associated with the 1990 switchover to ACE. Additionally, the bill eliminated the arbitrary and burdensome book income depreciation limitation.

Because the bill's revenue loss could not be accommodated in the context of budget reconciliation that year, the final legislation was approved with just one element of simplification, the removal of the book backstop. However, the complicated AMTI-ACE two-step remained and went into effect last year.

The current proposal in S. 1394 focuses on the complexity of depreciation calculations. The framework of this proposal is excellent and it would change an extremely complex calculation into a relatively simple one. Because the bill is drafted to achieve simplification, rather than economic relief, there are no so-called "winners" nor "losers."

While we strongly support and endorse this initiative, this proposal alone will not achieve true simplification. Because the effective date of the simplification proposed in S. 1394 is for tax years beginning after 1990, property placed in service in 1990 will still be subject to the complicated double calculation that the proposed simplification amendment seeks to replace for years after 1990.

Our written testimony outlines several alternatives that could be adopted to eliminate the need to deal with property placed in service in 1990 under a separate formula. With this important change, we would strongly, even more strongly than we already support, the AMT simplification proposal in S. 1394.

In 1989 House testimony, I called for a "kinder, gentler AMT." Revenue constraints prohibited gentleness in 1989, but if kindness can be equated with simplicity, you have certainly provided kindness in 1991. [Laughter.]

Mr. MACK. And if you can do something about the unkind separate set of books that are required for 1990 property, we would be even more grateful.

Finally, we urge you to study, not in the context of this bill, but to study the impact of the AMT on America's productivity. The AMT increases the cost of capital relative to our foreign competitor's cost. It drives merger and acquisition activity and in these recessionary times when we should be encouraging capital investment, to bring about renewed economic growth. The AMT in its current form actually discourages important investments in our Nation's future.

The need, Mr. Chairman, for simplification is urgent and we hope that the committee can act soon in refining and approving the proposal before you.

Thank you, Mr. Chairman.

Senator BOREN. Thank you very much, Mr. Mack. I certainly agree with the comments you have made and read with interest some of the recent studies, one from an economist at the University of Maryland indicating, for example, that a U.S. producer of engine blocks within the first 5 years of purchasing those blocks, will recover something like 35 percent of the cost of the investment; and in Japan and Germany, it is in the 70 to 80 percent range; in Korea, it was as high as 88 percent. I do not know how in the world we can continue to write our tax laws in this country in a vacuum without considering the impact that they have on our ability to compete.

Speaking as one of those who did not vote for the provisions that are now in current law, I will certainly try to take your message of kinder and gentler changes to those who are controlling the policy. I think it is extremely important we make these changes.

[The prepared statement of Mr. Mack appears in the appendix.]

Senator BOREN. Let me ask one question on the retroactivity. As you know, in general, I am not very much an advocate of retroactive changes in the Tax Code. Do you think it would create any complication in this case to make that provision apply back to 1990, rather than to 1991? Will there be any down-side problem to it, or will the benefit achieved be so great that it will be worth it in your opinion?

Mr. MACK. I think a lot of folks share your concern about retroactivity. As I mentioned, the AMT itself imposes some retroactive problems.

Senator BOREN. Exactly.

Mr. MACK. But, no. We suggested in our written testimony a number of ways you could accommodate our proposal. One would be more complicated, perhaps, for the taxpayer than the other two. The revenue loss should be negligible. The proposal that appears in S. 1394 was before the Congress in 1990. It was intended over in the other body to go into effect in 1990. It is something that should have been taken care of last year. For reasons beyond everyone's control, it did not make it through the reconciliation conference.

I think that there is considerable justification for not requiring folks to continue to handle 1990 property for as long as it is being depreciated for AMT purposes differently than the reform that you are putting in place in the bill.

Senator BOREN. Thank you very much.

Mr. Goldstein?

STATEMENT OF BENSON S. GOLDSTEIN, MANAGER, TAX POLICY CENTER, U.S. CHAMBER OF COMMERCE, WASHINGTON, DC

Mr. GOLDSTEIN. Thank you, Mr. Chairman. We thank you very much for holding these very important hearings. My name is Benson Goldstein, Manager for Tax Policy for the U.S. Chamber of Commerce.

The U.S. Chamber is pleased to provide testimony on S. 1394, the Tax Simplification Act of 1991. The Chamber supports the Senate Finance Committee's efforts to rationalize and simplify the current tax law.

The business community views simplification in the foreign provisions of the Internal Revenue Code as a high priority. In order to achieve meaningful simplification in the foreign area a review of complex sourcing and allocation rules is necessary. Basic simplification also necessitates a review of the underlying complexities of the foreign tax credit basket and limitation rules as well as an analysis of the complicated rules governing deferral.

Although some of the foreign provisions of the bill may indicate a modicum of simplification, the provisions generally do not appear to provide much simplification in practice and appear to be almost as complicated as current law. At a time when Congress and the nation are concerned about the competitiveness of U.S. industry in world markets there is a fear among the business community that the foreign provisions of the Act may actually worsen to a degree the competitive provision of American corporations and international markets and increase the tax burden of U.S. multi-national corporations.

The Chamber does support the provisions of S. 1394 which extends Code Section 1248 to the sale of stock and lower-tier controlled foreign corporations. By extending Section 1248 to sales of stock and lower-tier corporations as the bill proposes Congress would accomplish true simplification. This would eliminate an aspect of the Tax Code which serves no legitimate economic or tax policy rationale.

The Chamber also recommends that the Committee give careful consideration to S. 936, foreign simplification legislation introduced by Senator Max Baucus. This bill includes meaningful simplification provisions which are designed to improve the competitive standing of U.S. corporations and world markets.

Simplification of the payroll tax deposit system is very important to small business. The current system is unnecessarily complex and warrants overhaul. A large percentage of IRS and taxpayer disputes over payroll tax deposits are as a result of the unnecessary complex system for determining the due dates of deposits.

In this regard the Chamber supports the small depositor rules of S. 1610, a payroll tax simplification measure also introduced by

Senator Baucus. This bill would increase the currently monthly small deposit threshold from $3,000 to $6,000.

Unlike the Senator's proposal, the small deposit rules of H.R. 2775 are clearly in acceleration of tax payments for certain small businesses. The Chamber is opposed to this acceleration in tax payments for small businesses under the House bill.

The current regulations provide a 5 percent safe harbor regarding the deposit shortfall of employers with monthly payroll tax accumulations of $3,000 or more. Any attempt to reduce the current 5 percent safe harbor should be opposed.

Businesses, particularly those with multiple payrolls in a changing work force, encounter significant problems in accurately determining their withholding liability on a next-day basis. Many find it impossible. The 5 percent safe harbor provides employers with a modicum of flexibility.

S. 1394 includes a provision regarding the interest rate on large corporate underpayments. This provision represents true simplification and thus should be supported by the committee. Moreover, the S corporation provisions of the bill represent a step forward for an important segment of the business community.

Mr. Chairman, with respect to the alternative minimum tax I would like to address that as well. The simplification act eliminates the depreciation calculation under the adjusted current earnings or ACE calculation of the corporate AMT, but maintains the depreciation calculation for AMT purposes.

While this proposal is a good first step forward, the Chamber continues to be concerned that the large depreciation preference of the AMT system overstates economic income and therefore results in overpayment of tax by low profit, capital intensive firms.

As in the foreign area, the committee should review the underlying policy rationale of the AMT in a broader context of simplification.

Thank you, Mr. Chairman.

Senator BOREN. Thank you very much, Mr. Goldstein.

[The prepared statement of Mr. Goldstein appears in the appendix.]

Senator BOREN. Let me bring you back to the question of the 5 percent safe haven on the payroll question. You obviously heard the earlier testimony from the General Accounting Office. Were you here when the General Accounting Office testified?

Mr. GOLDSTEIN. Yes.

Senator BOREN. They, of course, asserted that it was unnecessary, that there are very few firms that utilized it, and that a waiver procedure would be sufficient to take care of it without either a 5 percent or 2 percent safe haven provision in the legislation.

What is your response to that argument from the General Accounting Office?

Mr. GOLDSTEIN. Well, I think two things. First of all, the discussion was with large depositors, particularly with $100,000 or more per pay period. They already deposit on a next day basis. I think that that was in a sense a speed up that was done in the 1989 and 1990 Acts.

I think that that should in some ways take care of some of these so-called concerns that have been addressed by GAO. But more particularly to a waiver process with respect to the IRS I am not sure that too many taxpayers would agree with that kind of notion. Because what happens often within IRS waiver procedure, the IRS has the authority to do it but grants it in very limited and probably in very few circumstances.

Senator BOREN. They are not known for over using their discretionary authority in this area?

Mr. GOLDSTEIN. Exactly.

Senator BOREN. Thank you very much.

Just one last question to Mr. Fink. You were talking about the differences in the market, the way securities are traded now as opposed to 1936 when the 30 percent rule was adopted. Could you elaborate on that just a little bit?

Mr. FINK. Well, I think the markets were much less volatile then.

Senator BOREN. Yes.

Mr. FINK. We did a study of volatility and volume on the New York stock exchange. I do not recall the numbers now, but I think a million or two million shares were traded a day then.

Senator BOREN. Right.

Mr. FINK. And today the exchange can trade 100 million shares each day. That volume just makes market swings much greater and requires professional money managers to move in the market on behalf of their clients. Pension fund managers, banks, and insurance companies can move in and out of the market as they see fit. The only managers (on behalf of their shareholders) that cannot move freely in the market are mutual fund managers.

Senator BOREN. Right.

Mr. FINK. I think that is the main reason, Senator.

Senator BOREN. Thank you very much.

Mr. FINK. Thank you.

Senator BOREN. Well, again, I appreciate the testimony that all three of you have given and thank you for taking the time to come and share your views with the committee. We appreciate it very much and regard the suggestions you have made as very good and constructive ones.

Thank you for being with us.

Mr. MACK. Thank you.

Senator BOREN. The hearings will stand in recess.

[Whereupon, the hearing recessed at 3:38 p.m.]

APPENDIX

Additional Material Submitted

Prepared Statement of Denise Bode

My name is Denise Bode. I am President of the Independent Petroleum Association of America (IPAA). I welcome the opportunity to comment on the behalf of our national association which represents some 5,500 independent crude oil and natural gas explorers/producers in all 33 states with oil and natural gas production. The IPAA includes among its members a number of publicly traded master limited partnerships, besides the significant number of smailer partnerships in which our members maintain interests.

Overview:

Partnerships have long been used by the oil and gas industry as a means of raising investment capital. The use of partnerships as an investment vehicle is now less attractive, due in part to the tax provisions enacted in the Tax Reform Act of 1986. However, a recent survey indicated that 21 percent of independent producers have raised venture capital through the use of limited partnerships, indicating the ongoing importance of partnerships to the industry. The Independent Petroleum Association of America (IPAA) also includes among its members a number of publicly traded master limited partnerships, besides the significant number of smaller partnerships in which our members maintain interests.

The Department of the Treasury and the Coalition of Publicly Traded Partnerships have each submitted studies to Congress on compliance and administrative issues associated with widely held partnerships. We are concerned that these studies paid little attention to the problems and concerns that are raised by oil and gas investments held in partnership form.

IPAA does support the concept of simplified reporting to the extent that new requirements reduce the number of items required to be separately reported to partners. Yet, primarily because oil and gas partnerships that elect the simplified reporting benefits under the Act are subject to the loss of percentage depletion benefits, the Act will significantly reduce the attractiveness of oil and gas investments held in partnership form. Other changes in the Act, primarily those that relate to changes in partnership audit procedures, are also of significant concern to the industry.

Minimum Tax Reform is of Paramount Importance:

Much of the complexity that is prevalent in oil and gas partnerships has resulted from the impact of the minimum tax laws. The oil and gas industry is perhaps the most heavily affected by the impact of the alternative minimum tax, with an estimated 75 percent of producers subject to this tax, on an annual basis. The oil and gas industry is subject to numerous adjustments for purposes of the minimum tax, resulting from the treatment of intangible drilling costs, percentage depletion, and equipment depreciation. The need to separately state these items would be eliminated for the majority of investors if the disparate treatment of these items was modified.

Domestic producers should be allowed to use their long established ordinary and business deductions such as drilling costs and the allowance for depletion of the resource. At a time when investment in domestic petroleum resources is in a perilous decline due to problems with oil and natural gas price volatility and lack of capital, current tax law only serves to exacerbate the problem.

For instance, due to price volatility and the complexities of the minimum tax, a potential investor may not know if he made a wise decision to drill until almost a full year after the drilling date. Given the risks an investor must undertake, he needs little additional aggravation in the form of punitive and regressive tax provisions. The IPAA feels that Congress would best advance the goals of tax simplification and wise energy policy by not penalizing these legitimate business deductions under the minimum tax.

Simplified Reporting and Percentage Depletion:

Act Section 210 would add a new section 775 to the Internal Revenue Code, which provides that the simplified reporting requirements would not apply to large oil and gas partnerships, unless the partnership makes an election to apply these requirements. However, a partnership electing the simplified reporting requirements must forego the benefits of percentage depletion and can only deduct cost depletion.

IPAA supports the elective treatment of oil and gas partnerships to be included within the reporting provisions. This elective treatment should be preserved in the legislation in view of the many items that are normally separately stated as a result of other oil and gas provisions in the Internal Revenue Code (especially the treatment of intangible drilling costs and percentage depletion).

However, we can see no valid reason why large partnerships should not be entitled to compute percentage depletion on behalf of their partners, if they elect to have the simplified reporting provisions apply. Although percentage depletion now must be separately reported to partners, there is little reason why this computation could not occur at the partnership level. Under the existing bill, partners with a greater than five percent capital interest in the partnership and integrated oil companies are treated as excluded partners. If there is concern that partnership level treatment would allow depletion to the companies affected by depletable quantity limitations, these concerns can be easily alleviated by requiring these partners to be treated as excluded partners. Because substantially all of the remaining partners would be individuals that likely would not be subject to the 65 percent of overall net income limitation, there would seem to be negligible revenue loss that would result from the allowance of percentage depletion computed at the partnership level.

Denial of percentage depletion benefits as a condition of obtaining simplified reporting runs counter to the tax policy decisions made in enacting the oil and gas provisions in the Revenue Reconciliation Act of 1990, which expanded the availability of percentage depletion benefits in order to improve the economic viability of production from marginal properties. Percentage depletion remains an important deduction to investors in oil and gas partnerships, as it acts to "level the playing field" with investments in nondepletable assets by recognizing that oil and gas assets have no residual value, and that replacement costs for oil and gas assets is significantly greater than assets in nondepleting industries.

The IPAA recommends that there should be no limitations on the allowance of percentage depletion deductions by large partnerships, if the partnership elects to apply the simplified reporting provisions. In order to advance the goals of simplified reporting, depletion could be computed at the partnership level, except for those partners otherwise excluded from the simplified provisions.

We also note that a clarification needs to be made to the exclusion for oil and gas partnerships from the definition of a "large partnership." Many oil and gas partnerships do not directly hold working interests in oil and gas properties, and often hold these interests

through other operating partnerships. The Act should be clarified to provided that the exclusion applies if 50 percent or more (by value) of the assets of the partnership (including assets held indirectly thorough other pass- through entities) are oil and gas properties.

Magnetic Media Filing and Oil and Gas Partnerships:

Act section 203 amends section 6011(e)(2) of the Internal Revenue Code to provide that the I.R.S. may require large partnerships with more than 250 partners to file their tax returns and copies of the schedules sent to each partner on magnetic media. However, oil and gas partnerships that are not subject to simplified reporting may pass out as many as twenty different items to partners. Often, these items do not fit into any kind of standardized category and are simply listed separately and referred to in the line items described as "other items of income or loss" on the I.R.S. form K-1, reporting the partner's distributive share of the partnership's taxable items. It would be extremely difficult to fit these items into the simplified reporting categories that would be necessary for magnetic media reporting.

It appears that the purpose of the magnetic media filing requirements is to facilitate matching of the information reported by a large partnership to its partnership returns. Matching requires consistent treatment of partnership items on both the partnership and partner's returns. However, it is unlikely that items that do not fit into a standardized reporting category (e.g. those items described as other deductions on form K-1) would be correctly picked up correctly and accounted for through any kind of mechanized procedure. In addition, correct matching could not occur relative to those items for which the partner may make a separate election (e.g. the section 59(e) election, relating to an optional election to capitalize and amortize intangible drilling costs), or that are subject to partner level limitations (e.g. percentage depletion, pursuant to section 613A(d)(1)). Thus, comparison of the magnetic media filing would be difficult, if not impossible, and would most likely require partners to spend a large amount of time and money to reconcile differences if matching was attempted. For these reasons, the IPAA feels that only those oil and gas partnerships that have elected simplified reporting should be subject to magnetic media reporting.

Proposals Affecting Assessment of Deficiencies With Respect to Widely Held Partnerships:

Act section 202 provides for a number of changes in the audit procedures of widely held partnerships, apparently arising out of the Treasury study's recommendation that audit procedures should be changed. However, we question the need for changes in this area based upon the Treasury Department's conclusion that a significant amount of unreported partnership income exists from widely held partnerships. The Treasury study is notable in that it offers no factual evidence to back up this conclusion. However, the approach adopted in Act section 202 would severely damage the ability of partners to resell partnership interests and would impose an unfair burden on partners by subjecting them to tax on income they may have never received.

Certainly the Treasury study is correct in noting that the current TEFRA audit system is not ideal for large partnerships. For instance, giving each individual partner the right to participate in negotiations with the Service and in court proceedings may result in a cumbersome process. In addition, the requirement that the I.R.S. must give notice of the beginning of partnership-level administrative proceedings and the resulting administrative adjustments is also cumbersome. However, the proposed system represents a radical departure form existing partnership tax principles, and would appear to violate the principles and stated criteria on which the simplification bill is based.

We note that most large partnerships and all publicly traded partnerships are subject to independent audits by certified public accountants. In addition, the Service has audited many "tax-shelter" type nonpublicly traded partnerships. Yet, despite the fact that these partnerships are routinely audited, the Treasury study suggests that the Service is unable to

audit these partnerships under current law. We are not aware of any circumstances where the Service has even attempted to audit a large publicly traded partnership in the oil and gas industry. However, if relatively minor changes in the notification requirements are made, the Service should be able to audit most large partnerships using the system that is generally applicable under current law.

We also believe that most partners report the taxable income that is passed through to them by the partnership, and that most partnerships take reasonable positions based on existing tax law in preparing partnership returns. Most partnerships have little reason to take aggressive positions on their returns, as a public relations debacle would result with investor partners if significant changes were made arising out of a partnership audit.

Act section 202 specifically adopts the approach recommended by the Treasury Department study that would provide that an item of a partnership shortfall in a prior year would be treated as a current item of income in the year in which a final determination of the adjustment is made, and would provide for the collection of interest and penalties with respect to the shortfall directly from the partnership. This approach represents a significant departure from usual partnership principles. The Treasury department proposal acknowledges that the approach would give a "windfall" to the partner in the year income was understated and would impose an unfair burden on the partner buying into the tax liability. The Treasury report minimizes this problem, stating that the "detriment to a partner who buys into a tax liability of a widely held partnership under the current assessment approach would be less than the detriment to a shareholder who buys into a corporation with a similar tax liability."

This statement is erroneous as to its application to the approach adopted in the Act. For example, a partner that becomes subject to a partnership adjustment may have reportable income on which he must pay tax. But yet, the partnership may have otherwise have incurred a loss for the year such that the partner receives no cash with which to pay the tax. This is different from the corporate situation, where the corporation (and not the partner) is liable to pay the tax. However, we are not advocating that the partnership pay (on a nonelective basis) the tax liability on behalf of the partner. We feel, consistent with current law, that the tax liability is best collected from the partner that was in the partnership at the time the underpayment of tax arose.

The new audit provisions would have the effect of severely decreasing the marketability and resale of partnership interests. Few partners would wish to purchase partnership interests with respect to which they could be-purchasing contingent tax liabilities. The problem is especially acute in those partnerships that were formed for a singular purpose (i.e. an exploratory well drilling program), rather than those partnerships which operate ongoing businesses. For example, those partnerships formed for a single business venture often incur losses in the early years of partnership formation and realize income in later years. The earlier loss years are most susceptible to change upon partnership audit. Few investors would be willing to purchase partnership interests knowing that audit adjustments arising out of the loss years would be passed through to them.

The Treasury study also indicates that this approach may present serious liquidity problems for existing partnerships. This is a valid concern. In many audits, by the time the audit is settled, the collection of interest and penalties associated with a tax deficiency may be as large as the deficiency itself. Collection of interest and penalties from the partnership itself could easily cause partnerships with insufficient cash reserves to sell assets or liquidate in order to satisfy the interest and penalties. Such a threat would further depress the value of partnership interests.

Again, we believe that the proposed changes in the partnership audit provisions are unwarranted. If significant changes must be made, we recommend that the changes apply to publicly traded partnerships only and those partnerships that are not publicly traded and were formed for purposes of conducting a single business venture be exempted from the new rules.

Advance of Due Date for Furnishing Information to Partners:

Section 107 of the Act would amend section 6031(b) of the Internal Revenue Code to provide that a partnership must supply information returns to partners by the 15th date of the third month following a close of a partnership's taxable year, in order to better facilitate the partner's return preparation. Most partnerships are sensitive to the needs of their investor partners to file their returns, and most partnerships work extremely diligently in getting this information out to partners on a timely basis. Indeed, many partnership agreements provide that this information must be furnished to partners by March 15 after the end of the calendar year.

It is important that legislators understand the amount of work that must be accomplished within an extremely small window of time after the end of a partnership's taxable year. The partnership must first close its books and records for the taxable year. After the books and records are closed, the partnerships are often audited by independent certified public accountants. Partnerships that have units held by brokers in street name must collect and process the information necessary pertaining to the beneficial owners of these interests. After the audit (if one occurs), the income tax workpapers are prepared and are often reviewed by independent tax counsel. After the workpapers have been prepared, the return is usually completed with the assistance of an outside computer services and processing company. The completion of the finished return requires a tremendous amount of coordination between staff of the partnership, independent auditors, tax counsel, and computer services personnel. This work must be completed at a time of year when the workloads of all parties involved are exceptionally heavy, placing them under significant pressure.

A few of the largest partnerships, because of their size and complexity, are unable to get information returns to partners by the 15th day of the third month following the close of their taxable year. This partnerships may not be able to meet the new information reporting requirement in any event. Given the choice of mandatory compliance with the new due date, the partnerships may have to either close their books one month earlier in order to have adequate time to prepare the return, or may take "shortcuts" that would minimize proper review of the return and would increase the chance for errors. In any event, the chances for an incorrect filing would be dramatically increased.

In addition, many partnerships that are experiencing financial difficulties are not able to file their returns on a timely basis. These partnerships may not be able to afford to hire in-house personnel that are usually necessary to prepare such returns. In addition, the costs of hiring outside personnel to prepare the returns (usually from C.P.A. firms) is often prohibitive during the initial months of the year because of their significant workloads and higher fees during the tax season. These partnerships will often file their returns during the summer months in order to save money on preparation fees. Although inconvenient for partners, the burden of waiting until the summer months for return preparation may be preferable to the loss in their investment from the payment of increased fees.

We believe that partnerships should be allowed to extend the due date for filing their partnership returns (and sending information returns to partners) if reasonable cause for the extension exists. Accordingly, if a due date of two and a half months after year end is used for partner information returns, we believe that this date should be allowed to be extended if reasonable cause for a later filing exists. If it is important that the information returns be provided to partners by an earlier due date, we recommend that the partnerships be given the opportunity to elect instead to have an earlier year end (such as a November 30 year end). This year end would allow more time for return preparation, but would minimize any opportunity for deferral of partnership income.

[SUBMITTED BY SENATOR DAVID L. BOREN]

[JOINT COMMITTEE PRINT]

TECHNICAL EXPLANATION OF THE TAX SIMPLIFICATION ACT OF 1991 (H.R. 2777 and S. 1394)

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

JUNE 28, 1991

U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON : 1991

JCS-10-91

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

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the "Tax Simplification Act of 1991" (H.R. 2777 and S. 1394). H.R. 2777 (Representatives Rostenkowski and Archer) and S. 1394 (Senators Bentsen and Packwood) were introduced on June 26, 1991.

The Tax Simplification Act of 1991 includes seven titles:

Title I—Individual Tax Provisions;
Title II—Treatment of Large Partnerships;
Title III—Foreign Provisions;
Title IV—Other Income Tax Provisions;
Title V—Provisions Relating to Estate and Gift Taxation;
Title VI—Excise Tax Provisions; and
Title VII—Administrative Provisions.

[1] This document may be cited as follows: *Technical Explanation of the Tax Simplification Act of 1991 (H.R. 2777 and S. 1394)* (JCS-10-91), June 28, 1991.

TECHNICAL EXPLANATION OF THE BILL

TITLE I.—INDIVIDUAL TAX PROVISIONS

1. Rollover of gain on sale of principal residence (sec. 101 of the bill and sec. 1034 of the Code)

Present Law

No gain is recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his or her principal residence within a specified period of time (sec. 1034). This replacement period generally begins two years before and ends two years after the date of sale of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of section 1034.

In general, nonrecognition treatment is available only once during any two-year period. In addition, if the taxpayer purchases more than one residence during the replacement period and such residences are each used as the taxpayer's principal residence within two years after the date of sale of the old residence, only the last residence so used is treated as the new replacement residence.

Special rules apply, however, if residences are sold in order to relocate for employment reasons. First, the number of times nonrecognition treatment is available during a two-year period is not limited. Second, if a residence is sold within two years after the sale of the old residence, the residence sold is treated as the last residence used by the taxpayer and thus as the only replacement residence.

Reasons for Simplification

The rollover provision governing the sale of a principal residence is unnecessarily complex, in part due to the different set of rules that applies depending on whether the sale is work related. The bill simplifies the rollover provision by applying only one set of rules to the sale of a principal residence regardless of whether the sale is work related.

Explanation of Provision

Under the bill, gain is rolled over from one residence to another residence in the order the residences are purchased and used, regardless of the taxpayer's reasons for the sale of the old residence. In addition, gain may be rolled over more than once within a two-year period. Thus, the rules that formerly applied only if a taxpayer sold his residence in order to relocate for employment purposes will apply in all cases.

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As under present law, the basis of each succeeding residence is reduced by the amount of gain not recognized on the sale of the prior residence.

Effective Date

The provision applies to sales of old residences (within the meaning of section 1034) after the date of enactment.

2. Due dates for estimated tax payments of individuals (sec. 102 of the bill and sec. 6654 of the Code)

Present Law

In order to avoid an addition to tax, estimated tax payments of individuals generally are due on April 15th, June 15th, and September 15th of the taxable year for which the payment relates, and January 15th of the following taxable year. The amount of the estimated tax payments generally must be based on 90 percent of the tax shown on the return for the taxable year or 100 percent of the tax shown on the return for the preceding taxable year.

The due date for the tax return of an individual generally is April 15th of year following the taxable year to which the return relates. The due date may be automatically extended to August 15th.

Reason for Simplification

Delaying the due date of the second estimated tax installment would allow for a more accurate determination of the amount of the required payment if the payment is based on the tax shown on the return for the current year or if the payment is based on the tax shown on the return for the preceding year and the due date of the return for the preceding year has been extended.

Explanation of Provision

Under the bill, the due date for the second estimated tax payment of individuals is July 15th of the taxable year for which the payment relates.

Effective Date

The provision is effective for taxable years beginning after December 31, 1991.

3. Permit payment of taxes by credit card (sec. 103 of the bill and sec. 6311 of the Code)

Present Law

Payment of taxes may be made by checks or money orders, to the extent and under the conditions provided by regulations.

Reasons for Simplification

Credit cards are a commonly used and reliable form of payment. Some taxpayers may find paying taxes by credit card more convenient than paying by check or money order.

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Explanation of Provision

The bill permits payment of taxes by credit card, to the extent and under the conditions provided by regulations.

Effective Date

The provision is effective on the date of enactment.

4. Election by parent to claim unearned income of certain children on parent's return (sec. 104 of the bill and secs. 1(g)(7) and 57(j)(1) of the Code)

Present Law

The net unearned income of a child under 14 years of age is taxed to the child at the top rate of the parents. Net unearned income means unearned income less the sum of $500 and the greater of: (1) $500 of the standard deduction or $500 of itemized deductions or (2) the amount of allowable deductions directly connected with the production of the unearned income. The dollar amounts are adjusted for inflation.

In certain circumstances, a parent may elect to include a child's unearned income on the parent's income tax return if the child's income is less than $5,000. A parent making this election must include the gross income of the child in excess of $1,000 in income for the taxable year. In addition, the parent must report an additional tax liability equal to the lesser of (1) $75 or (2) 15 percent of the excess of the child's income over $500. The dollar amounts for the election are not adjusted for inflation.

A person claimed as a dependant cannot claim a standard deduction exceeding the greater of $500 or such person's earned income. For alternative minimum tax purposes, the exemption of a child under 14 years of age generally cannot exceed the sum of such child's earned income plus $1,000. The $500 amount is adjusted for inflation but the $1,000 amount is not.

Reasons for Simplification

The election by a parent to include a child's unearned income on a return is intended to eliminate the need to file a separate return for a child without reducing the family's total tax liability. Indexation of the underlying dollar amounts simplifies return preparation by making the election available to more taxpayers.

The restriction upon the exemption allowed to a child for alternative minimum tax purposes is intended to treat the family the same as if the child's income had been included on the parent's return. Indexation of this exemption amount achieves this goal and simplifies transfers by removing a tax consideration influencing the ownership of property within the family.

Explanation of Provision

The bill adjusts for inflation the dollar amounts involved in the election to claim unearned income on the parent's return. It likewise indexes the $1,000 amount used in computing the child's alternative minimum tax.

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Effective Date

The provision applies to taxable years beginning after December 31, 1991.

5. Simplified foreign tax credit limitation for individuals (sec. 105 of the bill and sec. 904 of the Code)

Present Law

In order to compute the foreign tax credit, a taxpayer computes foreign source taxable income, and foreign taxes paid, in each of the applicable separate foreign tax credit limitation categories. In the case of an individual, this requires the filing of IRS Form 1116, designed to elicit sufficient information to perform the necessary calculations.

In many cases, individual taxpayers who are eligible to credit foreign taxes may have only a modest amount of foreign source gross income, all of which is income from investments (e.g., dividends from a foreign corporation subject to foreign withholding taxes, or dividends from a domestic mutual fund that can pass through its foreign taxes to the shareholder (see sec. 853)). Taxable income of this type ordinarily is subject to the single foreign tax credit limitation category known as passive income. However, under certain circumstances, the Code treats investment-type income (e.g., dividends and interest) as income in several other separate limitation categories (e.g., high withholding tax interest income, general limitation income) designed to accomplish certain policy objectives or forestall certain abuses. For this reason, any taxpayer with foreign source gross income is required to provide sufficient detail on form 1116 to ensure that foreign source taxable income from investments, as well as all other foreign source taxable income, is allocated to the correct limitation category.

Reasons for Simplification

It is believed that a significant number of individuals are entitled to credit relatively small amounts of foreign tax, imposed at modest effective tax rates on foreign source investment income. For taxpayers in this class, it is believed that applicable foreign tax credit limitations typically exceed the amounts of taxes paid. Therefore, it is believed that relieving these taxpayers from application of the full panoply of foreign tax credit rules may achieve significant reduction in the complexity of the tax law without significantly altering actual tax liabilities. At the same time, however, it is believed that the benefits of simplified treatment should be limited to cover those cases where the taxpayer is receiving a payee statement showing the amount of the foreign source income and the foreign tax.

Explanation of Provision

The bill allows individuals with no more than $200 of creditable foreign taxes, and no foreign source income other than income which is in the passive basket, to elect a simplified foreign tax credit limitation equal to the lesser of 25 percent of the individual's

foreign source gross income or the amount of the creditable foreign taxes paid or accrued by the individual during the taxable year. (It is intended that an individual electing this simplified limitation calculation not be required to file Form 1116 in order to obtain the benefit of the credit.) A person who elects the simplified foreign tax credit limitation is not allowed a credit for any foreign tax not shown on a payee statement (as that term is defined in sec. 6724(d)(2)) furnished to him or her. Nor is the person entitled to treat any excess credits for a taxable year to which the election applied as a carryover to another taxable year. Because the limitation for a taxable year to which the election applies can be no more than the creditable foreign taxes actually paid for the taxable year, it is also the case under the bill that no excess credits from another year can be carried over to the taxable year to which the election applies.

For purposes of the simplified limitation, passive income generally is defined to include all types of income that would be foreign personal holding income under the subpart F rules, plus income inclusions from passive foreign corporations (as defined above by the bill), so long as the income is shown on a payee statement furnished to the individual. Thus, for purposes of the simplified limitation, passive income includes all dividends, interest (and income equivalent to interest), royalties, rents, and annuities, and net gains from dispositions of property giving rise to such income, from certain commodities transactions, and from foreign currency transactions that give rise to foreign currency gains and losses as defined in section 988. The statutory exceptions to treating these types of income as passive for foreign tax credit limitation purposes, such as the exceptions for high-taxed income and high withholding tax interest, are not applicable in determining eligibility to use the simplified limitation.

Although an estate or trust generally computes taxable income and credits in the same manner as in the case of an individual (Code sec. 641(b); Treas. Reg. sec. 1.641(b)-1), the simplified limitation does not apply to an estate or trust.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

6. Personal transactions by individuals in foreign currency (sec. 106 of the bill and sec. 988 of the Code)

Present Law

When a U.S. taxpayer with a dollar functional currency makes a payment in a foreign currency, gain or loss (referred to as "exchange gain or loss") arises from any change in the value of the foreign currency relative to the U.S. dollar between the time the currency was acquired (or the obligation to pay was incurred) and the time that the payment is made. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for Federal income tax purposes.

Exchange gain or loss can arise in the course of a trade or business or in connection with an investment transaction. Exchange gain or loss can also arise where foreign currency was acquired for personal use. For example, the IRS has ruled that a taxpayer who converts U.S. dollars to a foreign currency for personal use—while traveling abroad—realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency (Rev. Rul. 74-7, 1974-1 C.B. 198).

Prior to the Tax Reform Act of 1986 (the "1986 Act"), most of the rules for determining the Federal income tax consequences of foreign currency transactions were embodied in a series of court cases and revenue rulings issued by the Internal Revenue Service ("IRS"). Additional rules of limited application were provided by Treasury regulations and, in a few instances, statutory provisions. Pre-1986 law was believed to be unclear regarding the character, the timing of recognition, and the source of gain or loss due to fluctuations in the exchange rate of foreign currency. The result of prior law was uncertainty of tax treatment for many legitimate transactions, as well as opportunities for tax-motivated transactions. Therefore, in 1986 Congress determined that a comprehensive set of rules should be provided for the U.S. tax treatment of transactions involving "nonfunctional currencies;" that is, currencies other than the taxpayer's "functional currency."

However, the 1986 Act provisions designed to clarify the treatment of currency transactions, primarily found in section 988, apply to transactions entered into by an individual only to the extent that expenses attributable to such transactions would be deductible under section 162 (as a trade or business expense) or section 212 (as an expense of producing income, other than expenses incurred in connection with the determination, collection, or refund of taxes). Therefore, the principles of pre-1986 law continue to apply to personal currency transactions.[2]

Reasons for Simplification

An individual who lives or travels abroad generally cannot use U.S. dollars to make all of the purchases incident to ordinary daily life. Instead, the local currency must often be used, yet the individual will not be treated for tax purposes as having changed his or her functional currency to the local currency. If it were necessary to treat foreign currency in this instance as property giving rise to U.S. dollar income or loss every time it was, in effect, "bartered" for goods or services, the U.S. individual living in or visiting a foreign country would have a significant administrative burden that may bear little or no relation to whether U.S.-dollar measured income has increased or decreased. An analogous issue arises for a corporation that has a qualified business unit ("QBU") in a foreign country but nevertheless uses the U.S. dollar as its functional currency pursuant to section 986(b)(3). Complexity concerns aside, Congress could have required in that case that gain or loss be comput-

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[2] See, e.g., Rev. Rul. 90-79, 1990-2 C.B. 26 (where the taxpayer purchased a house in a foreign country, financed by a foreign currency loan, and the currency appreciates before the house is sold and the loan is repaid, the taxpayer's exchange loss on repayment of the loan is not deductible under sec. 988 and does not offset taxable gain on the sale of the house).

ed on each transaction carried out in the local currency. Instead, however, Congress directed the Treasury to adopt a method of translation of the QBU's results that merely approximates the results of determining exchange gain or loss on a transaction-by-transaction basis.[3] It is believed that individuals also should be given relief from the requirement to keep track of gains on an actual transaction-by-transaction basis in certain cases.

Explanation of Provision

In a case where an individual acquires nonfunctional currency and then disposes of it in a personal transaction, and where exchange rates have changed in the intervening period, the bill provides for nonrecognition of an individual's resulting exchange gains not exceeding $200. The bill does not change the treatment of resulting exchange losses. It is understood that under other Code provisions, such losses typically are not deductible by individuals (e.g., sec. 165(c)).

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

7. Advance due date for furnishing information to partners (sec. 107 of the bill and sec. 6031(b) of the Code)

Present Law

A partnership required to file an income tax return with the IRS must also furnish an information return to each of its partners on or before the day on which the income tax return for the year is required to be filed, including extensions. Under regulations, a partnership must file its income tax return on or before the fifteenth day of the fourth month following the end of the partnership's taxable year (on or before April 15, for calendar year partnerships). This is the same deadline by which most individual partners must file their tax returns.

Reasons for Simplification

Information returns that are received on or shortly before April 15 (or later) are difficult for individuals to use in preparing their tax returns (or in computing their payments) that are due on that date.

Explanation of Provision

The bill provides that a large partnership must furnish information returns to partners by the 15th day of the third month following the close of the partnership's taxable year. A large partnership is any partnership with 250 or more partners, as well as any partnership subject to the simplified reporting rules for large partnerships (contained in sec. 201 of this bill, described below).

[3] See Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986* at 1096 (1987); Treas. Reg. sec. 1.985-3.

Effective Date

The provision is effective for taxable years ending on or after December 31, 1992.

8. Make income tax withholding rules parallel to rules for exclusion from income for combat pay (sec. 108 of the bill and sec. 3401(a)(1) of the Code)

Present Law

Exclusion for combat pay

Gross income does not include certain combat pay of members of the Armed Forces (sec. 112). If enlisted personnel serve in a combat zone during any part of any month, military pay for that month is excluded from gross income (special rules apply if enlisted personnel are hospitalized as a result of injuries, wounds, or disease incurred in a combat zone). In the case of commissioned officers, these exclusions from income are limited to $500 per month of military pay.

Income tax withholding

There is no income tax withholding with respect to military pay for a month in which a member of the Armed Forces of the United States is entitled to the benefits of section 112 (sec. 3401(a)(2)). With respect to enlisted personnel, this income tax withholding rule parallels the exclusion from income under section 112: there is total exemption from income tax withholding and total exclusion from income. With respect to officers, however, the withholding rule is not parallel: there is total exemption from income tax withholding, although the exclusion from income is limited to $500 per month.

Reasons for Simplification

In most instances, the wage withholding rules closely parallel the inclusion in income rules. Consequently, most individuals whose income is subject to withholding may rely on withholding to fulfill their tax obligations. The differences between the withholding rules and the exclusion rules with respect to combat pay could cause affected taxpayers (primarily officers) to be surprised at the size of their additional tax liability at the time of filing their tax returns as a result of underwithholding. Paying the additional tax liability with their tax returns could lead to greater financial hardship than would withholding that is parallel to the exclusion rules.

Explanation of Provision

The bill makes the income tax withholding exemption rules parallel to the rules providing an exclusion from income for combat pay.

Effective Date

The provision is effective as of January 1, 1992.

9. Expanded access to simplified income tax returns (sec. 109 of the bill)

Present Law

There are three principal tax forms that are utilized by individual taxpayers: Form 1040EZ, Form 1040A, and Form 1040.

Reasons for Simplification

Many individual taxpayers find the tax forms to be complex.

Explanation of Provision

The bill provides that the Secretary of the Treasury (or his delegate) shall take such actions as may be appropriate to expand access to simplified individual income tax forms and to otherwise simplify the individual income tax returns.

The bill also requires that the Secretary submit a report to the Congress on the actions undertaken pursuant to this provision, together with any recommendations he may deem advisable.

Effective Date

The report is due no later than one year after the date of enactment.

10. Simplification of tax treatment of rural letter carriers' vehicle expenses (sec. 110 of the bill and sec. 162 of the Code)

Present Law

A taxpayer who uses his or her automobile for business purposes may deduct the business portion of the actual operation and maintenance expenses of the vehicle, plus depreciation (subject to the limitations of sec. 280F). If the taxpayer is an employee and these expenses are not reimbursed, the deduction is subject to the 2-percent floor on miscellaneous itemized deductions. Alternatively, the taxpayer may elect to utilize a standard mileage rate in computing the deduction allowable for business use of an automobile that has not been fully depreciated. Under this election, the taxpayer's deduction equals the applicable rate multiplied by the number of miles driven for business purposes, and is taken in lieu of deductions for depreciation and actual operation and maintenance expenses.

An employee of the U.S. Postal Service may compute his or her deduction for business use of an automobile in performing services involving the collection and delivery of mail on a rural route by using, for all business use mileage, 150-percent of the standard mileage rate.

Reasons for Simplification

The filing of tax returns by rural letter carriers can be complex. Under present law, those who are reimbursed at more than the 150-percent rate must report their reimbursement as income, and deduct their expenses as miscellaneous itemized deductions (subject to the 2-percent floor). Permitting the income and expenses to

wash, so that neither will have to be reported on the rural letter carrier's tax return, will simplify these tax returns.

Explanation of Provision

The bill repeals the special reimbursement rate of 150 percent of the standard mileage rate. In its place, the bill provides that the rate of reimbursement provided by the Postal Service to rural letter carriers is considered to be equivalent to their expenses. The rate of reimbursement that is considered to be equivalent to their expenses is the current rate of reimbursement contained in the 1991 collective bargaining agreement, which may in the future be increased by no more than the rate of inflation.

Effective Date

The provision is effective for taxable years beginning after December 31, 1991.

11. Exemption from luxury excise tax for certain equipment installed on passenger vehicles for use by disabled individuals (sec. 111 of the bill and sec. 4004(b)(3) of the Code)

Present Law

The Code imposes a 10-percent excise tax on the portion of the retail price of a passenger vehicle that exceeds $30,000. The tax also applies to separate purchases of component parts and accessories occurring within six months of the date the vehicle is placed in service.

Reasons for Simplification

It is appropriate to reduce the compliance burdens on handicapped persons.

Explanation of Provision

The bill provides that the luxury excise tax does not apply to a part or accessory installed on a passenger vehicle to enable or assist an individual with a disability to operate the vehicle, or to enter or exit the vehicle, by compensating for the effect of the disability.

Effective Date

The provision is effective for purchases after December 31, 1990.

Title II.—Treatment of Large Partnerships

A. General Provisions

1. Simplified flow-through for large partnerships (sec. 201 of the bill and new secs. 771-777 of the Code)

Present Law

Treatment of partnerships in general

A partnership generally is treated as a conduit for Federal income tax purposes. Each partner takes into account separately his distributive share of the partnership's items of income, gain, loss, deduction or credit. The character of an item is the same as if it had been directly realized or incurred by the partner. Limitations affecting the computation of taxable income generally apply at the partner level.

The taxable income of a partnership is computed in the same manner as that of an individual except that no deduction is permitted for personal exemptions, foreign taxes, charitable contributions, net operating losses, certain itemized deductions, or depletion. Elections affecting the computation of taxable income derived from a partnership are made by the partnership, except for certain elections such as those relating to discharge of indebtedness income and the foreign tax credit.

Capital gains

The net capital gain of an individual is taxed generally at the same rates applicable to ordinary income, subject to a maximum marginal rate of 28 percent. Net capital gain is the excess of net long-term capital gain over net short-term capital loss. Individuals with a net capital loss generally may deduct up to $3,000 of the loss each year against ordinary income. Net capital losses in excess of the $3,000 limit may be carried forward indefinitely.

A special rule applies to gains and losses on the sale, exchange or involuntary conversion of certain trade or business assets (sec. 1231). In general, net gains from such assets are treated as long-term capital gains but net losses are treated as ordinary losses.

A partner's share of a partnership's net short-term capital gain or loss and net long-term capital gain or loss from portfolio investments is separately reported to the partner. A partner's share of a partnership's net gain or loss under section 1231 generally is also separately reported to the partner.

Deductions

Miscellaneous itemized deductions (e.g., certain investment expenses) are deductible as an itemized deduction, but only to the

extent that, in the aggregate, they exceed two percent of the individual's adjusted gross income.

In general, taxpayers are allowed a deduction for charitable contributions, subject to certain limitations. In the case of an individual, the deduction cannot exceed 50 percent of the individual's contribution base (generally, the individual's adjusted gross income) for the taxable year. In the case of a corporation, the deduction cannot exceed 10 percent of the corporation's taxable income (computed with certain modifications). Excess contributions are carried forward for five years.

A partner's distributive share of a partnership's miscellaneous itemized deductions and charitable contributions are separately reported to the partner.

Credits in general

Each partner is allowed his distributive share of credits against his taxable income. A refundable credit for gasoline used for exempt purposes is allowed. Nonrefundable credits for clinical testing expenses for certain drugs for rare diseases, for producing fuel from nonconventional sources, and for the general business credit are also allowed. The general business credit includes the investment credit (which in turn includes the rehabilitation credit), the targeted jobs credit, the alcohol fuels credit, the research credit, and the low-income housing credit.

The credits for clinical testing expenses and for fuel from nonconventional sources are limited to the excess of regular tax over tentative minimum tax. Excess credits generally cannot be carried forward. The amount of general business credit allowable in a taxable year is limited to the excess of a partner's net income over the greater of (1) the tentative minimum tax for the year or (2) 25 percent of the taxpayer's net regular tax liability in excess of $25,000. The general business credit in excess of this amount is carried back three years and forward 15 years.

The benefit of the investment credit and the low-income housing credit is recaptured if, within a specified time period, the partner transfers his partnership interest or the partnership converts or transfers the property for which the credit was allowed.

Foreign tax credit

The foreign tax credit generally allows U.S. taxpayers to reduce U.S. income tax on foreign income by the amount of foreign income taxes paid with respect to that income. In lieu of electing the foreign tax credit, a taxpayer may deduct foreign taxes from adjusted gross income.

The total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income bears to the taxpayer's worldwide taxable income for the taxable year. In addition, the foreign tax credit limitation is calculated separately for various categories of income, generally referred to as "separate limitation categories." That is, the total amount of the credit for foreign taxes on income in each category may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income in that category bears to the taxpayer's worldwide taxable income for the tax-

able year. A partner generally reports his share of partnership income from each category. A special rule, however, treats the distributive share of a limited partner owning less than ten percent of a partnership as *per se* in the passive category.

The amount of creditable taxes paid or accrued in any taxable year which exceeds the foreign tax credit limitation may be carried back to the two immediately preceding taxable years and carried forward to the first five succeeding taxable years and credited to the extent that the taxpayer otherwise has excess foreign tax credit limitations for the appropriate separate limitation category for those years.

Unrelated business taxable income

Tax-exempt organizations are subject to tax on income from unrelated businesses. Certain types of income (such as dividends, interest and certain rental income) are not treated as unrelated business taxable income. Thus, for a partner that is an exempt organization, whether partnership income is unrelated business taxable income depends on the character of the underlying income. Income from a publicly traded partnership, however, is treated as unrelated business taxable income regardless of the character of the underlying income.

Passive losses

The passive loss rules generally disallow deductions and credits from passive activities to the extent they exceed income from passive activities. Losses not allowed in a taxable year are suspended and treated as current deductions from passive activities in the next taxable year. These losses are allowed in full when a taxpayer disposes of the entire interest in the passive activity to an unrelated person in a taxable transaction. Passive activities include trade or business activities in which the taxpayer does not materially participate. (Limited partners generally do not materially participate in the activities of a partnership.) Passive activities also include rental activities (regardless of the taxpayer's material participation).[4] Portfolio income (such as interest and dividends), and expenses allocable to such income, are not treated as income or loss from a passive activity.

A partnership's operations may be treated as multiple activities for purposes of the passive loss rules. In such case, the partnership must separately report items of income and deductions from each of its activities.

Income from a publicly traded partnership is treated as portfolio income under the passive loss rules. In addition, loss from such a partnership is treated as separate from income and loss from any

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[4] An individual who actively participates in a rental real estate activity and holds at least a 10-percent interest may deduct up to $25,000 of passive losses. The $25,000 amount phases out as the individual's income increases from $100,000 to $150,000.

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 income phaseout range for the $25,000 allowance for these credits is $200,000 to $250,000 (rather than $100,000 to $150,000). For interests acquired after December 31, 1989 in partnerships holding property placed in service after that date, the $25,000 deduction-equivalent allowance is permitted for the low-income hou[illegible]

other publicly traded partnership, and also as separate from any income or loss from passive activities.

REMICs

A tax is imposed on partnerships holding a residual interest in a real estate mortgage investment conduit (REMIC). The amount of the tax is the amount of excess inclusions allocable to partnership interests owned by certain tax-exempt organizations ("disqualified organizations") multiplied by the highest corporate tax rate.

Contribution of property to a partnership

In general, a partner recognizes no gain or loss upon the contribution of property to a partnership. However, income, gain, loss and deduction with respect to property contributed to a partnership by a partner must be allocated among the partners so as to take into account the difference between the basis of the property to the partnership and its fair market value at the time of contribution. In addition, the contributing partner must recognize gain or loss equal to such difference if the property is distributed to another partner within five years of its contribution (sec. 704(c)). Under regulations, the amount of depreciation and gain or loss that is allocated under these rules is limited to the depreciation allowable to, or gain or loss recognized by, the partnership for tax purposes with respect to the contributed property (the "ceiling rule").

Election of optional basis adjustments

In general, the transfer of a partnership interest or a distribution of partnership property does not affect the basis of partnership assets. A partnership, however, may elect to make certain adjustments in the basis of partnership property (sec. 754). Under a section 754 election, the transfer of a partnership interest generally results in an adjustment in the partnership's basis in its property for the benefit of the transferee partner only, to reflect the difference between that partner's basis for his interest and his proportionate share of the adjusted basis of partnership property (sec. 743(b)). Also under the election, a distribution of property to a partner in certain cases results in an adjustment in the basis of other partnership property (sec. 734(b)).

Terminations

A partnership terminates if either (1) all partners cease carrying on the business, financial operation or venture of the partnership, or (2) within a 12-month period 50 percent or more of the total partnership interests is sold or exchanged (sec. 708).

Reasons for Simplification

The requirement that each partner take into account separately his distributive share of a partnership's items of income, gain, loss, deduction and credit can result in the reporting of a large number of items to each partner. The Schedule K-1, on which such items are reported, contains space for more than 40 items. Reporting so m ny r rat ly stat d it ms 'a burd n m for individu l inv

tors with relatively small, passive interests in large partnerships. In many respects such investments are indistinguishable from those made in corporate stock or mutual funds, which do not require reporting of numerous separate items.

In addition, the number of items reported under the current regime makes it difficult for the Internal Revenue Service to match items reported on the K-1 against the partner's income tax return. Matching is also difficult because items on the K-1 are often modified or limited at the partner level before appearing on the partner's tax return.

By significantly reducing the number of items that must be separately reported to partners, the provision eases the reporting burden of partners and facilitates matching by the IRS. Moreover, it is understood that the Internal Revenue Service is considering restricting the use of substitute reporting forms by large partnerships. Reduction of the number of items makes possible a short standardized form.

In addition, the rules governing allocations with respect to property contributed to a partnership and the rules regarding partnership terminations are ill-suited to large partnerships, whose interests are commonly transferred. By adopting a deferred sale approach for property contributions and by reducing the possibility of partnership terminations, the provision improves the administration of the tax rules governing large partnerships.

Explanation of Provisions

In general

The bill modifies the tax treatment of a large partnership (generally, a partnership with at least 250 partners) and its partners. The bill provides that each partner takes into account separately the partner's distributive share of the following items, which are determined at the partnership level: (1) taxable income or loss from passive loss limitation activities; (2) taxable income or loss from other activities (e.g., portfolio income or loss); (3) net capital gain to the extent allocable to passive loss limitation activities and other activities; (4) net alternative minimum tax adjustment separately computed for passive loss limitation activities and other activities; (5) general credits; (6) low-income housing credit; (7) rehabilitation credit; (8) for certain partnerships, tax-exempt interest; and (9) for certain partnerships, foreign taxes paid and foreign source partnership items.[5]

Under the bill, the taxable income of a large partnership is computed in the same manner as that of an individual, except that the items described above are separately stated and certain modifications are made. These modifications include disallowing the deduction for personal exemptions, the net operating loss deduction and certain itemized deductions.[6] All limitations and other provisions

[5] In determining the amounts required to be separately taken into account by a partner, those provisions of the large partnership rules governing computations of taxable income are applied separately with respect to that partner by taking into account that partner's distributive share of the partnership's items of income, gain, loss, deduction or credit. This rule permits partnerships to make otherwise valid special allocations of partnership items to partners.

[6] A large partnership is allowed a deduction under section 212 for expenses incurred for the production of income, subject to 70-percent disallowance, as described below.

affecting the computation of taxable income or any credit (except for the at risk, passive loss and section 68 itemized deduction limitations, and any other provision specified in regulations) are applied at the partnership (and not the partner) level. Thus, for example, any investment interest of the partnership is limited at the partnership level, and any carryover is made at that level.

All elections affecting the computation of taxable income or any credit are made by the partnership.

Capital gains

Under the bill, netting of capital gains and losses occurs at the partnership level. A partner in a large partnership takes into account separately his distributive share of the partnership's net capital gain.[7] Any excess of capital losses over capital gains, however, is not separately reported to partners; rather, such excess is carried over at the partnership level. The partnership cannot offset any portion of capital losses against ordinary income.

A partner's distributive share of the partnership's net capital gain is allocated between passive loss limitation activities and other activities. The net capital gain is allocated to passive loss limitation activities to the extent of net capital gain from sales and exchanges of property used in connection with such activities, and any excess is allocated to other activities.

Any gains and losses of the partnership under section 1231 are netted at the partnership level. Net gain is treated as long-term capital gain and is subject to the rules described above. Net loss is treated as ordinary loss and consolidated with the partnership's other taxable income.

Deductions

The bill contains two special rules for deductions. First, miscellaneous itemized deductions are not separately reported to partners. Instead, 70 percent of the amount of such deductions is disallowed at the partnership level;[8] the remaining 30 percent is allowed at the partnership level in determining taxable income, and is not subject to the two-percent floor at the partner level.

Second, charitable contributions are not separately reported to partners under the bill. Instead, the charitable contribution deduction is allowed at the partnership level in determining taxable income, subject to the limitations that apply to corporate donors.

Credits in general

Under the bill, general credits are separately reported to partners as a single item. General credits are any credits other than the low-income housing credit and the rehabilitation credit. A partner's distributive share of general credits is taken into account as a current year general business credit. Thus, for example, the credits for clinical testing expenses and the production of fuel from nonconventional sources are subject to the present law limitations on

[7] Any excess of net short-term capital gain over net long-term capital loss is consolidated with the partnership's other taxable income and is not separately reported.

[8] The "70 percent" figure is intended to approximate the amount of such deductions that would be denied at the partner level as a result of the two-percent floor.

the general business credit. The refundable credit for gasoline used for exempt purposes is allowed to the partnership, and thus is not separately reported to partners.

In recognition of their special treatment under the passive loss rules, the low-income housing and rehabilitation credits are separately reported.[9]

The bill imposes credit recapture at the partnership level and determines the amount of recapture by assuming that the credit fully reduced taxes. Such recapture is applied first to reduce the partnership's current year credit, if any; the partnership is liable for any excess over that amount. Under the bill, the transfer of an interest in a large partnership does not trigger recapture.

Foreign tax credit

Elections, computations and limitations regarding the foreign tax credit generally are made at the partnership level without regard to a partner's other foreign source income or foreign taxes paid. For purposes of determining foreign tax credit limitations, the partnership is treated as an individual subject to tax at a 25-percent rate. Excess credits can be carried forward at the partnership level but cannot be carried back. The foreign tax credit is reported to the partner as a general credit. The partner's distributive share of all items of income, gain, loss or deduction are treated as derived from sources within the United States.

A different rule applies if either the partnership elects, or 25 percent or more of the gross income of the partnership is derived from sources outside the United States. In such case, elections, computations and limitations are made by the partner, as under present law. The partnership reports to the partner creditable foreign taxes and the source of any income, gain, loss or deduction taken into account by the partnership. As under present law, such income is generally treated as passive for separate limitation purposes.

Tax-exempt interest

Under the bill, interest on a State or local bond is treated as taxable (and thus not separately reported) unless at the end of each quarter of the taxable year at least 50 percent of the value of partnership assets consists of State or local bonds the interest on which is exempt from taxation.

Unrelated business taxable income

The bill retains present-law treatment of unrelated business taxable income. Thus, a tax-exempt partner's distributive share of partnership items is taken into account separately to the extent necessary to comply with the rules governing such income. Under the bill, all income from a publicly traded partnership continues to be treated as unrelated business taxable income.

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[9] It is intended that the rehabilitation and low-income housing credits which are subject to the same passive loss rules (i.e., in the case of the low-income housing credit, where the partnership interest was acquired or the property was placed in service before 1990) could be reported together on the same line.

Passive losses

Under the bill, a partner in a large partnership takes into account separately his distributive share of the partnership's taxable income or loss from passive loss limitation activities. The term "passive loss limitation activity" means any activity which involves the conduct of a trade or business (including any activity treated as a trade or business under sec. 469(c)(5) or (6)) and any rental activity. A partner's share of a large partnership's taxable income or loss from passive loss limitation activities is treated as an item of income or loss from the conduct of a trade or business which is a single passive activity, as defined in the passive loss rules. Thus, a large partnership is not required to separately report items from multiple activities.

A partner in a large partnership also takes into account separately his distributive share of the partnership's taxable income or loss from activities other than passive loss limitation activities. Such distributive share is treated as an item of income or expense with respect to property held for investment. Thus, portfolio income (e.g., interest and dividends) is reported separately and is reduced by portfolio deductions and allocable investment interest expense.

Under the bill, income from a publicly traded partnership continues to be treated as portfolio income.

Alternative minimum tax

Under the bill, alternative minimum tax adjustments and preferences are combined at the partnership level. A large partnership would report to partners a net AMT adjustment separately computed for passive loss limitation activities and other activities. In determining a partner's alternative minimum taxable income, a partner's distributive share of any net AMT adjustment is taken into account instead of making separate AMT adjustments with respect to partnership items. Except as provided in regulations, the net AMT adjustment is determined by using the adjustments applicable to individuals, and is treated as a deferral preference for purposes of the section 53 minimum tax credit.

REMICs

For purposes of the tax on partnerships holding residual interests in REMICs, all interests in a large partnership are treated as held by disqualified organizations. Thus, a large partnership holding a residual interest in a REMIC is subject to a tax equal to the excess inclusions multiplied by the highest corporate rate.

Deferred sale treatment for contributed property

In general

For all partners contributing property to a large partnership (including partners otherwise excluded from application of the large partnership rules, as described below), the bill replaces section 704(c) with a "deferred sale" approach. Under the bill, a large partnership is treated as if it had purchased the property from the contributing partner for its then fair market value, thus taking a fair market value basis in the property. The contributing partner's gain

or loss on the contribution (the "precontribution gain or loss") [10] is deferred until the occurrence of specified recognition events. In general, the character of the precontribution gain or loss is the same as if the property had been sold to the partnership by the partner at the time of contribution. The contributing partner's basis in his partnership interest is adjusted for precontribution amounts recognized under the provision. These adjustments generally are made immediately before the recognition event.

The provision effectively repeals the ceiling rule for large partnerships, i.e., the amount of precontribution gain or loss recognized by the contributing partner under the provision is not limited to the overall gain or loss from the contributed property recognized by the partnership. In addition, the amount of depreciation allowable to the partnership is not limited to the contributing partner's basis in the property.

Recognition events

Certain events occurring at either the partnership or partner level cause recognition of precontribution gain or loss. Loss is not recognized, however, by reason of a disposition to a person related (within the meaning of sec. 267(b)) to the contributing partner.

Transactions at partnership level.—The contributing partner recognizes precontribution gain or loss as the partnership claims an amortization, depreciation, or depletion deduction with respect to the property. The amount of gain (or loss) recognized equals the increase (or decrease) in the deduction attributable to changes in basis of the property occurring by reason of its contribution. Any gain or loss so recognized is treated as ordinary.

The contributing partner also recognizes precontribution gain or loss if the partnership disposes of the contributed property to a person other than the contributing partner. If such property is distributed to the contributing partner, its basis in the hands of the contributing partner equals its basis immediately before the contribution, adjusted for any gain or loss previously recognized on account of the deferred sale. No adjustment is made to the basis of undistributed partnership property on account of a distribution to the contributing partner.[11]

Transactions at partner level.—A contributing partner recognizes precontribution gain or loss to the extent that he disposes of his partnership interest other than at death.[12] Such partner also recognizes precontribution gain or loss to the extent that the cash and fair market value of property (other than the contributed property) distributed to him exceeds the adjusted basis of his partnership interest immediately before the distribution (determined without regard to any basis adjustment under the deemed sale rules resulting from the distribution).

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[10] Precontribution gain is the excess of the fair market value of the contributed property at the time of contribution over the adjusted basis of such property immediately before such contribution. Precontribution loss is the excess of the adjusted basis of such property over its fair market value.

[11] Amounts recognized by reason of these recognition events are taken into account in the partner's taxable year in which or with which ends the partnership taxable year of the deduction or disposition.

[12] It is intended that a deceased partner's successor in interest would not recognize any remaining precontribution gain or loss.

Election of optional basis adjustments

Under the bill, a large partnership may still elect to adjust the basis of partnership assets with respect to transferee partners. The computation of a large partnership's taxable income is made without regard to the section 743(b) adjustment. As under present law, the section 743(b) adjustment is made only with respect to the transferee partner. In addition, a large partnership is permitted to adjust the basis of partnership property under section 734(b) if property is distributed to a partner, as under present law.

Terminations

The bill provides that a large partnership does not terminate for tax purposes solely because 50 percent of its interests is sold or exchanged within a 12-month period.

Partnerships and partners subject to large partnership rules

Definition of large partnership

A "large partnership" is any partnership if the number of persons who were partners in such partnership in a taxable year was at least 250.[13] Any partnership treated as a large partnership for a taxable year is so treated for all succeeding years, even if the number of partners falls below 250. Regulations may provide, however, that if the number of persons who are partners in any taxable year falls below 100, the partnership is not treated as a large partnership. Partnerships with at least 100 partners can elect to be treated as if they had 250 partners. The election applies to the year for which made and all subsequent years and cannot be revoked without the Secretary's consent.

A large partnership does not include any partnership if substantially all of its activities involve the performance of personal services by individuals owning, directly or indirectly, interests in the partnership, or if 50 percent or more of the value of the partnership's assets consists of oil or gas properties.

Treatment of excluded partners

In general, the large partnership rules do not apply to an excluded partner's distributive share of partnership items. An excluded partner is any partner (1) owning more than a five percent partnership interest at any time during the taxable year, or (2) materially participating in the partnership's activities during the year and holding any interest which is not a limited partnership interest. Any partner treated as an excluded partner for a taxable year is so treated for all succeeding years. In determining whether a partner is an excluded partner, the treatment on the large partnership's tax return binds the partnership and the partner, but not the Secretary.

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[13] The number of partners is determined by counting only persons directly holding partnership interests in the taxable year; persons holding indirectly (e.g., through another partnership) are not counted. It is not necessary for a partnership to have 250 or more partners at any one time in a taxable year for the partner [illegible]

Treatment of partnerships holding oil or gas properties

As described above, the large partnership rules do not apply to a partnership if at least 50 percent of the value of its assets consists of oil or gas properties.[14] In addition, the rules do not apply to any item attributable to any partnership oil or gas property. However, oil or gas partnerships can elect to be treated as large partnerships. In addition, partnerships owning oil or gas properties but which otherwise qualify as large partnerships (i.e., because less than 50 percent of their assets consists of oil or gas properties) can elect to apply the large partnership rules to items attributable to their oil or gas properties. If either type of partnership makes the election, (1) depletion is computed without regard to percentage depletion, (2) any partner who is an integrated oil company is treated as an excluded partner, and (3) any partner who holds a working interest in an oil or gas property (either directly or through an entity which does not limit the partner's liability) is treated as an excluded partner with respect to such interest. The election applies to the year for which made and all subsequent years, and cannot be revoked without the Secretary's consent.

Regulatory authority

The Secretary of the Treasury is granted authority to prescribe such regulations as may be appropriate to carry out the purposes of the provisions.

Effective Date

The provisions generally apply to partnership taxable years ending on or after December 31, 1992. The deferred sale provision applies to any contribution of property (other than cash) made on or after January 1, 1992, to a partnership which is, or is reasonably expected to become, a large partnership.

2. Simplified audit procedures for large partnerships (sec. 202 of the bill and secs. 6240, 6241, 6242, 6245, 6246, 6247, 6249, 6251, 6252, 6255, and 6256 of the Code)

Present Law

In general

Prior to 1982, a partnership (regardless of its size) was audited only by auditing each partner individually. Because a large partnership sometimes had many partners located in different audit districts, adjustments to items of income, gains, losses, deductions, or credits of the partnership had to be made in numerous actions in several jurisdictions, sometimes with conflicting outcomes.

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") established unified audit rules applicable to all but certain small (10 or fewer partners) partnerships. These rules require the determination of all "partnership items" at the partnership, rather than the partner, level. Partnership items are those items that are more

[14] For this purpose, oil or gas properties means the mineral interests in oil or gas which are of a character with respect to which a deduction for depletion is allowable under section 611.

appropriately determined at the partnership level than at the partner level, as provided by regulations.

Administrative proceedings

Under the TEFRA rules, a partner must report all partnership items consistently with the partnership return or must notify the IRS of any inconsistency. If a partner fails to report any partnership item consistently with the partnership return, the IRS may make a computational adjustment and immediately assess any additional tax that results.

The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. But the IRS must still assess any resulting deficiency against each of the taxpayers who were partners in the year in which the understatement of tax liability arose.

Any partner of a partnership can request an administrative adjustment or a refund for his own separate tax liability. Any partner also has the right to participate in partnership-level administrative proceedings. A settlement agreement with respect to partnership items binds all parties to the settlement.

Tax Matters Partner

The TEFRA rules establish the "Tax Matters Partner" as the primary representative of a partnership in dealings with the IRS. The Tax Matters Partner is a general partner designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year. If no Tax Matters Partner is designated, and it is impractical to apply the largest profits interest rule, the IRS may select any partner as the Tax Matters Partner.

Notice requirements

The IRS generally is required to give notice of the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to all partners whose names and addresses are furnished to the IRS. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to partners whose profits interest is less than one percent.

Adjudication of disputes concerning partnership items

After the IRS makes an administrative adjustment, the Tax Matters Partner (and, in limited circumstances, certain other partners) may file a petition for readjustment of partnership items in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court.

Statute of limitations

The IRS generally cannot adjust a partnership item for a partnership taxable year if more than 3 years have elapsed since the later of the filing of the partnership return or the last day for the filing of the partnership return.

Reasons for Simplification

Present audit procedures for large partnerships are inefficient and more complex than those for other large entities. The IRS must assess any deficiency arising from a partnership audit against a large number of partners, many of whom cannot easily be located (some may no longer be partners). In addition, audit procedures are cumbersome and can be complicated further by the intervention of partners acting individually.

Explanation of Provision

In general

The bill creates a new audit system for large partnerships. The bill defines "large partnership" the same way for audit and reporting purposes (generally partnerships with at least 250 partners) except that certain oil and gas partnerships are large partnerships for the audit rules that are not subject to the large partnership reporting requirements.[15]

As under present law, large partnerships and their partners are subjected to unified audit rules. Partnership items are determined at the partnership, rather than the partner, level. The term "partnership items" is defined as under present law.

Unlike present law, however, partnership adjustments generally will flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners will adjust their current-year share of partnership items of income, gains, losses, deductions, or credits to reflect partnership adjustments that take effect in that year. The adjustments generally will not affect prior year returns of any partners (except in the case of changes to any partner's distributive shares).

In lieu of flowing an adjustment through to its partners, the partnership may elect to pay an imputed underpayment. The imputed underpayment generally is calculated by netting the adjustments to the income and loss items of the partnership and multiplying that amount by the highest individual or corporate tax rate. A partner may not file a claim for credit or refund of his allocable share of the payment.

Regardless of whether a partnership adjustment flows through to the partners, an adjustment must be offset if it requires another adjustment in a year after the adjusted year and before the year the offsetted adjustment takes effect. For example, if a partnership expensed a $1,000 item in year 1, and it was determined in year 4 that the item should have been capitalized and amortized ratably over 10 years, the adjustment in year 4 would be $600, apart from any interest or penalty. (The $1,000 adjustment for the improper deduction is offset by $400 of adjustments for amortization deductions.) The year 4 partners would be required ratably to include an additional $600 in income for that year.

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[15] The bill also excludes from the audit provisions partners who are excluded from the reporting rules. Such a partner who is excluded from the audit rules, however, is excluded only to the extent his or her interest in the partnership in the year in which an adjustment took effect does not exceed his or her interest in the partnership taxable year to which the adjustment related.

In addition, the partnership, rather than the partners individually, generally is liable for any interest and penalties that result from a partnership adjustment. Interest is computed for the period beginning on the return due date for the adjusted year and ending on the earlier of the return due date for the partnership taxable year in which the adjustment takes effect or the date the partnership pays the imputed underpayment. Thus, in the above example, the partnership would be liable for 4 years worth of interest (on a declining principal amount).

Penalties (such as the accuracy and fraud penalties) are determined on a year-by-year basis (without offsets) based on an imputed underpayment. All accuracy penalty criteria and waiver criteria (such as reasonable cause, substantial authority, etc.) are determined as if the partnership were a taxable individual. Accuracy and fraud penalties are assessed and accrue interest in the same manner as if asserted against a taxable individual.

If a partnership ceases to exist before a partnership adjustment takes effect, the former partners are required to take the adjustment into account, as provided by regulations. Regulations are also authorized to the extent necessary to prevent abuse and to enforce efficiently the audit rules in circumstances that present special enforcement considerations (such as partnership bankruptcy).

Administrative proceedings

Under the large partnership audit rules, a partner is not permitted to report any partnership items inconsistently with the partnership return, even if the partner notifies the IRS of the inconsistency. The IRS could treat a partnership item that was reported inconsistently by a partner as a mathematical or clerical error and immediately assess any additional tax against that partner.

As under present law, the IRS could challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Unlike present law, however, partners will have no right individually to participate in settlement conferences or to request a refund.

Partnership representative

The bill requires each large partnership to designate a partner or other person to act on its behalf. If a large partnership fails to designate such a person, the IRS is permitted to designate any one of the partners as the person authorized to act on the partnership's behalf. After the IRS' designation, a large partnership could still designate a replacement for the IRS-designated partner.

Notice requirements

Unlike present law, the IRS is not required to give notice to individual partners of the commencement of an administrative proceeding or of a final adjustment. Instead, the IRS is authorized to send notice of a partnership adjustment to the partnership itself by certified or registered mail. The IRS could give proper notice by mailing the notice to the last known address of the partnership, even if the partnership had terminated its existence.

Adjudication of disputes concerning partnership items

As under present law, an administrative adjustment could be challenged in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court. However, only the partnership, and not partners individually, can petition for a readjustment of partnership items.

Statute of limitations

Absent an agreement to extend the statute of limitations, the IRS generally could not adjust a partnership item of a large partnership more than 3 years after the later of the filing of the partnership return or the last day for the filing of the partnership return. Special rules apply to false or fraudulent returns, a substantial omission of income, or the failure to file a return. The IRS would assess and collect any deficiency of a partner that arises from any adjustment to a partnership item subject to the limitations period on assessments and collection applicable to the year the adjustment takes effect (secs. 6248, 6501 and 6502).

Effective Date

The provision applies to partnership taxable years ending on or after December 31, 1992.

3. Partnership returns on magnetic media (sec. 203 of the bill and sec. 6011 of the Code)

Present Law

Partnerships are permitted, but not required, to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K-1), to the Internal Revenue Service on magnetic media.

Reasons for Simplification

Most entities that file large numbers of documents with the Internal Revenue Service must do so on magnetic media. Conforming the reporting provisions for large partnerships to the generally applicable information reporting rules will facilitate integration of partnership information into already existing data systems.

Explanation of Provision

The bill authorizes the Internal Revenue Service to require large partnerships, and other partnerships with 250 or more partners, to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K-1), to the Internal Revenue Service on magnetic media.

Effective Date

The provision applies to partnership taxable years ending on or after December 31, 1992.

B. Partnership Proceedings Under TEFRA [16]

1. Clarify the treatment of partnership items in deficiency proceedings (sec. 211 of the bill and sec. 6234 of the Code)

Present Law

TEFRA partnership proceedings must be kept separate from deficiency proceedings involving the partners in their individual capacities. Prior to the Tax Court's opinion in *Munro v. Commissioner*, 92 T.C. 71 (1989), the IRS computed deficiencies by assuming that all items that were subject to the TEFRA partnership procedures were correctly reported on the taxpayer's return. However, where the losses claimed from TEFRA partnerships were so large that they offset any proposed adjustments to nonpartnership items, no deficiency could arise from a non-TEFRA proceeding and if the partnership losses were subsequently disallowed in a partnership proceeding, the non-TEFRA adjustments might be uncollectible because of the expiration of the statute of limitations with respect to nonpartnership items.

Faced with this situation in *Munro*, the IRS issued a notice of deficiency to the taxpayer that presumptively disallowed the taxpayer's TEFRA partnership losses for computational purposes only. Although the Tax Court ruled that a deficiency existed and that the court had jurisdiction to hear the case, the court disapproved of the methodology used by the IRS to compute the deficiency. Specifically, the court held that partnership items (whether income, loss, deduction, or credit) included on a taxpayer's return must be completely ignored in determining whether a deficiency exists that is attributable to nonpartnership items.

Reasons for Simplification

The opinion in *Munro* creates problems for both taxpayers and the IRS. For example, a taxpayer would be harmed in the case where he has invested in a TEFRA partnership and is also subject to the deficiency procedures with respect to nonpartnership item adjustments, since computing the tax liability without regard to partnership items will have the same effect as if the partnership items were disallowed. If the partnership items were losses, the effect will be a greatly increased deficiency for the nonpartnership items. If, when the partnership proceeding is completed, the taxpayer is ultimately allowed any part of the losses, the taxpayer will receive part of the increased deficiency back in the form of an overpayment. However, in the interim, the taxpayer will have been subject to assessment and collection of a deficiency inflated by items still in dispute in the partnership proceeding. In essence, a taxpayer in such a case would be deprived of a prepayment forum with respect to the partnership item adjustments. The IRS would be harmed if a taxpayer's income is primarily from a TEFRA partnership, since the IRS may be unable to adjust nonpartnership items such as medical expense deductions, home mortgage interest deductions or charitable contribution deductions because there

[16] Tax Equity and Fiscal Responsibility Act of 1982.

would be no deficiency since, under *Munro*, the income must be ignored.

Explanation of Provision

The bill is intended to overrule *Munro* and allow the IRS to return to its prior practice of computing deficiencies by assuming that all TEFRA items whose treatment has not been finally determined had been correctly reported on the taxpayer's return. This will eliminate the need to do special computations that involve the removal of TEFRA items from a taxpayer's return, and will restore to taxpayers a prepayment forum with respect to the TEFRA items. In addition, the bill provides a special rule to address the factual situation presented in *Munro*.

Specifically, the bill provides a declaratory judgment procedure in the Tax Court for adjustments to an oversheltered return. An oversheltered return is a return that shows no taxable income and a net loss from TEFRA partnerships. In such a case, the IRS is authorized to issue a notice of adjustment with respect to non-TEFRA items, notwithstanding that no deficiency would result from the adjustment. However, the IRS may only issue such a notice if a deficiency would have arisen in the absence of the net loss from TEFRA partnerships.

The Tax Court would be granted jurisdiction to determine the correctness of such an adjustment. No tax would be due upon such a determination, but a decision of the Tax Court would be treated as a final decision, permitting an appeal of the decision by either the taxpayer or the IRS. An adjustment determined to be correct would thus have the effect of increasing the taxable income that would be deemed to have been reported on the taxpayer's return. If the taxpayer's partnership items were then adjusted in a subsequent proceeding, the IRS would have preserved its ability to collect tax on any increased deficiency attributable to the nonpartnership items.

Alternatively, if the taxpayer chooses not to contest the notice of adjustment within the 90-day period, the bill provides that when the taxpayer's partnership items are finally determined, the taxpayer has the right to file a refund claim for tax attributable to the items adjusted by the earlier notice of adjustment for the taxable year. Although a refund claim is not generally permitted with respect to a deficiency arising from a TEFRA proceeding, such a rule is appropriate with respect to a defaulted notice of adjustment because taxpayers may not challenge such a notice when issued since it does not require the payment of additional tax.

In addition, the bill incorporates a number of provisions intended to clarify the coordination between TEFRA audit proceedings and individual deficiency proceedings. Under these provisions, any adjustment with respect to a non-partnership item that caused an increase in tax liability with respect to a partnership item would be treated as a computational adjustment and assessed after the conclusion of the TEFRA proceeding. Accordingly, deficiency procedures would not apply with respect to this increase in tax liability, and the statute of limitations applicable to TEFRA proceedings would be controlling.

Effective Date

The provision is effective for partnership taxable years ending after the date of the enactment of this Act.

2. Permit the IRS to rely on partnership returns to determine the proper audit procedures (sec. 212 of the bill and sec. 6231 of the Code)

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership items is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Reasons for Simplification

The IRS often finds it difficult to determine whether to follow the TEFRA partnership procedures or the regular deficiency procedures. If the IRS determines that there were fewer than 10 partners in the partnership but was unaware that one of the partners was a nonresident alien or that there was a special allocation made during the year, the IRS might inadvertently apply the wrong procedures and possibly jeopardize any assessment. Permitting the IRS to rely on a partnership's return would simplify the IRS' task.

Explanation of Provision

The bill permits the IRS to apply the TEFRA audit procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply. Similarly, the bill permits the IRS to apply the normal deficiency procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply.

Effective Date

The provision is effective for partnership taxable years ending after the date of the enactment of this Act.

3. Suspend statute of limitations during bankruptcy proceedings (sec. 213 of the bill and sec. 6229 of the Code)

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6503(h) provides for the suspension of the limitations period during the pendency of a bankruptcy proceeding. However, this provision only applies to the limitations periods provided in sections 6501 and 6502.

Under present law, because the suspension provision in section 6503(h) applies only to the limitations periods provided in section 6501 and 6502, some uncertainty exists as to whether section 6503(h) applies to suspend the limitations period pertaining to converted items provided in section 6229(f) when a petition naming a partner as a debtor in a bankruptcy proceeding is filed. As a result, the limitations period provided in section 6229(f) may continue to run during the pendency of the bankruptcy proceeding, notwithstanding that the IRS is prohibited from making an assessment against the debtor because of the automatic stay provisions of the Bankruptcy Code.

Reasons for Simplification

The ambiguity in present law makes it difficult for the IRS to adjust partnership items that convert to nonpartnership items by reason of a partner going into bankruptcy. In addition, any uncertainty may result in increased requests for the bankruptcy court to lift the automatic stay to permit the IRS to make an assessment with respect to the converted items.

Explanation of Provision

The bill clarifies that the statute of limitations is suspended for a partner who is named in a bankruptcy petition. The suspension period is for the entire period during which the IRS is prohibited by reason of the bankruptcy proceeding from making an assessment, and for 60 days thereafter. The provision is not intended to create any inference as to the proper interpretation of present law.

Effective Date

The provision shall take effect as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

4. Expand small partnership exception from TEFRA (sec. 214 of the bill and sec. 6231 of the Code)

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Reasons for Simplification

The mere existence of a C corporation as a partner or of a special allocation does not warrant subjecting the partnership and its partners of an otherwise small partnership to the TEFRA procedures.

Explanation of Provision

The bill permits a small partnership to have a C corporation as a partner or to specially allocate items without jeopardizing its exception from the TEFRA rules. However, the bill retains the prohibition of present law against having a flow-through entity (other than an estate of a deceased partner) as a partner for purposes of qualifying for the small partnership exception.

Effective Date

The provision is effective for partnership taxable years ending after the date of the enactment of this Act.

5. Exclude partial settlements from 1-year assessment rule (sec. 215 of the bill and sec. 6229(f) of the Code)

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6231(b)(1)(C) provides that the partnership items of a partner for a partnership taxable year become nonpartnership items as of the date the partner enters into a settlement agreement with the IRS with respect to such items.

Reasons for Simplification

When a partial settlement agreement is entered into, the assessment period for the items covered by the agreement may be different than the assessment period for the remaining items. This fractured statute of limitations poses a significant tracking problem for the IRS and necessitates multiple computations of tax with respect to each partner's investment in the partnership for the taxable year.

Explanation of Provision

The bill provides that if a partner and the IRS enter into a settlement agreement with respect to some but not all of the partnership items in dispute for a partnership taxable year and other partnership items remain in dispute, the period for assessing any tax attributable to the settled items would be determined as if such agreement had not been entered into. Consequently, the limitations period that is applicable to the last item to be resolved for the partnership taxable year shall be controlling with respect to all disputed partnership items for the partnership taxable year. The provision is not intended to create any inference as to the proper interpretation of present law.

Effective Date

The provision is effective for partnership taxable years ending after the date of the enactment of this Act.

6. Extend time for filing a request for administrative adjustment (sec. 216 of the bill and sec. 6227 of the Code)

Present Law

The non-TEFRA statute of limitations provides that if a statute extension agreement is entered into, that agreement also extends the statute of limitations for filing refund claims (sec. 6511(c)). There is no comparable provision for extending the time for filing refund claims with respect to partnership items subject to the TEFRA partnership rules.

Reasons for Simplification

The absence of an extension for filing refund claims in TEFRA proceedings hinders taxpayers that may want to agree to extend the TEFRA statute of limitations but want to preserve their option to file a refund claim later.

Explanation of Provision

The bill provides that if a TEFRA statute extension agreement is entered into, that agreement also extends the statute of limitations for filing refund claims until 6 months after the expiration of the limitations period for assessments.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

7. Provide innocent spouse relief for TEFRA proceedings (sec. 217 of the bill and sec. 6230 of the Code)

Present Law

In general, an innocent spouse may be relieved of liability for tax, penalties and interest if certain conditions are met (sec. 6013(e)). However, existing law does not provide the spouse of a partner in a TEFRA partnership with a judicial forum to raise the innocent spouse defense with respect to any tax or interest that relates to an investment in a TEFRA partnership.

Reasons for Simplification

Providing a forum in which to raise the innocent spouse defense with respect to liabilities attributable to adjustments to partnership items (including penalties, additions to tax and additional amounts) would make the innocent spouse rules more uniform.

Explanation of Provision

The bill provides both a prepayment forum and a refund forum for raising the innocent spouse defense in TEFRA cases.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

8. Determine penalties at the partnership level (sec. 218 of the bill and sec. 6221 of the Code)

Present Law

Partnership items include only items that are required to be taken into account under the income tax subtitle. Penalties are not partnership items since they are contained in the procedure and administration subtitle. As a result, penalties may only be asserted against a partner through the application of the deficiency procedures following the completion of the partnership-level proceeding.

Reasons for Simplification

Many penalties are based upon the conduct of the taxpayer. With respect to partnerships, the relevant conduct often occurs at the partnership level. In addition, applying penalties at the partner level through the deficiency procedures following the conclusion of the unified proceeding at the partnership level increases the administrative burden on the IRS and can significantly increase the Tax Court's inventory.

Explanation of Provision

The bill provides that the partnership level proceeding is to include a determination of the applicability of penalties at the partnership level. However, the bill allows partners to raise any partner-level defenses in a refund forum.

Effective Date

The provision is effective for partnership taxable years ending after December 31, 1991.

9. Clarify jurisdiction of the Tax Court (sec. 219 of the bill and secs. 6225 and 6226 of the Code)

Present Law

Improper assessment and collection activities by the IRS during the 150-day period for filing a petition or during the pendency of any Tax Court proceeding, "may be enjoined in the proper court." Present law may be unclear as to whether this includes the Tax Court.

For a partner other than the Tax Matters Partner to be eligible to file a petition for redetermination of partnership items in any court or to participate in an existing case, the period for assessing

any tax attributable to the partnership items of that partner must not have expired. Since such a partner would only be treated as a party to the action if the statute of limitations with respect to them was still open, the law is unclear whether the partner would have standing to assert that the statute of limitations had expired with respect to them.

Reasons for Simplification

Clarifying the Tax Court's jurisdiction simplifies the resolution of tax cases.

Explanation of Provision

The bill clarifies that an action to enjoin premature assessments of deficiencies attributable to partnership items may be brought in the Tax Court. The bill also permits a party to appear before a court for the sole purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired for that person.

Effective Date

The provision is effective for partnership taxable years ending after the date of the enactment of this Act.

10. Treatment of premature petitions filed by certain partners (sec. 220 of the bill and sec. 6226 of the Code)

Present Law

The Tax Matters Partner is given the exclusive right to file a petition for a readjustment of partnership items within the 90-day period after the issuance of the notice of a final partnership administrative adjustment (FPAA). If the Tax Matters Partner does not file a petition within the 90-day period, certain other partners are permitted to file a petition within the 60-day period after the close of the 90-day period. There are ordering rules for determining which action goes forward and for dismissing other actions.

Reasons for Simplification

A petition that is filed within the 90-day period by a person who is not the Tax Matters Partner is dismissed. Thus, if the Tax Matters Partner does not file a petition within the 90-day period and no timely and valid petition is filed during the succeeding 60-day period, judicial review of the adjustments set forth in the notice of FPAA is foreclosed and the adjustments are deemed to be correct.

Explanation of Provision

The bill treats premature petitions filed by certain partners within the 90-day period will be treated as being filed on the last day of the following 60-day period under specified circumstances, thus affording the partnership with an opportunity for judicial review that is not available under present law.

Effective Date

The bill is effective with respect to petitions filed after the date of the enactment of this Act.

11. Clarify bond requirement for appeals from TEFRA proceedings (sec. 221 of the bill and sec. 7485 of the Code)

Present Law

A bond must be filed to stay the collection of deficiencies pending the appeal of the Tax Court's decision in a TEFRA proceeding. The amount of the bond must be based on the court's estimate of the aggregate deficiencies of the partners.

Reasons for Simplification

The Tax Court cannot easily determine the aggregate changes in tax liability of all of the partners in a partnership who will be affected by the Court's decision in the proceeding. Clarifying the calculation of the bond amount would simplify the Tax Court's task.

Explanation of Provision

The bill clarifies that the amount of the bond should be based on the Tax Court's estimate of the aggregate liability of the parties to the action (and not all of the partners in the partnership).

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

12. Suspend interest where there is a delay in computational adjustment resulting from TEFRA settlements (sec. 222 of the bill and sec. 6601 of the Code)

Present Law

Interest on a deficiency generally is suspended when a taxpayer executes a settlement agreement with the IRS and waives the restrictions on assessments and collections and the IRS does not issue a notice and demand for payment of such deficiency within 30 days. Interest on a deficiency that results from an adjustment of partnership items in TEFRA proceedings, however, is not suspended.

Reasons for Simplification

Processing settlement agreements and assessing the tax due takes a substantial amount of time in TEFRA cases. A taxpayer is not afforded any relief from interest during this period.

Explanation of Provision

The bill suspends interest where there is a delay in a computational adjustment resulting from TEFRA settlements.

Effective Date

The provision is effective with respect to settlements entered into after December 31, 1991.

Title III.— Foreign Provisions

1. Deferral of tax on income earned through foreign corporations and exceptions to deferral (secs. 301-304 of the bill and secs. 453, 532, 535, 542, 543, 551-558, 563, 954, 1246-1247, and 1291-1297 of the Code)

Present Law

U.S. citizens and residents and U.S. corporations (collectively, "U.S. persons") are taxed currently by the United States on their worldwide income, subject to a credit against U.S. tax on foreign income based on foreign income taxes paid with respect to such income. Income earned by a foreign corporation, the stock of which is owned in whole or in part by U.S. persons, generally is not taxed by the United States until the foreign corporation repatriates that income by payment to its U.S. stockholders. The U.S. stockholders are subject to U.S tax on the repatriated income at that time. Foreign tax credits may reduce the U.S. tax.

Since 1937, the Code has set forth one or more regimes providing exceptions to the general rule deferring U.S. tax on income earned indirectly through a foreign corporation. These regimes currently include the controlled foreign corporation (or subpart F) rules (secs. 951-964); the foreign personal holding company rules (secs. 551-558); passive foreign investment company (PFIC) rules (secs. 1291-1297); the personal holding company rules (secs. 541-547); the accumulated earnings tax (secs. 531-537); and rules for foreign investment companies (sec. 1246) and electing foreign investment companies (sec. 1247). These regimes have multiple and overlapping application to foreign corporations owned in whole or in part by U.S. persons.

Reasons for Simplification

Some of the different anti-deferral regimes were enacted or modified at different times and reflect historically different Congressional policies. Different regimes provide different thresholds (either by type of income or asset at the foreign corporation level, or of U.S. stock ownership at the shareholder level) to their application. They provide for different mechanisms by which U.S. stockholders are denied the benefits of deferral. Some of the regimes have features directed at policy goals applicable to foreign corporations owned by U.S. corporations (e.g., the allowance of indirect foreign tax credits); others have features primarily directed at issues applicable to foreign corporations owned by U.S. individuals (e.g., the basis of property acquired from a decedent). Some regimes preserve the character of the income earned in the hands of a foreign corporation while others do not. Some provide for movement of losses between years of a single foreign corporation or between

multiple corporations while others do not. While a consistent theme of these regimes is to provide current taxation for certain types of interest, dividend, rental, royalty, and other similar income, the different regimes apply different criteria to these items of income to determine their current inclusion or noninclusion. Different regimes have different ordering rules for determining which dividends from foreign corporations subject to the regimes are subject to tax on repatriation and which are simply distributions of previously taxed income.

Simply because of the differences among the various anti-deferral regimes, U.S. taxpayers frequently are faced with the need to consult multiple sets of anti-deferral rules when they hold stock in a foreign corporation.

Moreover, the interactions of the rules cause additional complexity. There is significant overlap among the several regimes. This overlap requires the Code to provide specific rules of priority for income inclusions among the regimes, as well as additional coordination provisions pertaining to other operational differences among the several regimes. The overlapping or multiple application of anti-deferral regimes to a single corporation can result in significant additional complexity with little or no ultimate tax consequences.

Consolidation of the several anti-deferral regimes can achieve two major types of simplification. First, by reducing the number of separate definitions of entities among the anti-deferral regimes, taxpayers can be spared the burden of understanding and complying with a multiplicity of separate anti-deferral regimes with separate definitions and requirements.

Second, from an operational perspective, the number of anti-deferral regimes that can apply to any one shareholder in a foreign corporation can be reduced to one. As discussed above, the operational differences, including the overlapping applicability of the six present-law anti-deferral regimes, is a source of complexity. Under a consolidated regime, however, deferral can be denied for many corporations (whether in full or in part) solely through the provisions of subpart F. In the case of a controlled foreign corporation, for example, being subject to the rules for full denial of deferral (such as the PFIC or foreign personal holding company provisions under present law) can result in no additional compliance burdens or administrative or operational complexity.

Another source of complexity under present law is the need for shareholders of controlled foreign corporations to make "protective" current-inclusion elections in order to avoid adverse future consequences under the interest-charge method should the controlled foreign corporation also prove to be a PFIC.[17] By replacing elective current-inclusion treatment for PFICs that are also controlled foreign corporations by mandatory current inclusion through subpart F for passive foreign corporations that are also controlled foreign corporations, a consolidated regime can eliminate both the burdens of making protective elections and the risks of failing to do so.

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[17] For example, the "once a PFIC always a PFIC" rule of sec. 1297(b)(1) does not apply to shareholders that make current-inclusion elections.

It is understood that the interest-charge method of the present-law PFIC rules is a significant source of complexity both separately and in its interaction with other provisions of the Code. Even without eliminating the interest-charge method, significant simplification can be achieved by minimizing the number of taxpayers that may be subject to the method and by making certain modifications that may reduce the complexity engendered by the interest-charge method.

Explanation of Provision

In general

The bill replaces the separate anti-deferral regimes of present law with a unified set of rules providing for either partial or full elimination of deferral depending on the circumstances. The bill preserves the present-law approach under which partial current taxation is a function of the type of income earned by the foreign corporation and a level of U.S. ownership in the corporation exceeding some threshold (as currently embodied in subpart F). The bill also preserves the present-law approach under which full current taxation is a function of a type of income or assets of the corporation exceeding some threshold (as currently embodied in subpart F, the PFIC rules, and the foreign personal holding company rules). The bill eliminates regimes that are redundant or marginally applicable, and ensures that no more than one set of rules will ever apply to a shareholder's interest in any one corporation in any one year.

Generally, the bill retains the subpart F rules as the foundation of its unified anti-deferral regime (with certain modifications described below and also in item 2., following, describing secs. 311-313 of the bill). It includes a modified version of the PFIC rules while eliminating the other regimes as redundant to one or the other. The bill's unified anti-deferral regime sets forth various thresholds for subjecting U.S. persons to full or partial inclusions of corporate income. In addition, where deferral is eliminated by U.S. shareholder inclusions of foreign corporate-level income, the bill applies a single set of rules (the subpart F rules) for basis adjustments, characterization of actual distributions, foreign tax credits, and similar issues. As under present law, the bill in some cases affords U.S. persons owning stock in foreign corporations a choice of technique for recognizing income from the elimination of deferral. However, in a greater number of cases than under present law, the bill provides only one method of eliminating deferral.

Replacement of current law regimes for full elimination of deferral

The bill creates a single definition of a passive foreign corporation (PFC) that will unify and replace the foreign personal holding company and PFIC definitions. The rules applicable to PFCs represent a hybrid of characteristics of the foreign personal holding company rules, the PFIC rules, and the controlled foreign corporation rules (subpart F), plus a new mark-to-market regime, as well as a variety of simplifying or technical changes to rules under the existing systems. The following discussion explains the differences be-

tween the PFIC provisions of present law and the PFC provisions that will be applicable under the bill.

A PFC is any foreign corporation if (1) 60 percent or more of its gross income is passive income, (2) 50 percent or more of its assets (on average during the year, measured by value) produce passive income or are held for the production of passive income, or (3) it is registered under the Investment Company Act of 1940 (as amended) either as a management company or as a unit investment trust.[18] As under the PFIC rules, the foreign corporation is permitted to elect to measure its assets based on their adjusted basis rather than their value.

As under present law, passive income for this purpose is defined in the bill generally as any income of a kind which would be foreign personal holding company income as defined in section 954(c), subject to the current law exceptions for banking and insurance income and the current look-through rules for certain payments from related persons (current sec. 1296(b)(2)).[19] In addition, the bill provides two clarifications to present law. First, the bill clarifies that, as indicated in the legislative history of the 1988 Act, the same-country exceptions from the definition of foreign personal holding company income in section 954(c) are disregarded.[20] Second, the bill clarifies that any foreign trade income of a foreign sales corporation does not constitute passive income for purposes of the PFIC definition (*cf.* sec. 951(e)).

The bill modifies the present law application of the asset test by treating certain leased property as assets held by the foreign corporation for purposes of the PFC asset test. This rule applies to tangible personal property with respect to which the foreign corporation is the lessee under a lease with a term of at least 12 months.

The bill also modifies the present law rules that provide an exception from the definition of a PFIC in the case of a company changing businesses. Under the bill, if a foreign corporation holds 25 percent or more of the stock of a second corporation that qualifies for the change-of-business exception (current sec. 1297(b)(3)), then in applying the look-though rules (current sec. 1296(c)), the first corporation may treat otherwise passive assets or income of the second corporation as active.[21]

The bill generally retains those provisions of current law the application of which depends upon whether a foreign corporation was a PFIC for years after 1986 (e.g., current sec. 1291(d)), but modifies these provisions to test whether the foreign corporation was a PFC

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[18] It is understood that a mutual insurance company could be treated under the bill and under present law as a passive foreign corporation, notwithstanding the fact that such a company does not actually issue "stock."

[19] Thus, the bill retains the exception for income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation. It is intended that in determining whether a corporation is "predominantly engaged" for this purpose, the Secretary may require a higher standard or threshold than the definition of an insurance company under Treasury Regulations section 1.801-3(a).

[20] H.R. Rep. No. 100-795, 100th Cong., 2d Sess. 272 (1988); S. Rep. No. 100-445, 100th Cong., 2d Sess. 285 (1988).

[21] The bill retains the present law rules that provide an exception from the definition of a PFIC in the case of a start-up company (current sec. 1297(b)(2)). Under the bill, the start-up company exception is intended to be applied, where necessary to carry out the purposes of the PFC rules, by treating as one corporation all related foreign corporations that transferred assets to the start-up company.

for years after 1986. As a transitional definition, the bill provides that a foreign corporation that was treated as a PFIC for any taxable year beginning before the introduction of the bill is treated as having been a PFC for each such year.

The bill provides a new election that will allow certain passive foreign corporations to be treated as domestic corporations. A foreign corporation is eligible to make this election if (1) it would qualify for treatment as a regulated investment company (RIC) under the relevant provisions of the Code if it actually were a domestic corporation, (2) it meets such requirements as the Secretary may prescribe to ensure the collection of taxes imposed by the Internal Revenue Code on the passive foreign corporation, and (3) the electing passive foreign corporation waives all benefits which are granted by the United States under any treaty (including treaties other than tax treaties) and to which the corporation is otherwise entitled by reason of being a resident of another country. The rules governing such an election will be similar to those applicable to the election by a foreign insurance company to be treated as a domestic corporation under section 953(d).

The bill provides a special rule regarding the application of the PFC rules to tax-exempt organizations that own stock in passive foreign corporations. The passive foreign corporation rules, under the bill, have no application at all to any organization exempt from tax under section 501, unless the organization is subject to unrelated business income taxation on its investment income under section 512(a)(3) of the Code. In the case of a tax-exempt organization that is subject to tax on its investment income, the PFC rules apply with respect to amounts taken into account in computing unrelated business taxable income in the same manner as if the organization were fully taxable.

Tax treatment under full elimination of deferral

The benefits of deferral are eliminated with respect to the income of a PFC under three alternative methods: current inclusion, mark-to-market, or interest charge on excess distributions.

Current inclusion method

Mandatory current inclusion.—If a passive foreign corporation is U.S. controlled, the bill will subject every U.S. person owning (directly or indirectly) stock in the PFC to income inclusions under a modified version of the controlled foreign corporation rules. If a PFC is not U.S. controlled, every U.S. person owning (directly or indirectly) 25 percent or more of the vote or value of the stock of the PFC will be subject to the same rules. Under the bill, the entire gross income of the passive foreign corporation (subject to applicable deductions) is treated as foreign personal holding company income, and thus is included (net of appropriate deductions) on a pro rata basis in the income of each U.S. person directly or indirectly owning stock in the PFC, under a modified application of the rules of sections 951 and 961. Actual distributions of earnings by such a PFC are treated similarly to distributions of previously taxed income under sections 959 and 961. These rules supersede all application of the present-law rules applicable to foreign personal holding companies, under which earnings are deemed distributed

and then contributed to the capital of the foreign personal holding company.

In applying the subpart F inclusion rules to PFC inclusions, the bill departs from subpart F in that foreign personal holding company income is included in the income of U.S. persons without regard to otherwise applicable reductions pursuant to the high-tax exception (under sec. 954(b)(4)) or the export trade corporation rules (secs. 970 and 971). This modification to the application of the controlled foreign corporation rules preserves present law in that no high-tax exception generally is available to PFICs or foreign personal holding companies, and that the PFIC provisions apply in full force to export trade corporations.

A passive foreign corporation is treated under the bill as U.S. controlled for this purpose either if it would be treated as a controlled foreign corporation under the rules of subpart F, or if, at any time during the taxable year, more than 50 percent of the vote or value of the corporation's stock were owned directly or indirectly by five or fewer U.S. persons (including but not limited to individuals, and including all U.S. citizens regardless of their residence). Indirect stock ownership under the bill generally refers to stock ownership through foreign entities within the meaning of section 958(a)(2). In addition, for the purpose of determining whether a foreign corporation is U.S. controlled by virtue of the ownership of more than 50 percent of its stock by five or fewer U.S. persons, the constructive ownership principles of the present-law foreign personal holding company rules apply.

Elective current inclusion.—A U.S. person not subject to the above mandatory current inclusion rules—that is, a U.S. person owning less than 25 percent of the stock in a PFC that is not U.S. controlled—may elect application of those rules. As under current law, the PFC is characterized as a "qualified electing fund" with respect to such a U.S. person. In the application of the elective current-inclusion rules, the passive foreign corporation is treated as a controlled foreign corporation with respect to the taxpayer, and the taxpayer is treated as a U.S. shareholder of the corporation. For foreign tax credit purposes, amounts included in the taxpayer's gross income under this modified application of the controlled foreign corporation rules are treated as dividends received from a foreign corporation which is not a controlled foreign corporation.

The application and operation of the shareholder-level election for treatment as a qualified electing fund generally are the same as under the present-law PFIC rules. It is intended that, in the case of PFC stock owned through a foreign partnership, a partner-level election for treatment as a qualified electing fund will be permitted (except in the case of a foreign partnership that is subject to the simplified reporting rules available to certain large partnerships under title II of the bill).

Mark-to-market method

Less-than-25-percent shareholders of passive foreign corporations that are not U.S.-controlled, and who do not elect current inclusion ("nonelecting shareholders"), are subject under the bill to one of two methods for taxing the economic equivalent of the PFC's cur-

rent income: the mark-to-market method or the interest-charge method.

Under the bill, nonelecting shareholders of a PFC with marketable stock are required to mark their PFC shares to market annually. Under the mark-to-market method, the U.S. person is required to include in gross income each taxable year an amount equal to the excess (if any) of the fair market value of the PFC stock as of the close of the taxable year over the adjusted basis of the stock. In the event the adjusted basis of the stock exceeds its fair market value, the U.S. person is allowed a deduction for the taxable year equal to the lesser of the amount of the excess or the "unreversed inclusions" with respect to the stock. The bill defines the term "unreversed inclusions" to mean, with respect to any stock in a passive foreign corporation, the excess (if any) of the total amount of mark-to-market gains with respect to the stock included by the taxpayer for prior taxable years, over the amount of mark-to-market losses with respect to such stock that were allowed as deductions for prior taxable years.

The adjusted basis of stock in a passive foreign corporation is increased by the amount of mark-to-market gain included in gross income, and is decreased by the amount of mark-to-market losses allowed as deductions with respect to such stock. In the case of stock owned indirectly by the U.S. person, such as through a foreign partnership, foreign estate or foreign trust (as discussed below), the basis adjustments for mark-to-market gains and losses apply to the basis of the PFC stock in the hands of the intermediary owner, but only for purposes of the subsequent application of the PFC rules to the tax treatment of the indirect U.S. owner. In addition, similar basis adjustments are made to the adjusted basis of the property actually held by the U.S. person by reason of which the U.S. person is treated as owning PFC stock.

All amounts of mark-to-market gain on PFC stock, as well as gain on the actual sale or distribution of PFC stock, are treated as ordinary income. Similarly, ordinary loss treatment applies to the deductible portion of any mark-to-market loss on PFC stock, as well as to any loss realized on the actual sale or other disposition of PFC stock to the extent that the amount of such loss does not exceed the unreversed inclusions with respect to that stock. These loss deductions are treated as deductions allowable in computing adjusted gross income.

The source of any amount of mark-to-market gain on PFC stock is determined in the same manner as if the amount of income were actual gain from the sale of stock in the passive foreign corporation. Similarly, the source of any amount allowed as a deduction for mark-to-market loss on PFIC stock is determined in the same manner as if that amount were an actual loss incurred on the sale of stock in the passive foreign corporation.

The mark-to-market method under the bill only applies to passive foreign corporations the stock of which is "marketable." PFC stock is treated as marketable if it is regularly traded on a qualified exchange, whether inside or outside the United States. An exchange qualifies for this treatment if it is a national securities exchange which is registered with the Securities and Exchange Commission or the national market system established pursuant to sec-

tion 11A of the Securities and Exchange Act of 1934, or if the Secretary is satisfied that the requirements for trading on that exchange ensure that the market price on that exchange represents a legitimate and sound fair market value for the stock. It is intended that the Secretary may adopt a definition of the term "regularly traded" that differs from definitions provided for other purposes under the Code. Further, it is intended that the Secretary not be bound by definitions applied for purposes of enforcing other laws, including Federal securities laws. Similarly, in identifying qualified foreign exchanges for these purposes, it is intended that the Secretary not be required to include exchanges that satisfy standards established under Federal securities laws and regulations. PFC stock is also treated as marketable, to the extent provided in Treasury regulations, if the PFC continuously offers for sale or has outstanding any stock (of which it is the issuer) that is redeemable at its net asset value in a manner comparable to a U.S. regulated investment company (RIC).

In addition, the bill treats as marketable any stock in a passive foreign corporation that is owned by a RIC that continuously offers for sale or has outstanding any stock (of which it is the issuer) that is redeemable at its net asset value. It is believed that the RIC's determination of PFC stock value for this non-tax purpose would ensure a sufficiently accurate determination of the fair market value of PFC stock owned by the RIC. The bill also treats as marketable any stock in a passive foreign corporation that is held by any other RIC, except to the extent provided in regulations. It is believed that even for RICs that do not make a market in their own stock, but that do regularly report their net asset values in compliance with the securities laws, inaccurate valuations may bring exposure to legal liabilities, and this exposure may ensure the reliability of the values such RICs assign to the stock they hold in PFCs. However, it is intended that Treasury regulations will disallow mark-to-market treatment for nonmarketable stock held by any RIC that is not required to perform such a net asset valuation at the close of each taxable year, that does not publish such a valuation, or that otherwise does not provide what the Secretary regards as sufficient indicia of the reliability of its valuations under the relevant circumstances.

The bill coordinates the application of the mark-to-market method with the tax rules generally applicable to RICs. The bill treats mark-to-market gain on PFC stock as a dividend for purposes of both the 90-percent investment income test of section 851(b)(2) and the 30-percent short-short limitation of section 851(b)(3).

The mark-to-market method does not apply to the stock of a U.S. person in any PFC that is U.S. controlled (as discussed above), to the stock of a person choosing qualified electing fund treatment, or to stock of a U.S. person who is a 25-percent shareholder (as defined above).

In the case of a controlled foreign corporation (including a passive foreign corporation that is treated under the bill as a controlled foreign corporation) that owns or is treated as owning stock in a passive foreign corporation, the mark-to-market method generally is applied as if the controlled foreign corporation were a U.S.

person. For purposes of the application of subpart F to the controlled foreign corporation, mark-to-market gains are treated as if they were foreign personal holding company income of the character of dividends, interest, royalties, rents or annuities, and allowable deductions for mark-to-market losses are treated as deductions allocable to that category of foreign personal holding company income. The source of such income or loss, however, is determined by reference to the actual (foreign) residence of the controlled foreign corporation.

For purposes of the mark-to-market method, any stock in a passive foreign corporation that is owned, directly or indirectly, by or for a foreign partnership or foreign trust or foreign estate is treated as if it were owned proportionately by its partners or beneficiaries.[22] Stock in a passive foreign corporation that is thus treated as owned by a person is treated as actually owned by that person for the purpose of applying the constructive ownership rule at another level. In the case of a U.S. person who is treated as owning stock in a passive foreign corporation by application of this constructive ownership rule, any disposition by the U.S. person or by any other person that results in the U.S. person being treated as no longer owning the stock in the passive foreign corporation, as well as any disposition by the person actually owning the stock of the passive foreign corporation, is treated under the bill as a disposition by the U.S. person of stock in the passive foreign corporation.

Interest-charge method

Nonelecting shareholders [23] of a PFC with stock that is not marketable are subject to the interest-charge method, based on the PFIC interest-charge method that is currently provided in Code section 1291, with certain modifications.

First, although allowable foreign tax credits may reduce a U.S. person's net U.S. tax liability on an excess distribution, the interest charge computed on that excess distribution is computed, under the bill, without regard to reductions in net U.S. tax liability on account of direct foreign tax credits.

The PFIC provisions of present law, to the extent provided in regulations, impose recognition of gain in the case of a transfer of PFIC stock in a transaction that would otherwise qualify for the nonrecognition provisions of the Code. The bill imposes that result as a general rule, except as otherwise provided in Treasury regulations. In addition, the bill requires that proper adjustment be made to the basis of property, held by the U.S. person, through which the U.S. person is treated as owning stock in the passive foreign corporation.

The PFIC provisions of present law apply rules for the attribution of ownership of PFIC stock to U.S. persons, including a rule that attributes PFIC stock owned by a corporation to any person who owns, directly or indirectly, 50 percent or more of the value of

[22] For this purpose, it is intended that proportionate ownership will take into account any special or discretionary allocations of the distributions or gains with respect to stock in the passive foreign corporation.

[23] All citizens (and residents) of the United States are included, irrespective of residence in a U.S. commonwealth or possession.

the stock of the corporation. Under the bill, the 50-percent threshold applies not only to stock owned directly or indirectly, but also to stock treated as owned by application of the family attribution rules of the personal holding company provisions (sec. 544 (c)(2)).

The PFIC provisions of present law provide special rules for the application of the interest-charge method in the case of PFIC stock held by a U.S. person through an intermediary entity. These rules describe the dispositions that are treated as dispositions of PFIC stock by the U.S. person, and include rules to eliminate the possibility of double taxation (sec. 1297(b)(5)). The bill clarifies that these rules apply to any transaction that results in the U.S. person being treated as no longer owning the PFC stock, as well as any disposition of the PFC stock by the entity actually owning the PFC stock. These rules apply regardless of whether the transaction involves a disposition of the PFC stock, and regardless of whether the parties to the transaction include the U.S. person, the entity actually owning the PFC stock, or some other entity. For example, these rules apply to the issuance of additional stock by an intermediary corporation to an unrelated party in a case where, by increasing the total outstanding stock of the intermediary corporation, the transaction causes the U.S. person to fall below the ownership threshold for indirect ownership of the PFC stock. The bill also clarifies that an income inclusion under the interest-charge method takes precedence over an income inclusion under subpart F resulting from the same disposition. The second clarification ensures that the interest charge is imposed without regard to the structure of the transaction.

Under the bill, the interest-charge method applies to any stock in a passive foreign corporation unless either the stock is marketable (and therefore the mark-to-market method applies) as of the time of the distribution or disposition involved, or the stock in the passive foreign corporation was subject to the current inclusion method (under the bill or under prior law) for each taxable year beginning after December 31, 1986 which includes any portion of the taxpayer's holding period in the PFC stock. In the event that PFC stock, not subject to the current inclusion method, becomes marketable during the taxpayer's holding period, the interest-charge method applies to any distributions and dispositions during the year in which the stock becomes marketable, as well as to the mark-to-market gain (if any) as of the close of that year. In the event that PFC stock was initially marketable, and later becomes unmarketable and subject to the interest-charge method, the taxpayer's holding period in the PFC stock for purposes of the interest-charge method is treated as beginning on the first day of the first taxable year beginning after the last taxable year for which the mark-to-market method applies to the taxpayer's stock in the PFC.

Under the bill, as under the present-law PFIC rules, stock in a foreign corporation generally is treated as PFC stock if, at any time during the taxpayer's holding period of that stock, the foreign corporation (or any predecessor) is a passive foreign corporation subject to the interest-charge method (current sec. 1297(b)(1)). (This rule is sometimes referred to as the "once-a-PFIC-always-a-PFIC" rule.) Under present law this rule generally does not affect a tax-

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payer holding stock in a foreign corporation if at all times during the holding period of the taxpayer with respect to the stock when the foreign corporation (or any predecessor) is a PFIC, qualified electing fund treatment applies with respect to the taxpayer. Under the bill, the similar once-a-PFC-always-a-PFC rule does not apply if during the taxpayer's entire holding period with respect to the stock when the foreign corporation (or any predecessor) is a PFC, either (a) mark-to-market treatment applies, (b) mandatory current inclusion of income applies (either because the corporation is U.S. controlled or because the taxpayer is a 25-percent shareholder), or (c) elective current inclusion of income applies. Thus, for example, a shareholder of a controlled foreign corporation is subject to current inclusion with respect to all the corporation's income in any year for which the corporation is a PFC, but is subject to current inclusion only to the extent provided under subpart F in any year for which the controlled foreign corporation is not a PFC.

The bill also provides for full basis adjustment for partnerships and S corporations that own stock in a passive foreign corporation subject to the interest-charge method. Although tax is imposed on a distribution or disposition under the interest-charge method without including the distribution or disposition in gross income, thus precluding the natural basis adjustments for amounts included in gross income, the bill grants regulatory authority for appropriate basis adjustments to partnerships and S corporations based on the amount of income subject to tax under the interest-charge method and thereby excluded from gross income.

The bill also includes a special rule to coordinate the application of the interest-charge method to nonelecting shareholders of a passive foreign corporation who are or were residents of Puerto Rico. Under the bill, no interest charge is applicable to amounts of an excess distribution that, were the amounts actually earned in the year to which they are treated as earned under the interest-charge method, would have been eligible for the exclusion under section 933 (for income derived by residents of Puerto Rico from sources within Puerto Rico).

The bill includes a broad grant of regulatory authority, as does the present-law PFIC statute. However, the bill specifies that necessary or appropriate regulations under the PFC rules may include regulations providing that gross income should be determined without regard to the operation of the interest-charge method for such purposes as may be specified in the regulations. This permits the Secretary to relieve pressure on many aspects of the Code that result from the operation of the interest-charge method other than through gross income. In addition, the bill specifies that necessary or appropriate PFC regulations may include regulations dealing with changes in residence status by shareholders in passive foreign corporations (e.g., a resident alien becoming a nonresident, or a U.S. citizen becoming a resident of Puerto Rico).

Modification or repeal of other antideferral regimes

While the bill includes in the passive foreign corporation rules most of the provisions that it preserves from the present-law PFIC, foreign personal holding company, and foreign investment compa-

ny regimes, the bill modifies subpart F in one respect to reflect a present-law provision of the foreign personal holding company rules (sec. 553(a)(5)). The bill treats as foreign personal holding company income for subpart F purposes an amount received under a personal service contract if a person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract. The bill similarly treats as foreign personal holding company income for subpart F purposes any amount received from the sale or distribution or disposition of such a contract. This rule applies only if at some time during the taxable year 25 percent or more of the value of the corporation's stock is owned (directly, indirectly, or constructively) by or for the individual who may be designated to perform the services.[24] Income from such personal service contracts is not, however, treated as passive for foreign tax credit purposes.

The bill repeals the foreign personal holding company provisions, the PFIC provisions (except as modified and preserved as the passive foreign corporation provisions), and the foreign investment company provisions. The bill also excludes all foreign corporations from the application of the accumulated earnings tax and the personal holding company tax. It is understood that the purposes of all the anti-deferral regimes are adequately served by the passive foreign corporation provisions as set forth in the bill, in conjunction with the controlled foreign corporation provisions as modified by the bill.

In addition, the bill denies installment sales treatment for any installment obligation arising out of a sale of stock in a passive foreign corporation. This will prevent shareholders in passive foreign corporations from avoiding the interest charge by means of an installment sale of their PFC stock.

Effective Date

The bill generally is effective for taxable years of U.S. persons beginning after December 31, 1991, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

The denial of installment sales treatment is effective for sales or dispositions after December 31, 1991.

The bill does not affect the determination of the basis of stock in a PFIC that was acquired from a decedent in a taxable year beginning before January 1, 1991.

[24] This rule was included in the definition of foreign personal holding company income for purposes of subpart F prior to the amendments included in the 1986 Act.

2. Modifications to provisions affecting controlled foreign corporations (secs. 311, 312, and 313 of the bill and secs. 951, 952, 959, 960, 961, 964, and 1248 of the Code)

Present Law

Treatment of controlled foreign corporation earnings

In general

A U.S. shareholder generally treats dividends from a controlled foreign corporation as ordinary income from foreign sources that carries both direct and indirect foreign tax credits. Under look-through rules, the income and credits are subject to those foreign tax credit limitations which are consistent with the character of the income of the foreign corporation.

Several Code provisions result in similar tax treatment of a U.S. shareholder if it either disposes of the controlled foreign corporation stock, or the controlled foreign corporation realizes certain types of income (including income with respect to lower-tier controlled foreign corporations). First, under section 1248, gain resulting from the disposition by a U.S. person of stock in a foreign corporation that was a controlled foreign corporation with respect to which the U.S. person was a U.S. shareholder in the previous five years is treated as a dividend to the extent of allocable earnings.

Second, a controlled foreign corporation has subpart F income when it realizes gain on disposition of stock and, ordinarily, when it receives a dividend. Under sections 951 and 960, such subpart F income may result in taxation to the U.S. shareholder similar (but not identical) to that on a dividend from the controlled foreign corporation. In addition to provisions for characterizing income and credits in these situations, the Code also provides certain rules that adjust basis, or otherwise result in modifying the tax consequences of subsequent income, to account for these and other subpart F income inclusions.

Third, when in exchange for property any corporation (including a controlled foreign corporation) acquires stock in another corporation (including a controlled foreign corporation) controlled by the same persons that control the acquiring corporation, earnings of the acquiring corporation (and possibly the acquired corporation) may be treated under section 304 as having been distributed as a dividend to the seller.

Lower-tier controlled foreign corporations

For purposes of applying the separate foreign tax credit limitations, receipt of a dividend from a lower-tier controlled foreign corporation by an upper-tier controlled foreign corporation may result in a subpart F income inclusion for the U.S. shareholder that is treated as income in the same limitation category as the income of the lower-tier controlled foreign corporation. The income inclusion of the U.S. shareholder may carry deemed-paid credits for foreign taxes paid by the lower-tier controlled foreign corporation, and the basis of the U.S. shareholder in the stock of the first-tier controlled foreign corporation is increased by the amount of the inclusion. If, on the other hand, the upper-tier controlled foreign corporation

sells stock of a lower-tier controlled foreign corporation, then the gain is also included in the income of the U.S. shareholder as subpart F income and the U.S. shareholder's basis in the stock of the first-tier controlled foreign corporation is increased to account for the inclusion, but the inclusion is not treated for foreign tax credit limitation purposes by reference to the nature of the income of the lower-tier controlled foreign corporation. Instead it generally is treated as passive income.

If subpart F income of a lower-tier controlled foreign corporation is included in the gross income of a U.S. shareholder, there is no provision that adjusts the basis of the upper-tier controlled foreign corporation's stock of the lower-tier controlled foreign corporation.

Subpart F inclusions in year of disposition

The subpart F income earned by a foreign corporation during its taxable year is taxed to the persons who are U.S. shareholders of the corporation on the last day, in that year, on which the corporation is a controlled foreign corporation. In the case of a U.S. shareholder who acquired stock in a controlled foreign corporation in the middle of the year, such inclusions are reduced by all or a portion of the amount of dividends paid in that year by the foreign corporation to any person besides the acquirer with respect to that stock. The reduction is determined by multiplying the subpart F income for the year by the proportion of the year during which the acquiring shareholder did not own the stock.

Distributions of previously taxed income

If in a year after the year of a subpart F income inclusion, a U.S. shareholder in the controlled foreign corporation receives a distribution from the corporation, the distribution may be deemed to come first out of the corporation's previously taxed income and, therefore, may be excluded from the U.S. shareholder's income. However, a distribution by a foreign corporation to a domestic corporation of earnings and profits previously taxed under subpart F is treated as an actual dividend, solely for purposes of determining the indirect foreign tax credit available to the domestic corporation (sec. 960(a)(3)). Thus, a portion of the foreign taxes paid or accrued by the foreign corporation and not previously deemed paid by the domestic corporation are treated as paid by the domestic corporation under the principles of section 902 even though the domestic corporation recognizes no income in the current taxable year with respect to the distribution.

In addition, the domestic corporation is permitted to increase its foreign tax credit limitation in the year of the distribution of previously taxed earnings and profits in an amount equal to the excess of the amount by which its foreign tax credit limitation for the year of the subpart F inclusion was increased as a result of that inclusion, over the amount of foreign taxes which were allowable as a credit in that year and which would not have been so allowable but for the subpart F inclusion (sec. 960(b)). The increase in the foreign tax credit limitation may not, however, exceed the amount of the foreign taxes taken into account under this provision with respect to the distribution of previously taxed earnings and profits. In order for this rule to apply, the domestic corporation

either must have elected to credit foreign taxes in the year of the subpart F inclusion or must not have paid or accrued any foreign taxes in such year, and it must elect the foreign tax credit in the year of the distribution of previously taxed earnings and profits.

Treatment of United States source income earned by a controlled foreign corporation

As a general rule, subpart F income does not include income earned from sources within the United States if the income is effectively connected with the conduct of a U.S. trade or business by the controlled foreign corporation. This general rule does not apply, however, if the income is exempt from, or subject to a reduced rate of, U.S. tax pursuant to a provision of a U.S. treaty.

Reasons for Simplification

It is believed that complexities have been caused by uncertainties and gaps in the statutory schemes for taxing gains on dispositions of stock in controlled foreign corporations as dividend income or subpart F income. These uncertainties and gaps may prompt taxpayers to refrain from behavior that would otherwise be the result of rational business decisions, for fear of excessive tax—for example, double corporate-level taxation of income. In many cases, concerns about excessive taxation can be allayed, but only at the cost of avoiding the simpler and more rational economic behavior in favor of tax-motivated planning.

It is understood that, as a general matter, other aspects of the tax system may have interfered with rational economic decision making by prompting taxpayers to engage in tax-motivated planning in order to eliminate taxation in cases where income is in fact earned. Some such characteristics of the tax system have in the past been altered by Congress in order to reduce excessive interference by the tax system in labor, investment, and consumption decisions of taxpayers.[25] It is believed that in the context of this simplification bill, it generally is appropriate to reduce complexities caused by aspects of the rules governing controlled foreign corporations that provide for nonuniform tax results from dividends, on the one hand, and stock disposition proceeds to the extent earnings and profits underlie those proceeds, on the other.

It is understood that the present-law provisions which permit an indirect foreign tax credit and an increased foreign tax credit limitation to be claimed in the event of a distribution of previously taxed earnings by a controlled foreign corporation are particularly difficult to administer. This difficulty arises because taxpayers are required to compute and keep track of excess foreign tax credit limitation accounts with respect to subpart F income inclusions on a foreign corporation by foreign corporation basis, as well as on a year by year basis. Additional complexities arise as taxpayers are required, as a result of distributions, to trace earnings and profits up chains of foreign corporations. It is believed that retention of these rules may not be worth the system-wide recordkeeping and

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[25] See, e.g., Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess. *General Explanation of the Tax Reform Act of 1986* at 6 et seq. (1987) ("General Reasons For The Act").

computations involved. It is believed that the combination of foreign income tax rates on the foreign income of U.S. persons and their controlled foreign corporations, and the U.S. rules for taxing such income, will result in few cases where the effort will be rewarded by substantial tax savings. Moreover, it is believed that taxpayers who might be adversely affected may be able to plan around those adverse effects at less cost than the complexity cost that is engendered by the present system.

Explanation of Provisions

In general

The bill makes a number of modifications in the treatment of income derived from the disposition of stock in a controlled foreign corporation. The bill provides deemed dividend treatment for gains on dispositions of lower-tier controlled foreign corporations. Where the lower-tier controlled foreign corporation previously earned subpart F income, the bill permits the amount of gain taxed to the U.S. shareholder to be adjusted for previous income inclusions. Where proceeds from the sale of stock to a controlled foreign corporation that previously has earned subpart F income would be treated as a dividend under the principles of section 304, the bill expressly permits exclusion of the deemed section 304 dividend from taxation to the extent of the previously taxed earnings and profits of the controlled foreign corporation from which the property was deemed to be distributed. (Appropriate basis adjustments also are permitted to be made.) Where a controlled foreign corporation (whether or not it is a lower-tier controlled foreign corporation) earns subpart F income in a year in which a U.S. shareholder sells its stock, in a transaction that does not result in the foreign corporation ceasing to be a controlled foreign corporation, the bill contains statutory language providing for a proportional reduction in the taxation of the subpart F income in that year to the acquiring U.S. shareholder.

The bill contains two additional provisions related to controlled foreign corporations. First, the bill repeals the provision that currently permits an indirect foreign tax credit and an increased foreign tax credit limitation to be claimed upon certain distributions by controlled foreign corporations of previously taxed earnings and profits. Second, the bill clarifies the effect of a treaty exemption or reduction of the branch profits tax on the determination of subpart F income.

Lower-tier controlled foreign corporations

Characterization of gain on stock disposition

The bill provides that if a controlled foreign corporation is treated as having gain from the sale or exchange of stock in a foreign corporation, the gain is treated as a dividend to the same extent that it would have been so treated under section 1248 if the controlled foreign corporation were a U.S. person. However, this rule does not affect the determination of whether the second corporation was a controlled foreign corporation.

Thus, for example, if a U.S. corporation owns 100 percent of the stock a foreign corporation, which owns 100 percent of the stock of a second foreign corporation, then under the bill, any gain of the first corporation upon a sale of stock of the second corporation is treated as a dividend for purposes of subpart F income inclusions to the U.S. shareholder, to the extent of earnings and profits of the second corporation attributable to periods in which the first foreign corporation owned the stock of the second foreign corporation while the latter was a controlled foreign corporation with respect to the U.S. shareholder. As another example, assume that the U.S. corporation has always owned 51 percent of the stock of a foreign corporation, which has always owned 51 percent of the stock of a second foreign corporation. All the other stock of the foreign corporations has always been owned by other foreign individuals unrelated to the U.S. corporation. In this case, the second foreign corporation has never been a controlled foreign corporation. Therefore, none of the gain of the first corporation upon a sale of stock of the second corporation is treated as a dividend.

Gain on disposition of stock in a related corporation created or organized under the laws of, and having substantial part of its assets in a trade or business in, the same foreign country as the gain recipient, even if recharacterized as a dividend under the bill, is not therefore excluded from foreign personal holding company income under the same-country exception that applies to actual dividends.

Adjustments to basis of stock

The bill also provides that when a lower-tier controlled foreign corporation earns subpart F income, and stock in that corporation is later sold by an upper-tier controlled foreign corporation, the resulting income inclusion of the U.S. shareholders are, under regulations, adjusted to account for previous inclusions, in a manner similar to the adjustments now provided to the basis of stock in a first-tier controlled foreign corporation. Thus, just as the basis of a U.S. shareholder in a first-tier controlled foreign corporation rises when subpart F income is earned and falls when previously taxed income is distributed, so as to avoid double taxation of the income on a later sale, it is intended that by regulation the subpart F income from gain on the sale of a lower-tier controlled foreign corporation generally would be reduced by income inclusions of earnings that were not subsequently distributed by the lower-tier controlled foreign corporation. It is intended that the Secretary will have sufficient flexibility in promulgating regulations under this provision to permit adjustments only in those cases where, by virtue of the historical ownership structure of the corporations involved, the Secretary is satisfied that the inclusions for which adjustments can be made can be clearly identified.

Subpart F inclusions in year of disposition

Where a U.S. shareholder acquires the stock of a controlled foreign corporation from another U.S. shareholder during the middle of a year in which the controlled foreign corporation earns subpart F income, the bill reduces the acquirer's subpart F inclusion for that year by a portion of the amount of the dividend deemed

(under sec. 1248) to be received by the transferor. The portion by which the inclusion is reduced would (as is currently the case where a dividend was paid to the previous owner of the stock) not exceed the subpart F inclusion for that year times the proportion of the year for which the acquirer did not own the stock.

Avoiding double inclusions in other cases

The bill clarifies the appropriate scope of regulatory authority with respect to the treatment of cross-chain section 304 dividends out of the earnings of controlled foreign corporations that were previously included in the income of a U.S. shareholder under subpart F. The bill contemplates that in such a case, the Secretary in his discretion may by regulation treat such dividends as distributions of previously taxed income, with appropriate basis adjustments. It is also anticipated that other occasions may arise where the exercise of similar regulatory authority may be appropriate to avoid double income inclusions, or an inclusion or exclusion of income without a corresponding basis adjustment. Therefore, the bill states that, in addition to cases involving section 304, the Secretary may by regulation modify the application of subpart F in any other case where there would otherwise be a multiple inclusion of any item of income (or an inclusion or exclusion without an appropriate basis adjustment) by reason of the structure of a U.S. shareholder's holdings in controlled foreign corporations or by reason of other circumstances.

Foreign tax credit in year of receipt of previously taxed income

The bill repeals the rules that permit an indirect foreign tax credit to be claimed with respect to a distribution of previously taxed earnings and profits. Under the bill, foreign taxes paid by a foreign corporation with respect to previously taxed earnings and profits remain in that corporation's pool (or pools) of foreign taxes which are available for the indirect foreign tax credit upon subsequent distributions or deemed distributions of earnings and profits that have not been previously taxed at the U.S. shareholder level.

Treatment of United States income earned by a controlled foreign corporation

The bill provides that an exemption or reduction by treaty of the branch profits tax that would be imposed under section 884 on a controlled foreign corporation does not affect the general statutory exemption from subpart F income that is granted for U.S. source effectively connected income. For example, assume a controlled foreign corporation earns income of a type that generally would be subpart F income, and that income is earned from sources within the United States in connection with business operations therein. Further assume that repatriation of that income is exempted from the U.S. branch profits tax under a provision of an applicable U.S. income tax treaty. The bill provides that notwithstanding the treaty's effect on the branch tax, the income is not treated as subpart F income as long as it is not exempt from U.S. taxation (or subject to a reduced rate of tax) under any other treaty provision.

Effective Dates

Lower-tier controlled foreign corporations

The provision of the bill treating gains on dispositions of stock in lower-tier controlled foreign corporations as dividends under section 1248 principles applies to gains recognized on transactions occurring after date of enactment of the bill. The provision providing for regulatory adjustments in U.S. shareholder inclusions, with respect to gains of controlled foreign corporations from stock in lower-tier controlled foreign corporations that previously had subpart F income, is effective for U.S. shareholder inclusions in taxable years of U.S. shareholders beginning after December 31, 1991.

Subpart F inclusions in year of disposition

The provision of the bill permitting dispositions of stock to be taken into consideration in determining a U.S. shareholder's subpart F inclusion for a taxable year is effective with respect to dispositions occurring after the date of enactment of the bill.

Distributions of previously taxed income

The provision of the bill allowing the Secretary to make regulatory adjustments to avoid double inclusions in cases such as those to which section 304 applies takes effect on the date the bill is enacted.

Foreign tax credit on distribution of previously taxed income

The provision of the bill which repeals the ability to claim foreign tax credits on distributions of previously taxed income generally is effective for taxable years beginning after December 31, 1991. However, the provision is not effective with respect to distributions of previously taxed income which occur in taxable years beginning prior to January 1, 1997, if the distributions relate to subpart F income inclusions for taxable years of the U.S. corporate shareholders beginning before January 1, 1992.

Treatment of United States source income earned by a controlled foreign corporation

The provision of the bill concerning the effect of treaty exemptions from or reductions of the branch profits tax on the determination of subpart F income is effective for taxable years ending after the date of enactment.

3. Translation of foreign taxes into U.S. dollar amounts (sec. 321 of the bill and sec. 986(a) of the Code)

Present Law

Foreign income taxes paid in foreign currencies are required to be translated into U.S. dollar amounts using the exchange rate as of the time such taxes are paid to the foreign country or U.S. possession (sec. 986(a)(1)). This rule applies equally to foreign taxes paid directly by U.S. taxpayers, which are creditable only in the year paid or accrued (or during a carryover period), and to foreign taxes paid by foreign corporations that are deemed paid by a U.S.

corporation, and hence creditable, in the year that the U.S. corporation receives a dividend or income inclusion.

Reasons for Simplification

If each foreign income tax payment is required to be translated at a separate daily exchange rate for the day of the payment, the number of currency exchange rates that are relevant to foreign tax credit calculations varies directly with the frequency of foreign income tax payments. Where U.S. corporations are deemed to pay a portion of the "pool" of foreign taxes paid by foreign corporations, the correct amount of tax in the pool is the product of each tax payment times the relevant translation rate. The longer the period between the time the income is earned and its repatriation (or other inclusion) to the U.S. corporation, the greater the period over which the amounts of tax payments and translation rates are relevant to the determination of net U.S. tax liability.

It is believed that the record-keeping, verification, and examination burdens—both on the IRS and on taxpayers—associated with the advantages of deferral and the foreign tax credit (including the indirect credit) are not insignificant. For example, if events that happened in one year affected only the return filed for that year, and each tax return was affected only by events that happened in the year for which that return was filed, then presumably tax-related records would need to be maintained only between the time the taxable year began and the year that the assessment period for that year expired. On the other hand, if income earned in years 1 through 5 is taxed in year 6, then the amount of documentation relevant to the year 6 return potentially is increased five-fold, and the period over which that information must be maintained is at least five years longer.

U.S. persons who pay foreign income taxes directly and choose the benefits of the foreign tax credit have always been required to maintain detailed foreign tax payment documentation, including exchange rate data for the dates on which they paid foreign income taxes, and U.S. corporations that operate through foreign corporations have been required to maintain documentation regarding the earnings and foreign tax payments of the foreign corporations.[26] Some have argued, however, that relief is warranted for taxpayers that would otherwise bear the combined currency translation responsibilities applicable to direct foreign taxpayers with the extended record-keeping responsibilities applicable to taxpayers that receive the benefits of deferral.

It is believed that an appropriate response to this combination of burdens is to permit regulatory modification of the "time of payment" concept, in such a way that preserves the uniformity of treatment of branches and foreign subsidiaries of U.S. taxpayers, but permits recourse to reasonably accurate average translation rates for the period in which the tax payments are made. Simplification may be provided in this way by reducing, sometimes substantially, the number of translation calculations that are required

[26] Also, note that in *Commissioner v. American Metal Co.*, 221 F.2d 134, 141 (2d Cir.), *cert. denied*, 350 U.S. 879 (1955), where a foreign corporation kept its books in U.S. dollars, foreign taxes were translated as of their payment date.

to be made. There may be situations in which the use of an average exchange rate over a specified time period, to be applied to all tax payments made in that currency during that period, would provide results not substantially different than those that would be derived under present law. This could result, for example, where the value of a foreign currency as it relates to the U.S. dollar does not fluctuate significantly over the specified period.

One of the fundamental premises behind the amendments enacted in 1986 with respect to the translation of foreign taxes was that foreign taxes paid by foreign corporations should be translated in the same manner as foreign taxes paid by foreign branches of U.S. persons. In keeping with that premise, it is believed that any provision to allow the use of average exchange rates for this purpose should be made equally applicable to foreign branches and subsidiaries.

Explanation of Provision

The bill grants the Secretary of the Treasury authority to issue regulations that would allow foreign tax payments made by a foreign corporation or by a foreign branch of a U.S. person to be translated into U.S. dollar amounts using an average U.S. dollar exchange rate for a specified period. It is anticipated that the applicable average exchange rate would be the rate as published by a qualified source of exchange rates for the period during which the tax payments were made.

Effective Date

This provision is effective with respect to taxable years beginning after the date of enactment.

4. Foreign tax credit limitation under the alternative minimum tax (sec. 322 of the bill and sec. 59(a) of the Code)

Present Law

Computing foreign tax credit limitations requires the allocation and apportionment of deductions between items of foreign source and U.S. source income. Foreign tax credit limitations must be computed both for regular tax purposes and for purposes of the alternative minimum tax (AMT). Consequently, after allocating and apportioning deductions for regular tax foreign tax credit limitation purposes, additional allocations and apportionments generally must be performed in order to compute the AMT foreign tax credit limitation.

Reasons for Simplification

The process of allocating and apportioning deductions for purposes of calculating the regular and AMT foreign tax credit limitations can be complex. Taxpayers that have allocated and apportioned deductions for regular tax foreign tax credit purposes generally must reallocate and reapportion the same deductions for AMT foreign tax credit purposes, based on assets and income that reflect AMT adjustments (including depreciation). However, the differ-

ences between regular taxable income and alternative minimum taxable income are often relevant primarily to U.S. source income. As a result of the combined effects of these differences, it is believed that foreign source alternative minimum taxable income generally will not differ significantly from foreign source regular taxable income. By permitting taxpayers to use foreign source regular taxable income in computing their AMT foreign tax credit limitation, the bill eliminates the need to reallocate and reapportion every deduction.

Explanation of Provision

The bill permits taxpayers to elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source *regular* taxable income to entire alternative minimum taxable income, rather than the ratio of foreign source *alternative minimum* taxable income to entire alternative minimum taxable income. Foreign source regular taxable income may be used, however, only to the extent it does not exceed entire alternative minimum taxable income.

The election under the bill is available only in the first taxable year beginning after December 31, 1991, for which the taxpayer claims an alternative minimum tax foreign tax credit. The election applies to all subsequent taxable years, and may be revoked only with the permission of the Secretary of the Treasury.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

Title IV.—Other Income Tax Provisions

A. Provisions Relating to S Corporations

1. Determination of whether an S corporation has one class of stock (sec. 401 of the bill and sec. 1361 of the Code)

Present Law

Under present law, a small business corporation eligible to be an S corporation may not have more than one class of stock. Differences in voting rights are disregarded in determining whether a corporation has more than one class of stock. In addition, certain debt instruments may not be treated as a second class of stock for purposes of this rule.

The Treasury Department has issued proposed regulations [27] providing that a corporation will have more than one class of stock if all of the outstanding shares of stock do not confer identical rights to distribution and liquidation proceeds, regardless of whether any differences in rights occur pursuant to the corporate charter, articles or bylaws, by operation of State law, by administrative action, or by agreement. The proposed regulations also provide that, notwithstanding that all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, a corporation has more than one class of stock if the corporation makes nonconforming distributions (i.e., distributions that differ with respect to timing or amount with respect to each share of stock), with limited exceptions for certain redemptions and certain differences in the timing of distributions.

Reasons for Simplification

The provision promotes simplification by eliminating traps for the unwary that would be inherent in rules that use nonconforming distributions regardless of the rights of the shareholders as evidence of additional classes of stock.

Explanation of Provision

The bill provides that a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Applicable State law, determined by taking into account legally enforceable rights under the corporate charter, articles or bylaws, administrative action, and any agreements, determines whether the outstanding shares confer different rights to distribution or liquidation proceeds.

[27] Proposed Treasury Regulation sec. 1.1361-1(l)(2).

Where an S corporation in fact makes distributions which differ as to timing or amount, the bill in no way limits the Internal Revenue Service from properly characterizing the transaction for tax purposes. For example, if a distribution is properly characterized as compensation, the Service could require it to be so treated for tax purposes. Similarly, if a payment should be properly characterized as a distribution, the Service could require it to be so treated for tax purposes.

Effective Date

The provision applies to taxable years beginning after December 31, 1982.

2. Authority to validate certain invalid elections (sec. 402 of the bill and sec. 1362 of the Code)

Present Law

Under present law, if the Internal Revenue Service determines that a corporation's Subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and shareholders agree to be treated as if the election had been in effect for that period. Present law does not grant the Internal Revenue Service the ability to waive the effect of an inadvertent invalid Subchapter S election.

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

Reasons for Simplification

The bill promotes simplification by giving the Secretary the flexibility to validate an invalid S election where the failure to properly elect S status was inadvertent or untimely.

Explanation of Provision

Under the bill, the authority of the Internal Revenue Service to waive the effect of an inadvertent termination is extended to allow the Service to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents.

The bill also allows the Internal Revenue Service to treat a late Subchapter S election as timely where the Service determines that there was reasonable cause for the failure to make the election timely.

Effective Date

The provision applies to taxable years beginning after December 31, 1982.[28]

[28] This is the effective date of the present-law provision regarding inadvertent terminations.

3. Treatment of distributions by S corporations during loss year (sec. 403 of the bill and secs. 1366 and 1368 of the Code)

Present Law

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

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

Under present law, income (whether or not taxable) and expenses (whether or not deductible) serve, respectively, to increase and decrease an S corporation shareholder's basis in the stock of the corporation. These rules appear to require that the adjustments to basis for items of both income and loss for any taxable year apply before the adjustment for distributions applies.[29]

These rules limiting losses and allowing tax-free distributions up to the amount of the shareholder's adjusted basis are similar in certain respects to the rules governing the treatment of losses and cash distributions by partnerships. Under the partnership rules (unlike the S corporation rules), for any taxable year, a partner's basis is first increased by items of income, then decreased by distributions, and finally is decreased by losses for that year.[30]

In addition, if the S corporation has accumulated earnings and profits,[31] any distribution in excess of the amount in an "accumulated adjustments account" will be treated as a dividend (to the extent of the accumulated earnings and profits). A dividend distribution does not reduce the adjusted basis of the shareholder's stock. The "accumulated adjustments account" generally is the amount of the accumulated undistributed post-1982 gross income less deductions.

Reasons for Simplification

The provision promotes simplification by conforming the S corporation rules regarding distributions to the partnership rules and by eliminating uncertainty regarding the treatment of distributions made during the year.

Explanation of Provision

The bill provides that the adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year. Thus, distributions during a year reduce the adjusted basis for purposes of determining

[29] See section 1366(d)(1)(A); H. Rep. 97-826, p. 17; S. Rep. 97-640, p. 18.

[30] Treas. Reg. sec. 1.704-1(d)(2); Rev. Rul. 66-94, 1966-1 C.B. 166.

[31] An S corporation may have earnings and profits from years prior to its subchapter S election or from pre-1983 subchapter S years.

the allowable loss for the year, but the loss for a year does not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.

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

The following examples illustrate the application of these provisions:

Example 1.—X is the sole shareholder of A, a calendar year S corporation with no accumulated earnings and profits. X's adjusted basis in the stock of A on January 1, 1992, is $1,000 and X holds no debt of A. During the taxable year, A makes a distribution to X of $600, recognizes a capital gain of $200 and sustains an operating loss of $900. Under the bill, X's adjusted basis in the A stock is increased to $1,200 ($1,000 plus $200 capital gain recognized) pursuant to section 1368(d) to determine the effect of the distribution. X's adjusted basis is then reduced by the amount of the distribution to $600 ($1,200 less $600) to determine the application of the loss limitation of section 1366(d)(1). X is allowed to take into account $600 of A's operating loss, which reduces X's adjusted basis to zero. The remaining $300 loss is carried forward pursuant to section 1366(d)(2).

Example 2.—The facts are the same as in Example 1, except that on January 1, 1992, A has accumulated earnings and profits of $500 and an accumulated adjustments account of $200. Under the bill, because there is a net negative adjustment for the year, no adjustment is made to the accumulated adjustments account before determining the effect of the distribution under section 1368(c).

As to A, $200 of the $600 distribution is a distribution of A's accumulated adjustments account, reducing the accumulated adjustments account to zero. The remaining $400 of the distribution is a distribution of accumulated earnings and profits ("E&P") and reduces A's E&P to $100. A's accumulated adjustments account is then increased by $200 to reflect the recognized capital gain and reduced by $900 to reflect the operating loss, leaving a negative balance in the accumulated adjustment account on January 1, 1993, of $700 (zero plus $200 less $900).

As to X, $200 of the distribution is applied against A's adjusted basis of $1,200 ($1,000 plus $200 capital gain recognized), reducing X's adjusted basis to $1,000. The remaining $400 of the distribution is taxable as a dividend and does not reduce X's adjusted basis. Because X's adjusted basis is $1,000, the loss limitation does not apply to X, who may deduct the entire $900 operating loss. X's adjusted basis is then decreased to reflect the $900 operating loss. Accordingly, X's adjusted basis on January 1, 1993, is $100 ($1,000 plus $200 less $200 less $900).

Effective Date

These provisions apply to distributions made in taxable years beginning after December 31, 1991.

4. Treatment of S corporations as shareholders in C corporations (sec. 404(a) of the bill and sec. 1371 of the Code)

Present Law

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

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

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

Finally, an S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C (sec. 1371(a)(2)). The Internal Revenue Service has taken the position that this rule prevents the tax-free liquidation of a C corporation into an S corporation because a C corporation cannot liquidate tax-free when owned by an individual shareholder.[32] Thus, a C corporation may elect S corporation status tax-free or may merge into an S corporation tax-free, but may not liquidate into an S corporation tax-free.[33] Also, the Service's reasoning would also prevent an S corporation from making an election under section 338 where a C corporation was acquired by an S corporation.

Reasons for Simplification

The provision promotes simplification by treating similar transactions in a similar manner for tax purposes.

Explanation of Provision

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

[32] See PLR 8818049, (Feb. 10, 1988).

[33] A tax is imposed with respect to LIFO inventory held by a C corporation becoming an S corporation.

ing in immediate recognition of all the acquired C corporation's gains and losses (and the resulting imposition of a tax).

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

No inference is intended regarding the present-law treatment of these transactions.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

5. S corporations permitted to hold subsidiaries (sec. 404(b) of the bill and sec. 1361 of the Code)

Present Law

Under present law, an S corporation may not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). The legislative history indicates that this rule was adopted to prevent the filing of consolidated returns by a group which includes an S corporation.[34]

Reasons for Simplification

The provision promotes simplification by eliminating a barrier to using the S corporation form of entity and providing more appropriate treatment of corporations with subsidiaries, i.e., the prohibition of filing a consolidated return if S corporate status is elected rather than disqualification of the S election.

Explanation of Provision

The bill repeals the rule that an S corporation may not be a member of an affiliated group of corporations. Thus, an S corporation will be allowed to own up to 100 percent of the stock of a C corporation. However, an S corporation cannot be included in a group filing a consolidated return.

Under the bill, if an S corporation holds 100 percent of the stock of a C corporation that, in turn, holds 100 percent of the stock of another C corporation, the two C corporations may elect to file a consolidated return (if otherwise eligible), but the S corporation may not join in the election.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

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[34] See S. Rpt. No. 1983 (85th Cong., 2d Sess., 1958), p. 88.

6. Elimination of pre-1983 earnings and profits of S corporations (sec. 404(c) of the bill)

Present Law

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

Reasons for Simplification

The provision promotes simplification by eliminating the need to keep records of certain generally small amounts of earnings arising before 1983.

Explanation of Provision

The bill provides that if a corporation is an S corporation for its first taxable year beginning after December 31, 1991, the accumulated earnings and profits of the corporation as of the beginning of that year are reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Thus, such a corporation's accumulated earnings and profits will be solely attributable to taxable years for which an S election was not in effect. This rule is generally consistent with the change adopted in 1982 limiting the S shareholder's taxable income attributable to S corporation earnings to his share of the taxable income of the S corporation.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

7. Determination of shareholder's pro rata share where disposition of entire interest (sec. 404(d) of the bill and sec. 1377(a)(2) of the Code)

Present Law

Under present law, a shareholder of an S corporation takes into account separately his pro rata share of items of income, deduction, credit, etc. of the corporation. For this purpose, a shareholder's pro rata share means an allocation based on a per-share, per-day basis. However, in the case of a termination of a shareholder's interest, the corporation, with the consent of all shareholders, may elect to

allocate items as if the taxable year ended on the date of termination and another taxable year began the following day.

Reasons for Simplification

The provision provides simplification by allowing a selling shareholder to be certain that his share of income will not be affected by income earned after the sale.

Explanation of Provision

Under the bill, the present-law rule, allowing a corporation to elect to close its books for purposes of determining shares of income on the termination of a shareholder's interest, will be the mandatory rule in the case of the disposition of a shareholder's entire interest in the corporation.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

8. Treatment of items of income in respect of a decedent held by an S corporation (sec. 404(e) of the bill and sec. 1367 of the Code)

Present Law

Income in respect of a decedent (IRD) generally consists of items of gross income that accrued during the decedent's lifetime but were not yet includible in the decedent's income before his death under his method of accounting. IRD is includible in the income of the person acquiring the right to receive such item. A deduction for the estate tax attributable to an item of IRD is allowed to the person who includes the item in gross income (sec. 691(c)).

The cost or basis of property acquired from a decedent is its fair market value at the date of death (or alternate valuation date if that date is elected for estate tax purposes). This basis often is referred to as a "stepped-up basis". Property that constitutes a right to receive IRD does not receive a stepped-up basis.

The basis of a partnership interest or corporate stock acquired from a decedent generally is stepped-up at death. Under Treasury regulations, the basis of a partnership interest acquired from a decedent is reduced to the extent that its value is attributable to items constituting IRD.[35] Although S corporation income is included in the income of the shareholders in a manner similar to the inclusion of partnership income in the income of the partners, no comparable regulation provides for a reduction in the basis of stock of an S corporation acquired from a decedent where the S corporation holds items of IRD on the date of death of a shareholder. Thus, under present law, the treatment of an item of IRD held by an S corporation is unclear.

[35] Treas. Reg. sec. 1.742-1.

Reasons for Simplification

The provision promotes simplification by eliminating the uncertainty of present law, and by treating items of IRD held by a taxpayer directly, through a partnership, or through an S corporation in a similar manner.

Explanation of Provision

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

No inference is intended regarding the present-law treatment of IRD in the case of S corporations.

Effective Date

The provision applies with respect to decedents dying after the date of enactment of the bill.

B. Accounting Provisions

1. Modifications to the look-back method for long-term contracts (sec. 411 of the bill and sec. 460 of the Code)

Present Law

Taxpayers engaged in the production of property under a long-term contract generally must compute income from the contract under the percentage of completion method. Under the percentage of completion method, a taxpayer must include in gross income for any taxable year an amount that is based on the product of (1) the gross contract price and (2) the percentage of the contract completed as of the end of the year. The percentage of the contract completed as of the end of the year is determined by comparing costs incurred with respect to the contract as of the end of the year with the estimated total contract costs.

Because the percentage of completion method relies upon estimated, rather than actual, contract price and costs to determine gross income for any taxable year, a "look-back method" is applied in the year a contract is completed in order to compensate the taxpayer (or the Internal Revenue Service) for the acceleration (or deferral) of taxes paid over the contract term. The first step of the look-back method is to reapply the percentage of completion method using actual contract price and costs rather than estimated contract price and costs. The second step generally requires the taxpayer to recompute its tax liability for each year of the contract using gross income as reallocated under the look-back method. If there is any difference between the recomputed tax liability and

the tax liability as previously determined for a year, such difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily.[36] The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments.

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

The look-back method does not apply to any contract that is completed within two taxable years of the contract commencement date and if the gross contract price does not exceed the lesser of (1) $1 million or (2) one percent of the average gross receipts of the taxpayer for the preceding three taxable years. In addition, a simplified look-back method is available to certain pass-through entities and, pursuant to Treasury regulations, to certain other taxpayers. Under the simplified look-back method, the hypothetical underpayment or overpayment of tax for a contract year generally is determined by applying the highest rate of tax applicable to such taxpayer to the change in gross income as recomputed under the look-back method.

Reasons for Simplification

Present law may require multiple applications of the look-back method with respect to a single contract or may otherwise subject contracts to the look-back method even though the amounts necessitating the look-back computations are de minimis relative to the aggregate contract income. In addition, the use of multiple interest rates complicates the mechanics of the look-back method.

Explanation of Provisions

Election not to apply the look-back method for de minimis amounts

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

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

The election applies to all long-term contracts completed during the taxable year for which the election is made and to all long-

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

term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

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

Election not to reapply the look-back method

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

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

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

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

Interest rates used for purposes of the look-back method

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

Effective Date

The provisions apply to contracts completed in taxable years ending after the date of enactment.

2. Simplified method for applying uniform cost capitalization rules (sec. 412 of the bill and sec. 263A of the Code)

Present Law

In general, the uniform cost capitalization rules require taxpayers that are engaged in the production of real or tangible personal property or in the purchase and holding of property for resale to capitalize or include in inventory, the direct costs of the property and the indirect costs that are allocable to the property. In determining whether indirect costs are allocable to production or resale activities, taxpayers are allowed to use various methods so long as the method employed reasonably allocates indirect costs to production and resale activities.

Reasons for Simplification

The uniform cost capitalization rules require taxpayers to determine for each taxable year the costs of each administrative, service, or support function or department that are allocable to production or resale activities. If a taxpayer does not elect any of the simplified methods provided in Treasury regulations, this allocation may be unduly burdensome and costly.

Explanation of Provision

The bill authorizes (but does not require) the Treasury Department to issue regulations that allow taxpayers in appropriate circumstances to determine the costs of any administrative, service, or support function or department that are allocable to production or resale activities by multiplying the total amount of costs of any such function or department by a fraction, the numerator of which is the amount of costs of the function or department that was allocable to production or resale activities for a base period and the denominator of which is the total amount of costs of the function or department for the base period. It is anticipated that the regulations will provide that the base period is to begin no earlier than 4 taxable years prior to the taxable year with respect to which this simplified method applies.

Effective Date

The provision applies to taxable years beginning after the date of enactment of the bill. Thus, the regulations may permit the use of the simplified method for taxable years beginning after this date. The simplified method, however, may not be used for any taxable year that begins prior to the date that the Treasury Department publishes regulations that authorize the use of the simplified method and set forth the requirements that must be satisfied in order for the method to be used.

C. Minimum Tax Provisions

1. Depreciation under the corporate alternative minimum tax (sec. 421 of the bill and sec. 56 of the Code)

Present Law

Under present law, a corporation is subject to an alternative minimum tax (AMT) which is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax liability. Alternative minimum taxable income (AMTI) is the corporation's taxable income increased by the corporation's tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the deferral of income resulting from the regular tax treatment of those items.

One of the adjustments which is made to taxable income to arrive at AMTI relates to depreciation. Depreciation on personal property to which the modified ACRS system adopted in 1986 applies is calculated using the 150-percent declining balance method (switching to straight line in the year necessary to maximize the deduction) over the life described in Code section 168(g) (generally the ADR life of the property).

For taxable years beginning after 1989, AMTI is increased by an amount equal to 75 percent of the amount by which adjusted current earnings (ACE) exceed AMTI (as determined before this adjustment). In general, ACE means AMTI with additional adjustments that generally follow the rules presently applicable to corporations in computing their earnings and profits. For purposes of ACE, depreciation is computed using the straight-line method over the class life of the property. Thus, a corporation generally must make two depreciation calculations for purposes of the AMT—once using the 150-percent declining balance method and again using the straight-line method. Taxpayers may elect to use either depreciation method for regular tax purposes. If a taxpayer uses the straight-line method for regular tax purposes, it must also use the straight-line method for AMT purposes.

Reasons for Simplification

The use of two separate depreciation systems complicates the calculation of, and the recordkeeping for, the corporate alternative minimum tax.

Explanation of Provision

The bill applies a 120-percent declining balance method (switching to straight-line at a point maximizing depreciation deductions) for personal property (other than transition property to which the ACRS system in effect before the Tax Reform Act of 1986 applies) for determining the AMTI of a corporation. No further depreciation adjustment for this property would be required for ACE. Thus, corporations would be required to keep only one set of depreciation records for purposes of the AMT.

Corporate taxpayers may elect to use the 120-percent declining balance method of depreciation for regular tax purposes. As under present law, if a corporation uses the straight-line method for regular tax purposes, it must also use the straight-line method for AMT purposes.

Effective Date

The provision is effective for property placed in service in taxable years beginning after December 31, 1990.

2. Treatment of built-in losses for purposes of the corporate alternative minimum tax (sec. 422 of the bill and sec. 56(g) of the Code)

Present Law

For purposes of the regular corporate tax, if at the time of an ownership change, a corporation has a net operating loss or a net unrealized built-in loss, the use of such losses in post-change periods is limited. A corporation has a net unrealized built-in loss if the aggregate adjusted bases of the assets of the corporation exceed the fair market value of the assets immediately before the change of ownership (sec. 382).

For purposes of the adjusted current earnings (ACE) component of the corporate alternative minimum tax (AMT), if a corporation with a net unrealized built-in loss undergoes an ownership change in a taxable year beginning after 1989, the adjusted basis of each asset of such corporation generally is adjusted to each asset's fair market value (sec. 56(g)(4)(G)). This rule essentially eliminates, rather than limits, the use of built-in losses for ACE purposes. The net operating loss of a corporation, on the other hand, is not eliminated for AMT purposes after a change of ownership.

Reasons for Simplification

Present law complicates the treatment of built-in losses of a corporation after a change of ownership by providing different rules for regular and alternative minimum tax and by providing rules different than those applicable to net operating losses. The present-law alternative minimum tax rules applicable to built-in losses require a significant amount of additional recordkeeping.

Explanation of Provision

The bill repeals the ACE rule relating to the treatment of built-in losses after a change of ownership. Thus, for ACE purposes, the

treatment of built-in losses would be similar to the treatment of net operating loss carryovers (in the same way that the treatment of built-in losses is similar to the treatment of net operating losses for regular tax purposes).

Effective Date

The provision is effective for changes of ownership occurring after the date of enactment.

D. Tax-Exempt Bond Provisions

1. Overview

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

Unlike the interest on governmental bonds, described above, interest on private activity bonds generally is taxable. A private activity bond is a bond issued by a State or local governmental unit acting as a conduit to provide financing for a private party (or private parties) in a manner violating either (a) a private business use and payment test or (b) a private loan restriction. However, interest on private activity bonds generally is not taxable if (a) the financed activity is specified in the Code, (b) at least 95 percent of the net proceeds of the bond issue are used to finance the specified activity, and (c) numerous other requirements, including annual State volume limitations (for most private activity bonds) are satisfied.

Both private activity bonds and governmental bonds also must satisfy arbitrage restriction requirements for interest to be excluded from gross income. Interest on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986, is a preference item under the individual and corporate alternative minimum taxes. Additionally, interest on all State and local government bonds is included in determining a corporation's adjusted current earnings preference.

2. Issues under continuing review

It is expected that Congress will continue to review as the subject of possible legislative projects additional simplification options in two areas affecting State and local government bonds. These issues are—

a. Possible statutory rules for use by governmental units maintaining non-arbitrage motivated commingled accounting practices in determining their arbitrage rebate liability; and

b. Possible penalty alternatives to loss of tax-exemption for selected violations of the rules governing qualification for tax-exemption.

3. Provisions of the bill

a. Simplification of arbitrage rebate requirement for governmental bonds (sec. 431 of the bill and sec. 148 of Code)

Present Law

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

This six-month exception is deemed to be satisfied by issuers of governmental bonds (other than tax and revenue anticipation notes) and qualified 501(c)(3) bonds if (1) all proceeds other than an amount not exceeding the lesser of five percent or $100,000 are so spent within six months and (2) the remaining proceeds are spent within one year after the bonds are issued.

Reasons for Simplification

The principal Federal policy concern underlying the arbitrage rebate requirement is the earlier and larger than necessary issuance of tax-exempt bonds to take advantage of the opportunity to profit by investing funds borrowed at low-cost tax-exempt rates in higher yielding taxable investments. If at least 95 percent of the proceeds of an issue are spent within six months, and the remainder within one year, opportunities for arbitrage profit are significantly limited. In the case of larger issues, the administrative complexity of calculating rebate liability on relatively small amounts of proceeds, e.g., $100,000 of proceeds, is greater than the potential for arbitrage abuse from eliminating the rebate requirement.

Explanation of Provision

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

Effective Date

This provision applies to bonds issued after the date of enactment.

b. Simplification of compliance with 24-month arbitrage rebate exception for construction bonds (sec. 432 of the bill and sec. 148 of the Code)

Present Law

In general, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. An exception is pro-

vided for certain construction bond issues if the bonds are governmental bonds, qualified 501(c)(3) bonds, or exempt-facility private activity bonds for governmentally owned property.

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

Reasons for Simplification

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

Explanation of Provision

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

Effective Date

This provision applies to bonds issued after the date of enactment.

c. Automatic extension of initial temporary period for certain construction bonds (sec. 433 of the bill and sec. 148 of the Code)

Present Law

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

Second, generally all arbitrage profits earned on investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. Arbitrage profits generally in-

clude all earnings (in excess of bond yield) derived from the investment of bond proceeds (and subsequent earnings on any such earnings).

Reasons for Simplification

Notwithstanding the arbitrage rebate requirement, requiring yield restriction following initial temporary periods is an important factor in curbing earlier issuance of bonds than otherwise would occur. Provided that issuers substantially comply with a prompt expenditure requirement so that the opportunities for tax motivated arbitrage are limited, however, reliance on the rebate requirement for limited additional periods will allow issuers to continue to pursue more flexible and liquid investments while construction activities are being completed. Automatically allowing an additional 12-month period, where substantially all of the proceeds have been spent, will relieve issuers from the burden of seeking a ruling from the IRS without increasing the opportunity for arbitrage motivated investments.

Explanation of Provision

The bill provides that the initial temporary period for construction bonds is automatically extended for a period of 12 months if at least 85 percent of the available construction proceeds are spent within the original initial temporary period and the issuer reasonably expects to spend the remaining proceeds within the 12-month extension period. Construction bonds eligible for this automatic extension include only those bonds currently eligible for the 24-month rebate expenditure exception, described above.

The bill allows bond proceeds to be invested without yield restriction during this additional period. The arbitrage rebate or 1.5-percent penalty requirement will continue to apply to unspent proceeds during the extension period.

Effective Date

This provision applies to bonds issued after the date of enactment.

d. Simultaneous issuance of certain discrete issues not aggregated (sec. 434 of the bill)

Present Law

In certain cases, the Treasury Department treats multiple issues of tax-exempt bonds paid from substantially the same source of funds as a single issue in applying the Code's tax-exempt bond restrictions when the bonds are issued within a relatively short period of time (31 days) and pursuant to a common plan of marketing.

Reasons for Simplification

Requiring issuers that simultaneously issue discrete issues of tax and revenue anticipation notes ("TRANs") and other governmental bonds to separate issuance of discrete non-arbitrage motivated

issues by 31 days adds administrative complexity and increases their costs of issuance.

Explanation of Provision

The bill provides that discrete issues of governmental bonds issued simultaneously will not be treated as a single issue in cases where one of the issues is a TRAN reasonably expected to satisfy the arbitrage rebate safe harbor of section 148(f)(4)(B)(iii).

Effective Date

This provision applies to bonds issued after the date of enactment.

e. Authority for Treasury Department to exempt certain taxpayers from tax-exempt interest reporting requirement (sec. 435 of the bill and sec. 6012 of the Code)

Present Law

Present law requires all individuals to report on their income tax returns the amount of interest on State and local government bond interest they receive.

Reasons for Simplification

The Internal Revenue Service should be authorized to exempt taxpayers from requirements to compile and report information on income tax returns if the Secretary determines that such information is not useful to the administration of the tax laws.

Explanation of Provision

The bill authorizes the Internal Revenue Service to provide exceptions from the requirement that taxpayers report interest on State and local government bonds on their Federal income tax returns in cases where the Secretary determines that such information is not useful to the administration of the tax laws.

Effective Date

This provision is effective for taxable years beginning after the date of enactment.

f. Repeal of deadwood provisions (sec. 436 of the bill and sec. 148 of the Code)

Present Law

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

Explanation of Provision

The bill deletes these special exceptions as "deadwood."

Effective Date

This provision applies to bonds issued after the date of enactment.

E. Treatment of Certain Revocable Trusts as Estates (sec. 441 of the bill and sec. 7701 of the Code)

Present Law

A grantor trust is treated as owned by the grantor, who is taxed on its income and is entitled to its deductions. A grantor trust includes a revocable trust, one in which the grantor retains the power to revest the title of the trust property in himself (sec. 676).

Trusts and estates are subject to different income tax rules. An estate receives a higher exemption (sec. 642(b)) and is allowed a deduction for amounts permanently set aside for charity (sec. 642(c)), and, for two years after the decedents death, a $25,000 offset for rental real estate activities (sec. 469(i)). A trust is required to adopt a calendar year (sec. 645(a)), and a distribution from a trust in the first 65 days of the taxable year is treated as occurring on the last day of the preceding taxable year (sec. 663(b)) (the "65-day rule").

Trusts and estates generally are required to pay estimated taxes in the same manner as individuals. A special rule exempts estates from estimated taxes for taxable years ending within two years of the decedent's death. This exemption also applies to a grantor trust that either receives the residue of the probate estate under the grantor's will, or, (if there is no will) is primarily responsible for paying taxes, debts and expenses of administration.

Reasons for Simplification

Estate planners commonly use revocable trusts to avoid probate. Creating parity between such trusts and estates simplifies planning by reducing the role of tax considerations in the decision to utilize revocable trusts.

Explanation of Provision

The bill treats as an estate a revocable trust receiving the residue of the probate estate under the grantor's will. If there is no will, the revocable trust that is primarily responsible for paying taxes, debts and expenses of administration is treated as an estate. Such treatments apply only for years ending after the decedent's death and beginning within three years, nine months of the decedent's death. As a conforming amendment, the bill limits the rule treating grantor trusts as estates for purpose of estimated taxes to grantor trusts described in section 676.

The provision generally applies for all income tax purposes. It thus allows a revocable trust a deduction for an amount set aside for charity and the $25,000 offset for rental real estate activities to the extent the offset is not utilized by the estate. It denies such trust the benefit of the 65-day rule. The provision does not apply for transfer tax purposes.

The provision does not apply for purposes of determining the amount of personal exemption, the taxable year or any other pur-

pose specified in regulations. Thus, as under present law, revocable trusts will continue to receive a lower exemption amount and be required to adopt a calendar year. It is anticipated that the Treasury Department may exercise its regulatory authority in other situations to require consistency with prior tax treatment or to maintain parity with decedents having an estate but no revocable trust.

Effective Date

The provision applies to decedents dying after the date of enactment.

F. Other Provisions Relating to Partnerships

1. Matching rules for payments to partners (sec. 442 of the bill and secs. 267, 706 and 707 of the Code)

Present Law

If a partner engages in a transaction with a partnership other than in a capacity as a member of the partnership, the transaction is considered as occurring between the partnership and one who is not a partner. Under the timing rule applicable to such transactions (and to transactions among related persons generally), payments made to one who is not treated as a partner are deductible by the partnership in the year in which they are includible in the recipient's income. A partner generally is treated as acting in a capacity other than as a partner to the extent that his income from the transaction with the partnership does not depend upon partnership profit.

Payments to a partner for services or the use of capital that are determined without regard to partnership income ("guaranteed payments") are for specified purposes considered as made to one who is not a member of the partnership. Under the timing rule applicable to guaranteed payments, such payments generally are includible in the partner's income in the year in which they are deductible by the partnership.

Reasons for Simplification

Many payments to a partner can be described as either made to a person in a capacity other than as a partner or as guaranteed payments. The existence of two different timing rules creates uncertainty as to the proper tax treatment. By conforming the timing rule for guaranteed payments to the timing rule generally applicable to transactions among related parties, the provision reduces uncertainty and eliminates a potential issue of controversy.

Explanation of Provision

The bill defers the deduction of guaranteed payments by a partnership until the year in which they are includible in the partner's income. Thus, the bill conforms the timing rule for guaranteed payments to the timing rule for payments made to a partner acting in a capacity other than as a member of the partnership.

Effective Date

The bill applies to amounts taken into account after the date of enactment.

2. Close partnership taxable year with respect to deceased partner (sec. 443 of the bill and sec. 706(c) of the Code)

Present Law

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

Reasons for Simplification

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

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

Explanation of Provision

The bill provides that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation or otherwise.

Effective Date

The provision applies to partnership taxable years beginning after December 31, 1991.

G. Corporate Provision: Clarification of Amount of Gain Recognized by a Securityholder in a Reorganization, Etc. (sec. 444 of the bill and secs. 354-356 of the Code)

Present Law

Under present law, gain is recognized by a shareholder or securityholder in a reorganization (or distribution under sec. 355) only to the extent property other than stock or securities of the corpora-

tion or of a party to the reorganization are received. For purposes of this rule, the fair market value of the excess of the principal amount of any securities received over the principal amount of any securities surrendered is treated as other property. If the principal amount of the securities received and the principal amount of the securities surrendered are the same, no amount of the securities received is treated as other property.

Also, under present law, a certain portion of the stated redemption price at maturity of a security may be treated interest (referred to as "original issue discount" or "OID"), rather than principal. Also, in certain limited circumstances, a portion of a payment designated as principal may be treated as interest (under sec. 483).

It is unclear under present law whether the OID rules apply for purposes of determining the principal amount of a security for purposes of the nonrecognition rules described above.

Reasons for Simplification

The provision promotes simplification by conforming the rules for determining gain where securities are exchanged in a corporate reorganization with other rules in the Code allocating amounts in a debt instrument between principal and interest.

Explanation of Provision

The bill provides that for purposes of determining the amount of gain recognized to a securityholder in a reorganization (or a sec. 355 distribution), the excess of the issue price (as defined in secs. 1273 and 1274) of the securities received over the adjusted issue price of the securities surrendered would be treated as other property. If securities are received and none surrendered, the entire issue price is treated as other property. If the issue price of the securities received does not exceed the adjusted issue price of the securities surrendered, then no amount of the securities is treated as other property. These rules apply both to securityholders using the cash method and the accrual method of accounting.

The adjusted issue price of a security surrendered means the issue price of the security, increased by the OID previously included in the gross income of any holder of the security (determined without to the special rule for subsequent holders), or decreased by the amount of bond premium which would have been allowed as a deduction (or offset) if the bond had always been held by the original holder. Where section 1273(b)(4) applies to a security, the stated redemption price is reduced by the amount of the redemption price which is treated as interest (for example, under sec. 483).

The provision is not intended to create any inference as to the proper treatment of these transactions under present law.

The following examples illustrate the application of this provision:

Example (1).—Assume that a publicly traded security with a stated principal amount of $1,000 and a fair market value of $800 is issued by a corporation in a reorganization to a security holder in exchange for a security with a stated principal amount of $600 and an adjusted issue price of $500. Under the bill, the amount of

the excess issue price, or $300, is treated as "other property" for purposes of section 356.

Example (2).—Assume that a publicly traded security with a stated principal amount of $1,000 and a fair market value of $1,200 is issued by a corporation in a reorganization to a security holder in exchange for a security with a stated principal amount and an adjusted issue price of $1,000. Under the bill, the amount of the excess issue price, or $200, is treated as "other property" for purposes of section 356.

Effective Date

The provision applies to exchanges and distributions after the date of enactment.

Title V.—Provisions Relating to Estate and Gift Taxation

1. Waiver of right of recovery for certain marital deduction property (sec. 501 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 included in the surviving spouse's gross estate. The surviving spouse's estate is entitled to recover the portion of the estate tax attributable to such inclusion from the person receiving the property, unless the spouse directs otherwise by will (sec. 2207A). A will requiring that all taxes be paid by the estate may, under State law, waive the right of recovery.

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

Reasons for Simplification

It is understood that persons utilizing standard testamentary language often inadvertently waive the right of recovery with respect to QTIP. Allowing the right of recovery to be waived only by specific reference simplifies the drafting of wills to better conform with the testator's likely intent.

Explanation of Provision

The bill conforms the rule governing waiver of the right to contribution for QTIP to the rule governing waiver of the right of recovery for property includable under section 2036. Accordingly, the surviving spouse's estate has a right of recovery with respect to QTIP unless the spouse otherwise directs in a provision of the will (or revocable trust) specifically referring to section 2207A.

Effective Date

The provision applies to decedents dying after the date of enactment.

2. Inclusion in gross estate of certain gifts made within three years of death (sec. 502 of the bill and secs. 2035 and 2038 of the Code)

Present Law

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

The value of the gross estate includes the value of any previously transferred property if the decedent retained the power to revoke the transfer (sec. 2038). It also includes the value of any property with respect to which such power is relinquished during the three years before death (sec. 2035). This rule has been interpreted to include in the gross estate certain transfers made from a revocable trust within three years of death.[37] Such inclusion subjects gifts that would otherwise qualify under the annual $10,000 exclusion to estate tax.

Reasons for Simplification

The inclusion of certain property transferred during the three years before death is intended to address situations in which such transfer would otherwise reduce the value of property subject to transfer tax. Inclusion is unnecessary if the entire value of the underlying property is subject to gift tax and the transferor has retained no powers over such property. Repeal of such inclusion eliminates a principal tax disadvantage of funded revocable trusts, which are generally used for nontax purposes.

Explanation of Provision

The bill provides that a transfer from a revocable trust within three years of death does not result in the inclusion of the transfer in the gross estate. It is intended that no inference be drawn from the provision with respect to the treatment of transfers from revocable trusts under present law.

The bill also revises section 2035 to improve its clarity.

Effective Date

The provision applies to decedents dying after the date of enactment.

3. Definition of qualified terminable interest property (sec. 503 of the bill and secs. 2044, 2056(b)(7), and 2523(f) of the Code)

Present Law

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

[37] See, e.g., *Jalkut Estate v. Commissioner*. 96 T.C. No. 27 (April 29, 1991) (transfers from revocable trust to permissible beneficiaries of the trust includible in the grantor's gross estate); LTR 9117003 (same).

Under proposed regulations, an income interest may constitute a qualifying income interest for life even if income between the last distribution date and the date of the surviving spouse's death (the "accumulated income") 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, 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), *rev'd*, 910 F.2d 633 (9th Cir. 1990)).

Reasons for Simplification

The Tax Court opinion in *Estate of Howard* has created uncertainty as to when a trust qualifies for the marital deduction. This uncertainty makes planning difficult and necessitates closing agreements designed to prevent the whipsaw that would occur if a deduction is allowed for property that is not subsequently included in the spouse's estate. By codifying the Treasury Regulations, the bill eliminates uncertainty and simplifies the administration of the tax laws.

Explanation of Provision

Under the bill, an income interest does not fail to be a qualified income interest for life solely because the accumulated income is not required to be distributed to the surviving spouse. When the marital deduction is allowed, however, such income is includible in the surviving spouse's gross estate.

It is intended that no inference be drawn from the provision with respect to the definition of a qualified income interest for life under present law.

Effective Date

The provision applies to decedents dying, and gifts made, after the date of enactment. The proposal does not include in the surviving spouse's gross estate property for which no marital deduction was claimed.

4. Requirements for qualified domestic trust (sec. 504 of the bill and sec. 2056A of the Code)

Present Law

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

TAMRA defined a QDT as a trust, which, among other things, required that all trustees be U.S. citizens or domestic corporations. This requirement was modified in the Omnibus Budget Reconciliation Acts of 1989 and 1990 to provide that at least one trustee be a

U.S. citizen or domestic corporation and that no corpus distribution be made unless such trustee has the right to withhold any estate tax imposed on the distribution (the "withholding requirement").

Reasons for Simplification

Wills drafted under the TAMRA rules must be revised to conform with the withholding requirement, even though both the TAMRA rule and its successor ensure that a U.S. trustee is personally liable for the estate tax on a QDT. By reducing the number of will revisions necessary to comply with the statutory changes, the provision simplifies estate planning.

Explanation of Provision

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

Effective Date

The provision applies as if included in the Omnibus Budget Reconciliation Act of 1990.

5. Election of special use valuation of farm property for estate tax purposes (sec. 505 of the bill and sec. 2032A of the Code)

Present Law

An executor may elect to value certain real property used in farming or other closely held business operations for estate tax purposes based upon its current use value rather than its full fair market value (sec. 2032A). A written agreement signed by each person with an interest in the property must be filed with the election.

Treasury Department regulations require that a notice of election and certain information be filed with the Federal estate tax return (Treas. Reg. sec. 20.2032A-8). The administrative policy of the Treasury Department is to disallow current use valuation elections unless the required information is supplied.

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

Reasons for Simplification

In filing the estate tax return, executors commonly neglect to include a recapture agreement signed by all persons with an interest in the property or all information required by Treasury regulations. Allowing such signatures or information to be supplied later simplifies return filing.

Explanation of Provision

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

Effective Date

The provision applies to decedents dying after the date of enactment.

Title VI.—Excise Tax Provisions

A. Motor Fuel Excise Tax Provisions

1. Consolidate provisions imposing diesel and aviation fuel excise taxes (sec. 601 of the bill and secs. 4041 and 4091 of the Code)

Present Law

Code section 4091 imposes a tax on the sale of diesel and aviation fuel by a "producer." The term producer generally includes refiners, compounders, blenders, and wholesalers who are registered with the Internal Revenue Service. The term also includes persons to whom diesel or aviation fuel has been sold tax-free.

As a backup, Code section 4041 imposes a tax on certain sales or uses of diesel and aviation fuel if a taxable sale of such fuel has not occurred under section 4091.

Reasons for Simplification

Consolidating the diesel and aviation tax rules into one section of the Code will make the rules easier to find and understand.

Explanation of Provision

The bill combines the diesel and aviation fuel tax provisions currently divided between Code sections 4041 and 4091 into a revised section 4091. The use of diesel and aviation fuel in a taxable use by producers will be taxed under section 4091, and the definition of producer is clarified to include purchasers in tax-reduced sales.

The bill also simplifies the Code by eliminating two unnecessary provisions, sections 4041(b)(1)(B) and (j) of the Code. These provisions are redundant.

Effective Date

The provision is effective for sales or uses on or after January 1, 1992.

2. Permit refund of tax to taxpayer for diesel and aviation fuel resold to certain exempt purchasers (sec. 602(a) of the bill and sec. 6416(b) of the Code)

Present Law

As a general matter, purchasers who use tax-paid fuels for an exempt use are entitled to a refund or credit. Purchasers of tax-paid fuels generally are not permitted a refund or credit if they resell the fuels to another person who subsequently uses them in an exempt use.

However, persons who buy and then resell fuel subject to the special motor fuel or gasoline taxes and of certain other articles are permitted a refund or credit (rather than the ultimate user) if they resell the fuel or article for use in the following exempt uses: (1) export, (2) use as supplies for aircraft or vessels, (3) use by a State or local government, or (4) use by a nonprofit educational organization for its exclusive use.

Reasons for Simplification

Diesel and aviation fuel sales are not subject to the special refund or credit procedures, which forces users of such fuels for exempt purposes to bear the burden of filing for the refund or credit themselves and, therefore, makes such purchases more difficult.

Explanation of Provision

The bill allows a refund or credit to taxpayers for diesel and aviation fuel sold tax-paid to persons who resell for any of the exempt uses described above.

Effective Date

The provision is effective for sales on or after January 1, 1992.

3. Consolidate refund provisions for fuel excise taxes (sec. 602(b) of the bill and secs. 6420, 6421, and 6427 of the Code)

Present Law

As a general matter, purchasers who use fuels for an exempt use are entitled to a refund if the fuels have been purchased tax-paid. The refund provisions for the fuels excise taxes are found in several sections of the Code.

In general, a purchaser entitled to a refund may file a quarterly refund claim for any of the first three quarters of the purchaser's tax year, if the claim exceeds a threshold dollar amount (with the lowest being $750). The threshold amounts differ for different fuels and different exempt uses and whether quantities are aggregated. A purchaser cannot file a quarterly claim for refund for its fourth quarter, but must file the claim as a credit on that year's income tax return.

There is an expedited procedure for gasohol blenders claiming a refund of part of the excise tax included in the price of the gasoline used for blending into gasohol.

Finally, only an income tax credit, and not a refund, may be claimed for excise taxes on gasoline and special motor fuel used on a farm for farming purposes.

Reasons for Simplification

Consolidating the credit and refund provisions for fuel excise taxes into one section in the Code will make these provisions easier to find and understand. Standardizing the refund procedures will reduce confusion and allow taxpayers to obtain refunds more quickly.

Explanation of Provision

The bill consolidates the user credit and refund provisions for the fuels excise taxes into one section of the Code. The bill also combines the three refund procedures for fuels taxes into a uniform refund procedure. The new uniform refund procedure permits an exempt user to aggregate its refund claims for all fuels taxes and file for a refund in any calendar quarter in which the amount of the aggregate claim exceeds $750. The uniform refund procedure also permits such a user to file for a refund for its fourth quarter rather than apply for a credit.

The special expedited procedure for gasohol blenders is unchanged.

Effective Date

The provision is effective for sales on or after January 1, 1992.

4. **Repeal waiver requirement for fuel tax refunds for cropdusters and other fertilizer applicators (sec. 602(b) of the bill and sec. 6420 of the Code)**

Present Law

In general, farmers who use gasoline and aviation fuel on a farm are entitled to a refund of the tax that has been paid on that fuel. Cropdusters and other fertilizer applicators that use gasoline and aviation fuel on a farm are entitled to a refund of the tax paid on that fuel in lieu of the farmer, but only if the owner or operator of the farm waives its right to a refund for such fuel.

Reasons for Simplification

Eliminating the waiver will reduce the paperwork burden of a taxpayer seeking a refund.

Explanation of Provision

The bill eliminates the waiver requirement for fuels tax refunds for cropdusters and other fertilizer applicators.

Effective Date

The provision is effective for fuels purchased on or after January 1, 1992.

5. **Authorize exceptions from information reporting for certain sales of diesel and aviation fuel (sec. 603 of the bill and sec. 4093(c)(4) of the Code)**

Present Law

Certain producers and importers and purchasers are required to file information returns for reduced-tax sales of diesel and aviation fuel.

Reasons for Simplification

Allowing the Internal Revenue Service to exempt certain classes of taxpayers will simplify the IRS' administration of the registration requirements and eliminate unnecessary paperwork for taxpayers.

Explanation of Provision

The bill permits the IRS by regulation to provide exceptions to the mandatory information return requirement for certain sales of diesel and aviation fuel.

Effective Date

The provision applies to sales on or after January 1, 1992.

B. Provisions Relating to Distilled Spirits, Wines, and Beer (secs. 611-621 of the bill, secs. 5008(c), 5044, 5053, 5055, 5115, 5175(c), 5207(c), 5222(b), 5384(b) of the Code, and new sec. 5418 of the Code)

Present Law

Return of imported bottled distilled spirits

Present law provides that when tax-paid distilled spirits which have been withdrawn from bonded premises of a distilled spirits plant are returned for destruction or redistilling, the excise taxes are refunded (sec. 5008(c)). This provision does not apply to imported bottled distilled spirits, since they are withdrawn from customs custody and not from bonded premises.

Bond for exported distilled spirits

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

Distilled spirits plant records

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

Transfers from breweries to distilled spirits plants

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

Posting of sign by wholesale liquor dealers

Wholesale liquor dealers (i.e., dealers, other than wholesale dealers in beer alone, who sell distilled spirits, wines, or beer to other persons who re-sell such products) are required to post a sign con-

spicuously on the outside of their place of business indicating that they are wholesale liquor dealers (sec. 5115).

Refund of tax for wine returned to bond

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

Use of ameliorating material in certain wines

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

Domestically produced beer for use by foreign embassies, etc.

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

Withdrawal of beer for destruction

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

Records of exportation of beer

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

Transfer to brewery of beer imported in bulk

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

Reasons for Simplification

In addition to imposing taxes, the Internal Revenue Code regulates many aspects of the alcoholic beverage industry. These regulations date in many cases from the prohibition era or earlier. In

1980, the method of collecting excise taxes on alcoholic beverages was changed from a system under which Treasury Department inspectors regularly were present at production facilities to a bonded premises system, which more closely tracks the systems used in connection with other Federal taxes. Many of the recordkeeping requirements and other regulatory measures imposed in connection with these taxes have not been modified to conform to these collection changes. In addition, modification of statutory provisions is warranted in view of advances in technology used in the alcoholic beverage industry and environmental protection concerns.

Explanation of Provisions

Return of imported bottled distilled spirits

The procedures for refunds of tax collected on imported bottled distilled spirits returned to bonded premises are conformed to the rules for domestically produced and imported bulk distilled spirits. Thus, refunds are available for all distilled spirits on their return to a bonded distilled spirits plant.

Bond for exported distilled spirits

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

Distilled spirits plant records

Distilled spirits plant proprietors are permitted to maintain records of their activities at locations other than the premises where the operations covered by the records are carried on (e.g., corporate headquarters), provided that the records are available for inspection by the Treasury Department during business hours.

Transfers from breweries to distilled spirits plants

The bill allows beer to be transferred without payment of tax from a brewery to a distilled spirits plant to be used in the production of distilled spirits, regardless of whether the brewery is contiguous to the distilled spirits plant.

Posting of sign by wholesale liquor dealers

The requirement that wholesale liquor dealers post a sign outside their place of business indicating that they are wholesale liquor dealers is repealed.

Refund of tax for wine returned to bond

The bill deletes the requirement that wine returned to bonded premises be "unmerchantable" in order for tax to be refunded to the proprietor of the bonded wine cellar to which the wine is delivered.

Use of ameliorating material in certain wines

The wine labelling restrictions are modified to allow any wine made exclusively from a fruit or berry with a natural fixed acid of

20 parts per thousand or more (before any correction of such fruit or berry) to contain a volume of ameliorating material not in excess of 60 percent.

Domestically produced beer for use by foreign embassies, etc.

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

Withdrawal of beer for destruction

The bill allows beer to be removed from a brewery without payment of tax for purposes of destruction, subject to Treasury Department regulations.

Records of exportation of beer

The bill repeals the requirement that proof of exportation be submitted to the Treasury Department in all cases as a condition of receiving a refund of tax. This proof will continue to be required to be maintained at the exporter's place of business.

Transfer to brewery of beer imported in bulk

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

Effective Date

These provisions of the bill generally are effective beginning 180 days after date of the bill's enactment. The provision deleting the requirement that wholesale liquor dealers post a sign outside their place of business is effective on the date of the bill's enactment.

C. Other Excise Tax Provisions

1. Authority for IRS to grant exemptions from registration requirements (sec. 631 of the bill and sec. 4222 of the Code)

Present Law

Under section 4222, certain sales of articles subject to Federal excise taxes may not be made without payment of tax under section 4121 unless the manufacturer, the first purchaser, and the second purchaser (if any) are all registered under regulations prescribed by the Secretary.

Reasons for Simplification

Allowing the Internal Revenue Service to exempt certain classes of taxpayers from the registration requirements will simplify the Service's administration of the registration provisions. Also, the

provision will reduce unnecessary paperwork for affected taxpayers.

Explanation of Provision

The bill revises section 4222(a) so that certain sales of articles subject to Federal excise taxes may not be made without payment of tax under section 4221 to any person who is required by the Secretary to be registered but who is not so registered. This will allow the Secretary to provide exemption from registration requirements for certain classes of taxpayers.

Effective Date

The provision applies to sales after the 180th day after the date of enactment.

2. Repeal temporary reduction in tax on piggyback trailers (sec. 632(a) of the bill and sec. 4051(d) of the Code)

Present Law

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

Explanation of Provision

The bill repeals the temporary reduction in tax on piggyback trailers as "deadwood."

Effective Date

The provision is effective on the date of enactment.

3. Expiration of excise tax on deep seabed minerals (sec. 632(b) of the bill and secs. 4495-4498 of the Code)

Present Law

Background

The Deep Seabed Mineral Resources Act (the "Resources Act," P.L. 96-283), one title of which was the Deep Seabed Hard Mineral Removal Tax Act of 1979 (the "Tax Act"), was enacted into law on June 28, 1980. The Resources Act was intended to encourage the successful negotiation of an international deep seabed treaty by the United Nations Conference on the Law of the Sea (a U.N. international deep seabed treaty), and pending the entry into force of such a treaty, to establish a special fund to support international revenue sharing from deep seabed mineral recovery. To this end, the Act established an interim trust fund in the Treasury, the Deep Seabed Revenue Sharing Trust Fund (the Trust Fund), into which any Tax Act receipts would be deposited. There have been no tax collections under the Tax Act. The Trust Fund proceeds were intended to be used to help discharge any U.S. financial obligations under a U.N. international deep seabed treaty should the United States become a party thereto.

Subsequent to the enactment of the Resources Act, the U.N. Conference on the Law of the Sea completed negotiations for an international deep seabed treaty in 1982, and the United States announced that it would not sign the treaty.

If and when the Law of the Sea Convention (the Convention) enters into force, it would establish a regime for the regulation of mineral extraction from the deep seabed, and would impose revenue obligations on its adherents. Such obligations were to be fundable by the Deep Seabed Revenue Trust Fund, if the United States were to become obligated by the Convention.

Excise tax on certain hard minerals

The Tax Act added sections 4495 through 4498 to the Internal Revenue Code. These sections would impose an excise tax on the removal from the deep seabed of certain hard mineral resources pursuant to a deep seabed permit issued under the Resources Act. In general, a deep seabed permit issued under the Resources Act would authorize its holder to engage in commercial recovery activities with respect to hard mineral resources on or under deep seabeds. No such permits have been issued.

Deep seabeds are, in general, areas outside the continental shelf of any nation. In general, hard mineral resources are mineral nodules, lying on or just below the surface of deep seabeds, that contain one or more minerals including manganese, nickel, cobalt, or copper. Under the Tax Act, if a person removes a hard mineral resource from the deep seabed pursuant to a deep seabed permit, a tax is imposed on the permit holder equal to 3.75 percent of 20 percent (or 0.75 percent) of the fair market value of the commercially recoverable minerals removed.

The Tax Act was scheduled to terminate on the earlier of the date on which a U.N. international deep seabed treaty took effect with respect to the United States, or June 28, 1990 (10 years after the date of enactment of the Tax Act). Since the United States did not sign the treaty, the excise tax provisions expired on June 28, 1990.

Explanation of Provision

The bill deletes the deep seabed hard minerals excise tax provisions as "deadwood."

Effective Date

The provision is effective on the date of enactment.

Title VII.—Administrative Provisions

A. Administrative Provisions

1. Simplify employment tax reporting for household employees (sec. 701 of the bill and secs. 3102, 3121, 3306 and 6654 of the Code)

Present Law

An employer who pays a household employee wages of $50 or more in a calendar quarter for household work must withhold social security taxes (including medicare taxes) from wages paid to the employee during the quarter. The employer must also pay an amount of tax that matches the tax withheld from the employee's wages. The employer must file an Employer's Quarterly Tax Return (Form 942) each quarter and a Wage and Tax Statement (Form W-2) at the end of the year.

In addition, an employer must pay Federal unemployment taxes if he or she paid cash wages to household employees totalling $1,000 or more in a calendar quarter in the current or preceding year. The employer must file an Employer's Annual Federal Unemployment Tax Return (Form 940 or Form 940-EZ) at the end of the year.

Reasons for Simplification

Employer return requirements are confusing and burdensome for many individuals, who may be employers only because they employ a domestic employee on an intermittent basis. Streamlining the return requirements would reduce the filing burden.

Explanation of Provision

The bill changes the threshold for withholding and paying social security taxes from $50 a quarter to $300 a year. The bill requires an individual who employs only household employees to report any social security or Federal unemployment tax obligation for wages paid to such employees on his or her income tax return for the year. The bill includes a household employer's social security and unemployment taxes in the estimated tax provisions. The bill authorizes the Secretary to enter into agreements with States to collect State unemployment taxes in the same manner.

Effective Date

The provision is effective for remuneration paid in calendar years beginning after December 31, 1991.

2. Penalties for failure to provide reports relating to pension payments (sec. 702 of the bill and secs. 6652(e) and 6724 of the Code)

Present Law

Any person who fails to file an information report with the Internal Revenue Service on or before the prescribed filing date is subject to penalties for each failure. The general penalty structure provides that the amount of the penalty is to vary with the length of time within which the taxpayer corrects the failure, and allows taxpayers to correct a de minimis number of errors and avoid penalties entirely (sec. 6721). A different, flat-amount penalty applies for each failure to provide information reports to the IRS or statements to payees relating to pension payments (sec. 6652(e)).

Reasons for Simplification

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

Explanation of Provision

The bill incorporates into the general penalty structure the penalties for failure to provide information reports relating to pension payments to the IRS and to recipients. Thus, information reports with respect to pension payments would be treated in a similar fashion to other information reports.

Effective Date

The provision applies to returns and statements the due date for which is after December 31, 1991.

3. Clarify that reproductions from digital images are reproductions for recordkeeping purposes (sec. 703 of the bill and sec. 6103(p) of the Code)

Present Law

Reproductions of a return, document, and certain other matters have the same legal status as the original for purposes of judicial and administrative proceedings. It is unclear whether reproductions made from digital images are also accorded the same legal status as originals.

Reasons for Simplification

Reducing the IRS' need to maintain hard-copy originals of documents would simplify the administration of the tax laws. As part of its systems modernization plan, the IRS intends to store returns, documents, and other materials in digital image format. This plan will permit the IRS to respond much more quickly to taxpayers' inquiries about the status of their accounts. It will facilitate implementation of this plan to clarify that reproductions made from

such images would be accorded the same legal status as other reproductions.

Explanation of Provision

The bill provides that the term reproduction includes a reproduction from a digital image. The bill also requires the Comptroller General to conduct a study of available digital image technology for the purpose of determining the extent to which reproductions of documents stored using that technology accurately reflect the data on the original document and the appropriate period for retaining the original document.

Effective Date

The provision is effective on the date of enactment.

4. Repeal tax shelter registration requirements (sec. 704 of the bill and sec. 6111 of the Code)

Present Law

Organizers of tax shelters must register their shelters with the IRS before offering any interests for sale.

Reasons for Simplification

As a result of the passive loss provisions (and related provisions) of the Tax Reform Act of 1986, tax shelters are no longer being marketed as they were prior to that Act. Registration of tax shelters is therefore no longer necessary for the proper administration of the tax laws. Repeal of the registration requirements would reduce paperwork burdens for taxpayers and the IRS.

Explanation of Provision

The bill repeals the tax shelter registration requirements.

Effective Date

The provision is effective on the date of enactment.

5. Repeal of authority to disclose whether a prospective juror has been audited (sec. 705 of the bill and sec. 6103(h)(5) of the Code)

Present Law

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

Reasons for Simplification

This disclosure requirement, as it has been interpreted by several recent court decisions, has created significant difficulties in the

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

Explanation of Provision

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

Effective Date

The provision is effective for judicial proceedings pending on, or commenced after, the date of enactment.

6. Repeal TEFRA audit rules for S corporations (sec. 706 of the bill and secs. 6037, 6241, 6242, 6243, 6244, and 6245 of the Code)

Present Law

An S corporation generally is not subject to income tax on its taxable income. Instead, it files an information return and the shareholders report their pro rata share of the S corporation's income and deductions on the shareholders' tax return.

The Subchapter S Revision Act of 1982 generally made the TEFRA partnership audit and litigation rules applicable to S corporations. These rules require the determination of all "Subchapter S items" at the corporate, rather than the shareholder, level. These rules also require a shareholder to report all Subchapter S items consistently with the corporation's information return or to notify the IRS of any inconsistency. Temporary regulations contain an exception from these rules for "small S corporations," i.e., those with five or fewer shareholders, each of whom is a natural person or an estate.

Reasons for Simplification

An S corporation generally is limited to 35 investors. In addition, the vast majority of both existing and newly formed S corporations are expected to qualify for the small S corporation exception from

the unified audit and litigation provisions. Consequently, a unified audit procedure is unnecessary for S corporations.

Explanation of Provision

The bill repeals the unified audit procedures for S corporations. The bill retains, however, the requirement that shareholders report items in a manner consistent with the corporation's return.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

7. Clarify statute of limitations for items from passthrough entities (sec. 707 of the bill and sec. 6501(a) of the Code)

Present Law

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

Some believe that present law may be unclear as to whether the statute of limitations for adjustments that arise from distributions from passthrough entities should be applied at the entity or individual level (i.e., whether the 3-year statute of limitations for assessments runs from the time that the entity files its information return or from the time that a shareholder timely files his or her income tax return). (Compare *Fehlhaber v. Comm.*, 94 TC 863 (1990) with *Kelly v. Comm.*, 877 F.2d 7567 (9th Cir. 1989)).

Reasons for Simplification

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

Explanation of Provision

The bill clarifies that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit. The provision is not intended to create any inference as to the proper interpretation of present law.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

B. Tax Court Provisions

1. Clarify jurisdiction of Tax Court with respect to overpayment determinations (sec. 711 of the bill and sec. 6512(b) of the Code)

Present Law

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

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

Reasons for Simplification

Clarification of the jurisdiction of the Tax Court and the appealability of orders of the Tax Court would provide for greater certainty for taxpayers and the Government in conducting cases before the Tax Court. Clarification will also reduce litigation.

Explanation of Provision

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

Effective Date

The provision is effective on the date of enactment.

2. Clarify procedures for administrative cost awards (sec. 712 of the bill and sec. 7430 of the Code)

Present Law

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

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

Reasons for Simplification

The proper procedures for applying for a cost award are uncertain in some instances. Clarifying these procedures will decrease litigation over these procedural issues.

Explanation of Provision

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

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

Effective Date

The provision is effective on the date of enactment.

3. Clarify Tax Court jurisdiction over interest determinations (sec. 713 of the bill and sec. 7481(c) of the Code)

Present Law

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

Reasons for Simplification

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

Explanation of Provision

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

Effective Date

The provision is effective on the date of enactment.

4. Clarify net worth requirements for awards of administrative or litigation costs (sec. 714 of the bill and sec. 7430 of the Code)

Present Law

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

sonable litigation costs incurred in connection with any court proceeding.

A person who substantially prevails must meet certain net worth requirements to be eligible for an award of administrative or litigation costs. In general, only an individual whose net worth does not exceed $2,000,000 is eligible for an award, and only a corporation or partnership whose net worth does not exceed $7,000,000 is eligible for an award. (The net worth determination with respect to a partnership or S corporation applies to all actions that are in substance partnership actions or S corporation actions, including unified entity-level proceedings under sections 6226 or 6228, that are nominally brought in the name of a partner or a shareholder.)

Reasons for Simplification

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

Explanation of Provision

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

Effective Date

The provision applies to proceedings commenced after the date of enactment.

C. Permit IRS to Enter Into Cooperative Agreements With State Tax Authorities (sec. 721 of the bill and new sec. 7524 of the Code)

Present Law

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

Reasons for Simplification

Most taxpayers reside in States with an income tax and, therefore, must file both Federal and State income tax returns each year. Each return is separately prepared, with the State return often requiring information taken directly from the Federal return. Permitting the IRS to enter into agreements with States that are designed to promote efficiency through joint tax administration

programs would reduce the burden on taxpayers because much of the same information could be used by both Governments.

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

Explanation of Provision

The bill provides that the Secretary is authorized to enter into cooperative agreements with State tax authorities to enhance joint tax administration. These agreements may include (1) joint filing of Federal and State income tax returns, (2) single processing of these returns, and (3) joint collection of taxes (other than Federal income taxes).

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

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

Effective Date

This provision is effective on the date of enactment.

PREPARED STATEMENT OF R. SEAN BRENNAN

Chairman Boren and Members of the Subcommittee on Taxation, my name is R. Sean Brennan, and I am Director of Taxes for Mesa Limited Partnership ("Mesa") of Dallas, Texas. Mesa converted to a publicly traded partnership from a corporation in 1985. At that time, Mesa recognized $250 million in income. Currently, Mesa is one of the largest partnerships in the U.S. with approximately 125,000 partners.

We appreciate the opportunity to testify about the large partnership tax simplification proposals contained in S. 1394. We hope that Mesa's extensive experiences operating as a large publicly traded partnership will prove to be a helpful resource for the Committee.

My remarks focus primarily on an amendment Mesa would like to see incorporated into the simplification bill. This amendment would provide an election for large partnerships to report income and pay unrelated business income ("UBI") tax for tax-exempt partners. We believe that this amendment would simplify and enhance compliance, in accordance with the criteria we understand was used when this legislation was drafted. Further, the UBI composite reporting election should be allowed, even for those widely held partnerships which do not or cannot utilize the legislation's new reporting rules.

Under current law, UBI reporting is troublesome for all involved. For Individual Retirement Accounts ("IRAs") and smaller institutional investors, UBI reporting requires considerable knowledge to work through and understand complex rules not originally designed to apply to such entities. In many cases, reporting can be expensive to the investor. For the Treasury, complex reporting creates widespread deficiencies in compliance, which results in lost revenues. For large partnerships, current law creates a disincentive for investment by tax-exempt entities, such as institutional investors and IRA accounts.

The Solution: Composite UBI Reporting

Individuals, through their IRAs, and other tax-exempt entities often invest in widely held partnerships. For example, Mesa has approximately 23,000 tax-exempt investors. Although unknown by the general tax-exempt investor, widely held partnerships can generate UBI under current law. Any such investment which generates $1,000 of gross UBI requires the filing of an annual return (Internal Revenue Service Form 990-T). Furthermore, as an additional administrative burden, these accounts, including IRAs, must apply for employer identification numbers (EIN). EINs are generally not otherwise necessary in the creation and administration of these retirement arrangements. Although Mesa provides all the information to each account sufficient to complete this return, we believe there is widespread noncompliance deficiencies and erroneous reporting in this area.

Mesa's proposed amendment would provide a widely held partnership (as defined in the simplification bill) an election to file one composite Internal Revenue Service Form 990-T on behalf of all its tax-exempt partners. Although we are working with tax writing staff members on the details of this proposal, the following provides our initial suggestions on how this election would operate.

The election would be made each year, at the time the partnership's own return is due. To achieve maximum simplification, the partnership would pay any associated taxes on

behalf of its tax-exempt partners under a flat rate. This rate would be set so as to approximate the current aggregate effective tax rate under current law for such tax-exempt partners. In determining the rate, consideration would be given to the current $1,000 deduction allowed each partner and the tiered income tax brackets. Presumably, a hypothetical rate might be in the 20-25 percent range. The composite return and taxes would be due at the same time as current law generally requires for partners filing these returns; i.e., the 15th day of the 5th month after the end of the tax year, plus extensions.

The UBI attributable to the tax-exempt partner's investment would be calculated at the partnership level. Consistent with this treatment of income and deductions, credits would be calculated and utilized in the partnership's composite return and would not be passed through to the tax-exempt partners. Limitations and carryovers would be determined at the partnership level. Net unrelated business losses would not be passed through to the exempt partners. Any net composite UBI loss would be carried forward or backward at the partnership level as a net operating loss deductible in prior or future partnership UBI composite returns.

This proposal would eliminate the need for annual reporting of income, deductions and credits to the exempt partners. As a practical matter, the partnership would still need to report certain information, including basis amounts, to the exempt partners for their use in calculating gain or loss upon disposition of their interests. This reporting is necessary since the disposition gain or loss would have to be reported by the tax-exempt partner (similar to the current rules for stock transactions). Due to disparities in partnership size, number of partners, amount of trading and costs involved, our proposal would allow the partnership to elect the type of format and timing (i.e. annual reports or reports only in the year of actual disposition) for this information to its exempt partners.

The partnership (current partners) generally would be liable for any additional tax, interest and penalties. To the extent that deficiencies were attributable to inaccurate or untimely reporting to the partnership of ownership data, however, the partnership would not be assessed penalties. These errors would be beyond the control of the partnership, and current law already provides for penalties to be assessed upon those persons responsible for reporting accurate ownership information to the partnership.

<u>**Benefits of a Composite Return System**</u>

Even though a composite UBI return election could result in a detrimental cash cost to the partnership, the proposal could create a number of benefits to all parties involved.

First, IRA holders and other tax-exempt investors would no longer be subject to complicated administrative compliance requirements. In particular, a tax-exempt partner would no longer have to file a Form 990-T to report their UBI from the partnership.

Second, the IRS would achieve a significant reduction in volume of filings, greatly enhanced compliance, as well as a centralized audit system for the tax-exempt partners. In addition to the revenue enhancement associated with enhanced compliance, the proposal would also reduce IRS administrative costs and significant problems contained in the tax compliance and administration proposals associated with tax-exempt ownership.

Third, the partnership benefits because significant barriers to tax-exempt institutional and retirement fund investment are removed. This should ultimately result in making additional capital available for such critical industries as real estate and domestic energy.

Analysis of Mesa's Composite Return Amendment

I would like to briefly review Mesa's UBI composite return proposal in light of the criteria we understand the Committee used in developing the original simplification proposals contained in S. 1394.

1) **The composite return proposal would significantly reduce mechanical complexity and recordkeeping requirements of the partnership and the partners.** Composite UBI returns would eliminate a widely held partnership's need to provide a vast amount of complex information about the characterization of operating income and deductions to its partners.

   This specialized information is needed only by the tax-exempt partners to determine their UBI. Unfortunately, this information is generally distributed by widely held partnerships to all partners, because it is easier and less expensive for the partnership than producing separate mailings for tax-exempt partners. This additional information can be confusing to all partners. A composite return system would thus reduce complexity and record keeping requirements for both the partners and the partnership.

2) **The proposal would significantly reduce compliance and administrative costs to the partnership and the exempt partners.** As mentioned briefly above, there are significant costs related to a partnership which must report UBI to its tax exempt partners. This cost would be eliminated under the composite return proposal. Moreover, the IRA holders, who are generally unfamiliar with the complexities of partnership tax law, would be able reduce their tax preparation costs.

3) **The proposal would preserve underlying policy objectives of the current large partnership rules. The proposal would not create or reopen opportunities for abusive tax planning.** A clear benefit of the composite return proposal is that it would increase tax compliance. Currently, because of the complexity of the reporting system, taxes are not being paid by many IRA holders. Under this proposal, an individual partner's tax liability would be satisfied.

4) **The proposal would comport with generally accepted tax principles relating to large partnerships.** Current partnership law is a blending of the aggregate and entity approach to taxation. The composite return proposal is not inconsistent with this blending of tax policies. Moreover, the proposal reflects those principles in the simplification bill which require calculating income at the partnership level.

5) **The proposal would limit any significant reallocation of tax burdens among taxpayers.** An exempt partner's basis would reflect the income tax paid on their behalf. A taxable partner's income and basis would not be affected.

6) **The simplification that would be achieved by instituting a UBI composite return system would outweigh any instability created by statutory change.** In fact, because the proposal would be elective, it should not create any instability.

7) **The composite return proposal will comport with current revenue and budgetary constraints.** It should lead to an increase in revenue, as noncompliance with the unrelated business income rules is significantly reduced.

Mr. Chairman, Mesa and I thank you and the entire Subcommittee for holding this hearing on S. 1394. I would be pleased to answer any questions you may have.

PREPARED STATEMENT OF ROBERT M. BROWN

INTRODUCTION

Thank you, Mr. Chairman, for the opportunity to testify today on a subject that is of great importance to all American taxpayers. I am Robert M. Brown, Chairman of the Tax Simplification Committee of the American Institute of Certified Public Accountants. The AICPA is the national professional organization of CPAs, with over 300,000 members.

We would like to take this opportunity to publicly compliment the Committee on the steps you are taking to simplify the tax law. This hearing on the various simplification proposals is an important step in an ongoing, orderly process to simplify the tax laws. We recognize and strongly support the evolutionary process you have begun.

We appreciate the opportunity to comment on these proposed tax law changes which simplify the Code, make it more administrable, and improve the prospects for voluntary compliance, without adversely affecting revenues. This process is the antithesis of legislating without hearings or debate; it is methodology which, if continued, will ensure a stable, more acceptable, and simpler tax law.

The AICPA urges that tax simplification be made a legislative priority. We have made the need to simplify the tax law the focus of much of our work for the past three years. The Tax Simplification Committee was created in 1988 to spearhead this effort. As a result, we have entered into a broad range of simplification projects, such as: development of a comprehensive package of simplification recommendations submitted to the Congress starting in April 1990; co-sponsorship with the American Bar Association of the Invitational Conference on Reduction of Income Tax Complexity in January 1990; declaration of April 16th as Tax Simplification Day; and, offering testimony and support to Congressional efforts to simplify various areas of the tax law. We have been very visible in our support of simplification through such projects as our red SIMPLIFY buttons.

The AICPA would like to see additional areas which affect a large number of individual taxpayers considered for simplification. We hope you will give further consideration to some of the recommendations made by us and others in response to the Committee on Ways and Means' February 1990 request for simplification proposals. In addition, we are currently refining yet another package of simplification recommendations which will be submitted to the Congress in the near future.

THE PROBLEM

Complexity in the tax law has reached the point at which many tax practitioners and taxpayers believe that it is undermining our system of voluntary compliance. Taxpayers and tax practitioners are increasingly frustrated with the burden of trying to understand and comply with the law. Further, the Internal Revenue Service is finding it increasingly more difficult to administer the law. Frequent change, the current legislative process, and the increasing complexity and magnitude of the Code are serious concerns to us all.

The cornerstone of tax administration in the United States is a voluntary tax compliance system. Voluntary compliance depends both on the ability and the willingness of taxpayers to comply. Complexity threatens to erode this system because full compliance in many cases requires an unreasonable outlay of effort and resources. Complexity leads some taxpayers to believe that the IRS will be incapable of discovering their noncompliance. Some may have developed the impression that understanding the tax laws serves only to increase the amount of

taxes that they must pay. Some taxpayers believe it is to their advantage to use less knowledgeable tax preparers.

To maintain a voluntary tax system, it is imperative that simplification be given a very high priority at all stages of the tax process. Simplification concerns must coexist with policy and revenue objectives. Simplification must be an integral part of the tax legislative, regulatory, and administrative processes.

While it may be true that a "simple" tax system will never be designed for all taxpayers, a "simple" tax system for some and a "simpler" tax system for all is achievable.

WHAT IS NEEDED

Defining what constitutes simplification is not easy. We define simplification in terms of increasing the understandability and workability of the tax law.

In order to develop a simpler tax law, we must identify the factors that contribute to complexity, recognize opportunities for simplification and provide a framework which considers and balances tax policy objectives.

MEASURES AND EXAMPLES OF COMPLEXITY

One measure of the current level of complexity is the out-of-pocket costs incurred to comply with filing requirements. The majority of individual taxpayers, especially those with simple financial affairs, should not have to seek professional return preparation. According to recent estimates, the cost of collecting individual income taxes, including the value of time spent by taxpayers, is between 5 and 10 percent of the tax revenue raised.[1] This could be in the range of $20 to $40 billion[2] for individuals alone. Further, the cost of compliance with business income taxation rules is approximately twice as large.

COMMENTS ON SPECIFIC LEGISLATIVE PROPOSALS

The AICPA strongly supports S. 1394, The Tax Simplification Act of 1991. We also strongly support H.R. 2775, an additional simplification bill, and S. 1364, legislation designed to simplify and increase access to pension plans. We encourage the Congress to debate, revise and enact these measures. We support most of the provisions in the bills, as detailed in the summary of positions contained in this testimony and the attachments. However, we have concerns about a few. Detailed below are specific comments on some of the provisions in the bills. The AICPA technical committees and staff would welcome the opportunity to work with the Committee and provide assistance as these bills are refined.

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[1] Slemrod, Joel, "Did TRA86 Simplify Tax Matters?" a working paper presented at American Economic Association meeting December, 1990, pg. 2.

[2] Internal Revenue Statistics of Income Bulletin, Volume 9, Number 4, Spring 1990, pg. 5. Preliminary data for 1988 individual income tax returns shows total income tax collected of $416 billion.

Attached to this testimony is the AICPA's detailed response to the provisions of S. 1394 regarding the treatment of large partnerships (see Attachment II) and the pension simplification proposals being considered by the Congress (see Attachment III).

INDIVIDUAL TAXATION PROVISIONS

Earned Income Credit

The earned income credit is an area in critical need of simplification. This credit, which is refundable, is aimed at assisting a particular group of taxpayers -- low-income wage earners with dependent children, the group of taxpayers least able to deal with complex tax laws. Yet, the earned income credit, always far from simple, was made much more complicated in the Omnibus Budget Reconciliation Act of 1990 (1990 Act).

The 1990 Act expanded the credit by increasing the percentage and eligible wage base and by adding (1) an increased amount of "basic" credit for wage earners with more than one eligible dependent child, (2) a second credit (at a different percentage) for taxpayers with a qualifying child who is less than one year old at the end of the calendar year (the "supplemental young child credit"), and (3) a third credit (at a still different percentage) based on the amount of health insurance premiums paid by eligible taxpayers (the "health insurance credit").

We agree that all of these additions to the credit were for laudable purposes. However, how much good will they do if the interactive rules are so complex that the group of taxpayers to be benefitted find them incomprehensible and, therefore, do not apply for the credit? For example, (a) the addition to the basic credit or increased credit if there is more than one dependent child results in a second column on the tables issued by the IRS used to compute the credit, (b) the supplemental young child credit is elective, but, if elected, the taxpayer is prohibited from claiming a dependent care credit, and (c) any health insurance premiums forming the basis of the health insurance credit cannot be included as an itemized deduction.

H.R. 2775 contains a simplification proposal which would eliminate the supplemental young child credit. We encourage the Committee to consider this proposal. In addition, we believe the other two 1990 changes should be re-examined in light of the complexity they add. Even before the 1990 complications, the earned income credit was consistently among the top five sources of error on individual tax returns. It should be noted that the maximum additional credit for more than one child is only $43.

While we take no position on whether it is good tax or social policy to have a separate supplemental young child credit or a separate health insurance credit, something needs to be done to simplify this area of law. We strongly urge the Committee and the Congress to take a very hard look at the earned income credit and re-write it to be understandable and usable by the taxpayers it is intended to benefit. It is an excellent candidate to be turned into a model provision for simplicity in the Internal Revenue Code (IRC).

Other Individual Tax Provisions

Although advancing the due date for providing Schedule K-1 (S. 1394, sec. 107) to partners from April 15 to March 15 might facilitate the timely filing of individual returns by some partners, it would greatly increase the compliance burdens on partnerships and their tax advisors. Also, it would increase the number of amended Schedules K-1 and, therefore, amended Forms 1040. There already is pressure on partnerships to issue Schedules K-1 as soon as possible. We question whether this proposal would have any real effect and given our concerns about workload compression, we oppose it. However, we would support

advancing the maximum extension period for issuing Schedules K-1 from October 15 to September 15.

We would also draw the Committee's attention to the de minimis exception to the passive activity loss rules contained in H.R. 2775 (sec. 103) which we believe is beneficial. However, to make it work, items attributed to publicly traded partnerships should not be excluded. The de minimis exception should be applied on an activity-by-activity basis, not on net passive activities, in order to significantly reduce the recordkeeping burdens on taxpayers. If the de minimis rule must be at the net activity level, the dollar amount should be $1,000, not $200.

PROVISIONS AFFECTING PARTNERSHIPS

We agree that the current partnership tax rules are too complex and that simplified reporting, assessment and collection systems are needed, in particular, with respect to publicly traded partnerships and other truly large partnerships. Thus, we support the majority of the large partnership provisions contained in title II of S. 1394. In particular, we strongly support the concept of a simplified reporting system for large partnerships since, as stated in the Explanation to the bill, "Reporting so many separately stated items (i.e., over 40) is burdensome for individual investors with relatively small, passive interests in large partnerships." (Emphasis added.) However, we strongly urge the Committee to remember that the most fundamental principles of partnership taxation are that items of income, gain, loss, deduction and credit retain their character as they flow through to the partners and that the burden and responsibility for any Federal income tax liability is borne at the partner level. We would strongly object to overturning the longstanding fundamental principles of partnership taxation under the guise of simplification.

Also, we believe that the proposal replacing the current rules of IRC section 704(c) with the so-called "deferred sales approach" as well as the provision under which a large partnership would not terminate for Federal income tax purposes solely because 50 percent or more of its interests were sold or exchanged within a 12-month period would reduce "mechanical complexity" for large partnerships.

While the AICPA wholeheartedly agrees that simplification of the partnership rules is needed, we believe (as stated in greater detail in Attachment II) that certain of the proposals, if enacted in their proposed form, would not accomplish the stated objectives to "significantly reduce....recordkeeping requirements" and to "significantly reduce compliance and administrative costs," without creating "significant dislocations of tax burdens among taxpayers." In making changes in this area, we strongly urge the Committee to consider the extent to which it is retreating from the fundamental flow-through attributes of partnership taxation and, thus, to carefully limit its changes to truly large partnerships (i.e., partnerships, other than personal service partnerships, with 500 or more partners).

FOREIGN PROVISIONS

The modification of the tax treatment of income derived from the disposition of stock in a controlled foreign corporation (S. 1394, secs. 311-313) will simplify the current tax system. However, we are concerned that the provision related to previously taxed income, while simpler, could operate in an inequitable manner. If a U.S. parent includes income of a foreign subsidiary under Subpart F in a year prior to the year in which the income is taxed in a foreign jurisdiction, this provision could operate to preclude relief for the foreign taxes subsequently levied on the income.

PROVISIONS RELATING TO S CORPORATIONS

We support the proposed changes in the S corporation area. We recommend the following improvements.

Section 401 of S. 1394 was intended to address the significant problems created by the IRS' proposed regulations regarding the one-class-of-stock requirement issued on October 5, 1990. Revised proposed regulations issued on August 8, 1991, significantly alleviate the problems caused by the original proposed regulations. Nonetheless, we believe that enactment of this proposal would provide helpful clarification of the law.

Sections 402(a) and (b) of S. 1394 are excellent proposals. They will significantly eliminate the problems that result under current law when a corporation encounters difficulties in the process of making an S corporation election. We support both proposals. Further, we compliment the IRS on its past practice of waiving inadvertent terminations. These provisions will extend this waiver authority to other areas where it is needed.

Section 404(c) of S. 1394 is an excellent proposal that would correct an inequity for S corporations with pre-1983 earnings and profits. The provision would also eliminate cumbersome recordkeeping requirements. This proposal was included in our simplification recommendations submitted to the Committee last year.

Section 404(d) of S. 1394 would change the current rule regarding closing the corporation's books upon termination of a shareholder's interest from an elective rule to a mandatory rule. This change would not result in simplification, and would be particularly troublesome because of the unsophisticated nature of many of the businesses that operate in S corporation form. S corporation business owners often consult their accountant or other advisor only once a year, after the close of the business year. Therefore, the advisor may not know that the disposition of a shareholder's interest has occurred until after year-end. If the rule regarding closing the corporation's books were mandatory, the business would have to perform a retroactive cutoff from the accounting records. The most difficult situation would involve a business that keeps inventories, because an inventory count was probably not performed on the date that a shareholder's interest terminated.

When partners' interests change during the year, the partnership may choose to determine the partners' allocations under either of two methods. The partnership may perform a closing of the books, or it can prorate income and losses to each partner based on his percentage interest on each day of the year. Instead of the proposal in section 404(d), we recommend that allocations of income and loss be handled in a manner consistent with the treatment of partners in partnerships. Consistency between partnerships and S corporations would provide a more administrable rule in this area than the current proposal. We recommend that upon any change in a shareholder's ownership (not just a complete termination), the S corporation be allowed to elect either a closing of the books or a pro rata, per share, per day allocation.

ACCOUNTING PROVISIONS

We generally support the de minimis rule of ten percent for the look back method for long term contracts (S. 1394, sec. 411). We urge the Committee to carefully consider the effective date and election mechanisms associated with this proposal to ensure the broadest availability of the election.

The bill authorizes, but does not require, the issuance of regulations for a simplified method of applying uniform cost capitalization rules (S. 1394, sec. 412). Such regulations should apply to as broad a range of costs as possible, and should require less frequent recomputation of base period absorption

percentages than is required in the present language. The AICPA encourages the Committee to indicate its strongest support for the timely issuance of such regulations.

MINIMUM TAX PROVISIONS

The AICPA supports the provisions of S. 1394 that simplify the corporate alternative minimum tax. The provision of a unified depreciation calculation (sec. 421) applicable to both pre-adjustment alternative minimum tax and adjusted current earnings (ACE) is an important step in the elimination of duplicate complications in the two alternative minimum tax systems.

The AICPA applauds the repeal of the special ACE change in ownership rules (S. 1394, sec. 422). The application of these rules, requiring certain taxpayers to restate the basis of their assets exclusively for ACE purposes, is one of the most complex and onerous requirements of the Code. In the Omnibus Budget Reconciliation Act of 1989, Congress recognized that IRC sections 382 and 384 could be relied on to restrict the use of the built-in losses. The repeal of the ACE change of ownership rules eliminates a burdensome provision that served only to back-up those provisions.

The AICPA urges that the ACE change of ownership rules be repealed for all changes of ownership as if the rules had never been included in the Code. Limiting repeal to changes in ownership occurring after the date of enactment recognizes these rules are not necessary, while continuing to apply them for a short period of time to a limited number of taxpayers. The resources of the IRS, taxpayers, and their representatives are better devoted to understanding and interpreting permanent provisions of the law, rather than calculating the effect of a repealed provision that would have been effective for less than two years.

PROVISIONS RELATING TO INCOME TAX TREATMENT OF TRUSTS

We believe that the provision to treat certain revocable trusts as estates (S. 1394, sec. 441) could be greatly improved by allowing an estate and a revocable trust to be treated identically for tax purposes. The bill would create a third type of entity, somewhere between an estate and a trust. This adds tax planning and administrative complexity. Rather than add a new type of entity, the provision should eliminate unnecessary distinctions. Tax equity would be better served by allowing two entities with similar purposes to be taxed similarly. There is little possibility for abuse, and the revenue loss appears to be negligible.

Simplification, ease of administration, and equity are all served by allowing revocable trusts to have the same tax treatment as an estate. If distinctions continue, a cross reference will be needed in each provision of existing law to the proposed IRC section 7701(a)(47) as to whether estate or trust treatment applies. Furthermore, treatment of a revocable trust prior to the death of the grantor, who has become incapacitated, should be clarified.

PROVISIONS RELATING TO PECUNIARY MARITAL BEQUESTS

We would oppose section 401 of H.R. 2775 if this would eliminate the use of pecuniary marital bequests. This change would be undesirable, a substantive change in the law, and not provide any simplification. We support the provision if its sole purpose is to overrule the Alexander Estate case.

ADMINISTRATIVE PROVISIONS

With regard to the provision to simplify employment tax reporting for household employees (S. 1394, sec. 701), we applaud the innovative ideas included in this proposal to deal with a difficult administrative area. Including the payments on the individual's Form 1040 rather than on the Form 942 promotes simplification for affected employers. However, if it is possible, we believe that this provision should be elective rather than mandatory. Those taxpayers who are already accustomed to filing the separate Form 942 should not be required to be subject to the complexity of changing the process.

With regard to the deposit requirements of section 301 of H.R. 2775, we support changing the eighth-monthly rule to payments on Tuesdays and Fridays as being easier to deal with for affected employers. However, we suggest that even further simplification is possible. We propose the following alternative: For all taxpayers not subject to the next day deposit rules, employment taxes attributable to payments made in any week (defined as Sunday through Saturday) shall be deposited on or before the following Tuesday.

We strongly support the provision of H.R. 2775 that would simplify the estimated tax rules for smaller corporations (sec. 311) by restoring an estimated tax safe harbor even if no tax had been paid in the prior year. In such a case, the proposal would allow the taxpayer to use the second prior year tax as a basis for making estimated tax payments, and if no tax was paid in either prior year, no estimated tax payments would be due. This proposal was included in our recommendations submitted to the Committee last year. It would greatly simplify the estimated tax requirements for many smaller corporations and we urge its inclusion in S. 1394.

MUTUAL FUND PROVISIONS

In its deliberations regarding simplification proposals, we recommend that the Committee consider the provisions of H.R. 2735, regarding the tax treatment of mutual funds. We support these provisions, as we believe they would significantly simplify management and recordkeeping for mutual funds and their shareholders. We particularly support the repeal of the 30 percent gross income limitation of IRC section 851(b)(3), as provided by section 1 of H.R. 2735. The current law limitation imposes burdensome administrative requirements on mutual funds and places unnecessary restrictions on their investment activities, which ultimately are detrimental to individual investors.

CURRENT PENSION ACCESS AND SIMPLIFICATION ISSUES

The complexity implicit in the rules governing the taxation of private retirement plans is now at a point where it is: (1) discouraging the establishment of new plans and encouraging termination of existing plans; (2) diverting money to plan administration and away from benefits; and, (3) resulting in intentional and unintentional noncompliance with the law.

We believe that it is possible to substantially reduce the complexity of current law while still achieving virtually all of the policy objectives o current law. We propose that the appropriate test in analyzing a pension proposal from a simplification point of view is whether the incremental contribution to equity made by a rule outweighs the incremental contribution to complexity of the law? Accordingly, the AICPA takes the following positions (see Attachment III for greater detail):

Distributions

We support allowing any distribution other than a required minimum distribution to be rolled over; we support the repeal of 5-year averaging; we support termination of the 10-year averaging grandfather rule in 1996; and, we strongly oppose mandatory trustee-to-trustee transfer rules.

401(k) Plans

We believe the ADP test should be repealed and a notification provision enacted. If that is not possible, we support the alternative safe harbors in H.R. 2641 and the use of the prior year's deferral percentage to limit deferrals for highly compensated employees. We support extension of section 401(k) plans to tax exempt and state and local government employers.

Definitions

We support efforts to simplify the definition of "leased employees" and "highly compensated employees."

Simplified Plans for Small Employers

We support efforts to simplify the Simplified Employee Pension (SEP) rules by increasing the number of allowable employees to 100 and eliminating the 50 percent requirement for salary reduction SEPs. We believe that requiring employers to contribute 2 percent or more of compensation to a retirement plan to be exempt from ADP testing will add an alternative to the law which will have very limited acceptability in the marketplace. We question whether enactment of this proposal would either increase access to pension plans or simplify the law.

ATTACHMENT I

SUMMARY OF AICPA POSITIONS ON S. 1394 AND H.R. 2775

The following is a summary of the AICPA's positions on the proposals contained in S. 1394, the Tax Simplification Act of 1991, and H.R. 2775, relating to additional tax simplification. We have used the following abbreviations:

S = Support
SC = Support with Concerns
O = Oppose
NP = No Position

S.1394
TAX SIMPLIFICATION ACT OF 1991

TITLE I. INDIVIDUAL TAX PROVISIONS

S	1.	Rollover of gain on sale of principal residence (sec. 101)
S	2.	Due date for estimated tax payments of individuals (sec. 102)
S	3.	Permit payment of taxes by credit card (sec. 103)
S	4.	Election by parent to claim unearned income of certain children on parent's return (sec. 104)
S	5.	Simplified foreign tax credit limitation for individuals (sec. 105)
S	6.	Personal transactions by individuals in foreign currency (sec. 106)
O	7.	Advance due date for furnishing information to partners (sec. 107)

S 8. Make income tax withholding rules parallel to rules for exclusion from income for combat pay (sec. 108)
S 9. Expanded access to simplified income tax returns (sec. 109)
S 10. Simplification of tax treatment of rural letter carriers' vehicle expenses (sec. 110)
S 11. Exemption from luxury excise tax for certain equipment installed on passenger vehicles for use by disabled individuals (sec. 111)

Title II. TREATMENT OF LARGE PARTNERSHIPS (secs. 201-222)

(NOTE: The AICPA provided detailed testimony on the large partnership provisions of S. 1394 and H.R. 2777 on July 29, 1991 before the House Subcommittee on Select Revenue Measures. See Attachment II for positions taken and detailed discussion of these proposals.)

Title III. FOREIGN PROVISIONS

SC 1. Deferral of tax on income earned through foreign corporations and exceptions to deferral (secs. 301-304)

SC 2. Modification to provisions affecting controlled foreign corporations (secs. 311-313)
S 3. Translation of foreign taxes into U.S. dollar amounts (sec. 321)
S 4. Foreign tax credit limitation under the alternative minimum tax (sec. 322)

Title IV. OTHER INCOME TAX PROVISIONS

A. Provisions Relating to S Corporations
S 1. Determination of whether an S corporation has one class of stock (sec. 401)
S 2. Authority to validate certain invalid elections (sec. 402)
S 3. Treatment of distributions by S corporations during loss year (sec. 403)
S 4. Treatment of S Corporations as shareholders in C corporations (sec. 404(a))
S 5. S corporations permitted to hold subsidiaries (sec. 404(b))
S 6. Elimination of pre-1983 earnings and profits of S corporations (sec. 404(c))
O 7. Determination of shareholder's pro rata share of disposition of entire interest (sec. 404(d))
S 8. Treatment of items of income in respect of a decedent held by an S corporation (sec. 404(e))

B. Accounting Provisions
S 1. Modifications to the look-back method for long-term contracts (sec. 411)
S 2. Simplified method for applying uniform cost capitalization rules (sec. 412)

C. Minimum Tax Provisions
S 1. Depreciation under the corporate alternative minimum tax (sec. 421)
S 2. Treatment of built-in losses for purposes of the corporate alternative minimum tax (sec. 422)

NP D. Tax-Exempt Bond Provisions (secs. 431-436)

SC E. Treatment of Certain Revocable Trust as Estates (sec. 441)

F. Other Provisions Relating to Partnerships
S 1. Matching rules for payment to partners (sec. 442)
SC 2. Close partnership taxable year with respect to deceased partner (sec. 443)

NP G. Corporate Provisions: Clarification of Amount of Gain Recognized by a Security Holder in a Reorganization, Etc. (sec. 444)

Title V. PROVISIONS RELATING TO ESTATE AND GIFT TAXATION

S 1. Waiver of Recovery by a Surviving Spouse's Estate of Tax on QTIP Property (sec. 501)
S 2. Eliminate Transfer by a Revocable Trust from Section 2035 Inclusion (sec. 502)
S 3. Confirm the Appeals Court Decision in the Howard Estate Case (sec. 503)
S 4. Exempt a Qualified Domestic Trust Created Before the 1990 OBRA from its Withholding Tax Requirement (sec. 504)
S 5. Provide a Correction Period for a Defective Special Use Valuation Election (sec. 505)

Title VII. ADMINISTRATIVE PROVISIONS

A. Administrative Provisions
S 1. Simplify employment tax reporting for household employees (sec. 701)
S 2. Penalties for failure to provide reports relating to pension payments (sec. 702)
S 3. Clarify that reproduction from digital images are reproductions for recordkeeping purposes (sec. 703)
S 4. Repeal tax shelter registration (sec. 704)
S 5. Repeal of authority to disclose whether a prospective juror has been audited (sec. 705)
S 6. Repeal TEFRA audit rules for S corporations (sec. 706)
S 7. Clarify statute of limitations for items from passthrough entities (sec. 707)

B. Tax Court Provisions
S 1. Clarify jurisdiction of Tax Court with respect to overpayment determinations (sec. 711)
S 2. Clarify procedures for administrative cost awards (sec. 712)
S 3. Clarify Tax Court jurisdiction over interest determinations (sec. 713)
NP 4. Clarify net worth requirements for awards of administrative or litigation costs (sec. 721)

S C. Permit IRS to Enter Into Cooperative Agreements with State Tax Authorities (sec. 721)

H.R. 2775
RELATING TO ADDITIONAL TAX SIMPLIFICATION

TITLE I. INDIVIDUAL TAX PROVISIONS

S 1. Repeal supplemental young child credit portion of earned income tax credit and increase family size adjustment for earned income tax credit (sec. 101)
S 2. Rollover of gain on sale of principal residence in case of divorce or separation (sec. 102)
SC 3. De minimis exception to passive loss rules (sec. 103)

NP TITLE II. TAX-EXEMPT BOND PROVISIONS (secs. 201-204)

TITLE III. ADMINISTRATIVE PROVISIONS

S 1. Simplify payroll tax deposit requirements (sec. 301)
S 2. Simplify estimated tax payment rules for small corporations (sec. 311)
S 3. Interest rate on large corporate underpayments (sec. 321)

TITLE IV. ESTATE AND GIFT TAX PROVISION
SC Include fractional share of property qualifying for the marital deduction in the gross estate (sec. 401)

ATTACHMENT II

STATEMENT OF PHILIP J. WIESNER
CHAIRMAN OF THE
PARTNERSHIP TAXATION COMMITTEE
OF THE
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
WAYS AND MEANS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

HEARING ON
CERTAIN SIMPLIFICATION PROVISIONS
REGARDING PARTNERSHIPS AND TAX-EXEMPT BONDS
IN H.R. 2777, THE TAX SIMPLIFICATION ACT OF 1991, AND
H.R. 2775, RELATING TO ADDITIONAL TAX SIMPLIFICATION
JULY 29, 1991

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INTRODUCTION

Thank you, Mr. Chairman, for the opportunity to testify today on certain simplification provisions in H.R. 2777. We will confine our comments to the provisions regarding partnership taxation.

My name is Philip Wiesner, Chairman of the Partnership Taxation Committee of the American Institute of Certified Public Accountants. The AICPA is the national professional organization of CPAs, with over 300,000 members.

The AICPA is an enthusiastic supporter of tax simplification. After years of constant change, the Internal Revenue Code is in dire need of simplification. For its part, the Institute formed a Tax Simplification Committee in October 1988 to focus the efforts of our various technical committees. In the intervening years, we have entered into a broad range of simplification projects, including developing recommendations, co-sponsoring an Invitational Conference on Reduction of Income Tax Complexity, and offering testimony and support to Congressional efforts to simplify various areas of the tax law.

We agree that the current partnership tax rules are too complex and that simplified reporting, assessment and collection systems are needed, in particular, with respect to publicly traded partnerships and other truly large partnerships. Thus, we support the majority of the large partnership provisions contained in title II of H.R. 2777. In particular, we strongly support the concept of a simplified reporting system for large partnerships since, as stated in the Explanation to the bill, "Reporting so many separately stated items (i.e., over 40) is burdensome for individual investors with relatively small, passive interests in large partnerships." (Emphasis added.) However, we strongly urge the Committee to remember that the most fundamental principles of partnership taxation are that items of income, gain, loss, deduction and credit retain their character as they flow through to the partners and that the burden and responsibility for any Federal income tax liability is borne at the partner level. We would strongly object to overturning the longstanding fundamental principles of partnership taxation under the guise of simplification.

Also, we believe that the proposal replacing the current rules of Internal Revenue Code section 704(c) with the so-called "deferred sales approach" as well as the provision under which a large partnership would not terminate for Federal income tax purposes solely because 50 percent or more of its interests were sold or exchanged within a 12-month period would reduce "mechanical complexity" for large partnerships.

While the AICPA wholeheartedly agrees that simplification of the partnership rules is needed, we believe - as stated below - that certain of the proposals, if enacted in their proposed form, would not accomplish Chairman Rostenkowski's stated objectives to "significantly reduce....recordkeeping requirements" and to "significantly reduce compliance and administrative costs," without creating "significant dislocations of tax burdens among taxpayers."

Definition of Large Partnerships

Under the proposal, a large partnership is defined as any partnership if the number of persons who were partners in such partnership in a taxable year was at least 250. Also, a partnership with at least 100 partners can elect to be under the new reporting system. However, professional service partnerships and certain oil and gas partnerships are exempted from the new rules.

We believe that these rules should be mandatory only with respect to partnerships (other than personal service partnerships) with 500 or more partners. For partnerships with 250 or more but less than 500 partners, the rules should be elective. Of course, once an election is made, the election should apply to the year for which the election was made and all subsequent years and should not be revocable except with the Secretary's consent.

The AICPA believes that a threshold level defined as partnerships (other than personal service partnerships) with 500 or more partners is fairer than the proposed level of 250 partners. In particular, the apparent assumption behind the simplified reporting and audit rules, for example, (1) netting capital gains and losses at the partnership level with capital loss carryovers retained at the partnership level, (2) treating otherwise tax-exempt interest as taxable income, (3) applying a single activity rule for passive loss purposes (Code section 469), (4) automatically disallowing 70 percent of miscellaneous itemized deductions at the partnership level, (5) applying the investment interest expense limitation at the partnership level (which would be particularly burdensome in the development stage of a real estate partnership), and (6) collecting partnership adjustments from partners for the year in which the adjustment takes effect, is that each partner's share of any item of a large partnership's overall income or loss will be so small that the simplifying assumptions will not deprive a partner of any significant tax benefits provided by the Internal Revenue Code. Also, with respect to the proposal under which the burden of partnership tax adjustments would be shifted to current partners from those who were partners in the year or years that produced the benefit,the cost of the tax deficiency can perhaps be more equitably borne by the partners of partnerships with 500 or more partners.

In summary, we strongly question whether 250 partners is the proper dividing line at which such fundamental changes in the "flow-through" theory of partnership taxation should be automatically imposed.

Excluded Partners

Under the proposal, the large partnership rules would not apply to any excluded partner. An excluded partner is defined as "any partner (1) owning more than a five percent partnership interest at any time during the taxable year, or (2) materially participating in the partnership's activities during the year and holding any interest which is not a limited partnership interest." Presumably,

for such excluded partners the present system of partnership reporting of flow-through items as well as the partner level audit and collection rules (as modified by the unified partnership audit rules enacted in 1982) would continue to apply.

We believe that if a partnership meets the definition of a large partnership, the new rules should apply without exception to all partners of the partnership. Otherwise, we believe that the "simplified" rules for large partnerships could actually result in a more complex recordkeeping and tax reporting system for these partnerships. The net result in our view would not be simplification. For example, application of the new "deferred sale" approach to non-excluded partners, and the current section 704(c) rules to excluded partners, would add to the complexity of large partnership reporting.

State Conformity

Unfortunately, unless and until the states conform their income tax reporting provisions to those of the Federal system, the desired simplification objective of H.R. 2777 will not be achieved because the states would continue the existing reporting mechanisms. The result would be a duplication of effort by the affected partnerships, their partners and advisers. The result would be a recordkeeping and reporting nightmare which would undoubtedly delay the dissemination of partnership information to the partners. Thus, we strongly urge that the effective date of these changes be sufficiently prospective to give the states time to change their rules with respect to large partnerships.

Deferred Sale Treatment for Contributed Property

The bill would replace present law section 704(c) for large partnerships with a "deferred sale" approach under which precontribution gain or loss on the contributed property would be deferred until the occurrence of certain events. Perhaps the most significant aspect of the "deferred sale" approach is that depreciation would be computed at the property's fair market value without limitation under the so-called "ceiling rule" of the present Treasury regulation. We agree with the statement in the explanation of the bill that the present law rules "governing allocations with respect to property contributed to a partnership....are ill-suited to large partnerships, whose interests are commonly transferred." We note that the changes to section 704(c) in 1984 and the Committee Reports accompanying the Deficit Reduction Act of 1984 already give the Treasury Department the authority by regulation to adopt the deferred sale approach and/or to repeal the "ceiling rule" in appropriate circumstances. Unfortunately, no such regulations have yet been promulgated. Since the proposal would only be effective with respect to contributions made on or after January 1, 1992, we suggest that the proposal be made effective to all property contributed after March 31, 1984 where the partnership has consistently applied the deferred sale approach (or a substantially equivalent approach). At a minimum, the bill should require the Treasury Department to issue regulations that would provide for the use of the deferred sale approach for those years after the effective date of the 1984 Act.

Also, under the proposal, the deferred sale approach would be applied only when property is contributed to a large partnership. In its current form, the amendment would not apply in other situations to which section 704(c) currently applies, including situations where there is a revaluation of partnership property

under section 704(b) (for example, a "book-up" following the admission of a new partner). In order to better satisfy the simplification objective of the proposal, we recommend that the deferred sale approach be applied to all situations in which a ceiling rule limitation may otherwise apply under section 704(c), not just to situations where property is contributed to a partnership.

Further, we note that under the deferred sale approach contained in the bill, deferred sale gain on depreciable property is required to be treated as ordinary income rather than section 1231 gain to the extent it relates to an increase in depreciation expense resulting from a "step-up" in the basis of the property to fair market value at the time of contribution. The apparent intent of this approach is to minimize the impact on the Treasury that would otherwise result from giving the partnership an immediate step-up in the basis of such property to fair market value for depreciation purposes, while allowing the contributing partner to recognize a deferred section 1231 gain. Such concerns, however, do not prevent taxpayers who sell property to related parties in tax-deferred transactions in other situations from recognizing section 1231 gain. For example, a partner can sell depreciable property on an installment sale basis to a partnership in which he owns an interest and obtain section 1231 treatment on the deferred gain, while the partnership enjoys a step-up in basis of the asset to fair market value, as long as the partner does not own more than 50 percent of the capital or profits interest in the partnership.

We do not believe that recharacterizing the nature of the gain recognized under the deferred sale approach as ordinary income is justified in situations where the outright sale of the property to the partnership would produce a different result. As a result, we recommend that the bill be amended to reflect an approach to the characterization of gain under the deferred sale approach that is consistent with the rules of section 1231.

OTHER PARTNERSHIP PROVISIONS

Due Date for Furnishing Information to Partners of Large Partnerships

Section 107 of H.R. 2777 would require a large partnership (including personal service partnerships) to furnish information returns to partners by the 15th day of the 3rd month following the close of the partnership's taxable year. We do not believe that this provision would accomplish its intended result of providing complete and accurate partnership return information to partners in sufficient time for them to file their own returns by April 15.

Because of other Internal Revenue Code requirements, most large partnerships report on a calendar year basis. Therefore, under current law, most partnership returns (Forms 1065) and the reports to partners (Schedules K-1) must be filed by April 15. The bill would accelerate the deadline for reports to partners from April 15 to March 15. We understand that most partnership agreements currently state that the partnership and its outside accountants will use their best efforts to complete the Schedules K-1 on or before March 15. In fact, there is extreme pressure imposed on partnerships to send the Schedules K-1 as early as possible to avoid investor relations problems. Therefore, current practice largely makes the proposed change redundant. However, there are good reasons for not making the March 15 filing date mandatory. In particular, virtually all delays beyond March 15 are unavoidable. Enacting a March 15 deadline would not be more successful than the

provision that already exists in most partnership agreements. The proposed amendment would either result in late returns (and possible late filing penalties), or in timely filed but erroneous Schedules K-1 that would later have to be amended (causing, in turn, amended individual returns for all affected partners). Therefore, the AICPA does not support the proposal.

It should be noted that many large partnerships have invested in smaller partnerships that are not required to file until April 15. It will clearly be impossible for "upper tier" partnerships to comply with a March 15 filing requirement.

Publicly traded partnerships with a fiscal year-end would be doubly impacted by the enactment of a provision imposing a 2½ month deadline for furnishing tax information. The nominee clearinghouse has historically been unable to provide reliable street name investor identification until February of the year following the close of the partnership's tax year without regard to the partnership's year-end. As a result, it would be virtually impossible for fiscal year publicly traded partnerships with, for example, a September 30 year-end to furnish tax information under the existing nominee reporting system within 2½ months of the close of their tax year. If such partnerships were to attempt to bypass this system (for example, by gathering street name investor information directly from the nominees), they would most likely only create longer delays in providing accurate tax reporting to such investors and incur undue administrative costs by having to manually process data that is currently electronically linked into their tax reporting systems.

Furthermore, personal service partnerships frequently allocate profits based upon the performance of the individual partners. This requires an evaluation of partner performance before partnership profits can be allocated. This process frequently takes longer than 2½ months. In such instances it would be impossible for large personal service partnerships to comply with this provision. In addition, many large personal service partnerships have multinational operations thereby making it impossible to obtain all of the necessary information to complete the partnership's tax return within 2½ months after the close of its taxable year. For these reasons, we are strongly opposed to subjecting large personal service partnerships to this provision.

With respect to any fiscal year partnership (whether or not it is publicly traded), the objectives of the proposed legislation could be achieved without creating these administrative burdens by changing the proposal to require tax information to be furnished to the partners by March 15 of the year following the close of the partnership's tax year (or, if earlier, the extended due date of the partnership's tax return), rather than 2½ months after the partnership's year-end.

Timing Rules for Inclusion and Deduction of Partnership Guaranteed Payments

Section 442 of H.R. 2777 would conform the timing of the partnership's deduction of guaranteed payments with the income reported by the partner. The AICPA supports this proposal.

Closing of Partnership Taxable Year with Respect to Deceased Partner

Section 443 of H.R. 2777 would require the closing of a partnership taxable year with respect to a partner whose entire interest in the

partnership terminates, whether by death, liquidation or otherwise. Although we agree with the underlying concept of this provision, we believe that in certain situations, inequitable results could occur. Therefore, we recommend that the closing of the partnership taxable year be elective rather than mandatory. In addition, we believe this proposal should be expanded to allow for the elective closing of a partnership taxable year with respect to a partner who files for bankruptcy. Identical inequitable results occur in a bankruptcy as occur upon the death of a partner. Therefore, we urge you to apply the same remedy.

Repeal of Requirement to Register Tax Shelters

The AICPA agrees that because tax shelters were virtually eliminated by the Tax Reform Act of 1986, the tax shelter registration requirements are not needed. We support section 704 of H.R. 2777.

ADDITIONAL RECOMMENDATIONS

In addition to our comments on the specific partnership provisions in H.R. 2775 and H.R. 2777, we have fifteen recommendations for legislative changes which we believe would result in the simplification of the technical aspects of partnership tax law. These proposals will be submitted to you in the near future. In addition, stated below is a recommendation to simplify one reporting requirement imposed upon partnerships.

Elimination of Form 8308

In its March 1990 study on large partnerships, the Treasury recommended that consideration be given to eliminating the need for large partnerships to file form 8308's for certain transactions involving transfers of partnership interests. The reason for this recommendation was the reduced importance of the distinction between capital gains and ordinary income following the Tax Reform Act of 1986. Also, it should be noted that the mandatory use of straight-line depreciation for real property significantly has reduced the number of situations in which ordinary income from depreciation recapture constitutes a significant portion of the total gain on sale of partnership interests. Publicly traded partnerships, in particular, encounter difficulties in dealing with Form 8308's since it is impossible to match a particular transferor with a particular transferee (as required by the Form) since the interests are traded on a public market.

As a result of its decreasing level of importance, we recommend that section 6050K be repealed and the requirement to report section 751(a) transfers on a Form 8308 be eliminated.

CONCLUSION

While we completely agree that a need exists in certain limited situations for simplification of partnership reporting, audit and collections procedures, we believe that the need for simplifying rules is most urgent in the case of partnerships (other than personal service partnerships) with 500 or more partners. In making these changes, we strongly urge the Committee to consider the extent to which it is retreating from the fundamental flow-through attributes of partnership taxation and thus to carefully limit its changes to truly large partnerships.

ATTACHMENT III

Statement of the

Taxation Division

of the

American Institute of Certified Public Accountants

Before the Select Revenue Measures Subcommittee

of the Committee on Ways and Means

of the United States House of Representatives

Hearing on

Current Pension Access and Simplification Issues

July 25, 1991

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Thank you, Mr. Chairman, for the opportunity to testify today on a subject of considerable importance to the American Public and to our membership. I am David J. Kautter, Chairman of the Employee Benefits Taxation Committee of the American Institute of Certified Public Accountants Tax Division.

The AICPA is the national, professional organization of CPAs with over 300,000 members. Our testimony is from the perspective of CPA—tax practitioners who constantly observe the conduct of both plan participants and plan sponsors.

We would like to compliment Chairman Rostenkowski and others who have introduced or cosponsored legislation designed to increase access to pension plans by workers and to simplify the tax rules governing the treatment of private pension plans. We believe the issues of access and simplification are closely related.

The rules governing the taxation of private retirement plans have become increasingly intricate and complex over the past 15 years and we believe that they now rival any other area of the tax law in their complexity. In our opinion, this complexity is at a point where it is adversely affecting both the private pension system itself and the administration of the tax system, and we believe this is an unhealthy state of affairs.

Specifically, the current rules are having three adverse effects on the private pension system and the administration of the tax laws. First, they are discouraging the establishment of new plans and encouraging the termination of existing plans. Employers without qualified plans, primarily small employers, are discouraged from establishing new plans because of the cost of establishing and maintaining arrangements which they cannot understand. Employers with existing qualified plans have grown weary of continuously amending their plans with provisions that they cannot understand and which do not, to them, seem to enhance their employees' retirement security. Second, the current rules divert more money toward plan administration and less toward actual benefits to plan participants than would a simpler system. Third, the current rules are resulting in increased noncompliance—both intentional and unintentional. We believe this last trend is a particularly dangerous one since it not only means that our voluntary compliance system is diminished, but it means that taxpayers who attempt to comply with the law are at a competitive disadvantage with those who do not.

There are a number of reasons why the current rules are overly complex:

- One reason can be characterized as "incremental overload," the relentless layering of one set of changes upon another without the integration of these sets of changes into a comprehensive statutory scheme. Part of the reason for the incremental overload has been the budget deficit and the yearly pressure on Congress to raise revenues. There is no doubt that closing so-called "loopholes" in the qualified plan rules to raise revenues as part of this process has resulted in increased complexity. It is our hope that the budget agreement reached last year will diminish this source of complexity.
- A second reason is the attempt by policy makers to write rules that are so comprehensive and so specific that it is impossible for a taxpayer, even in the most remote circumstance, to contravene statutory intent in the slightest. Not all of the complexity attributable to this second cause emanates from Congress. The Executive Branch in its efforts to "fine tune" statutory language and fully implement the intent of Congress has written exhaustive regulations which are virtually incapable of being fully understood either by practitioners or Internal Revenue Agents. The current approach can be likened to that of a fisherman who weaves his nets so tightly, to prevent even the smallest fish from slipping through the net, that the fisherman is pulled overboard when the net is tossed into the water.
- A third reason is the process by which qualified plan rules have been changed in recent years. Often there have not been hearings held on the specific qualified plan proposals contained in budget reconciliation bills and continuing resolutions. These provisions became lost and buried in the volume of these bills as they were rushed to the floor with little time allowed for comment by the public, floor debate of many provisions, or any real opportunity to alter or amend their content.
- The final reason involves those of us in the private sector. It is the desire on the part of taxpayers and their advisors to retain as much flexibility as possible in designing retirement arrangements. It seems clear that some flexibility will have to be sacrificed if the rules are to be made simpler.

In the qualified plan area, as in other areas of tax policy, a balance must be struck between simplicity and equity. Equity usually comes in the form of nondiscrimination rules in the pension area. The size, shape, and scope of "undue" complexity are elusive and relative concepts, but it is clear that, in reducing the complexity implicit in some of the current pension rules, some equity of current law will be lost. In simplifying other areas of the pension rules, however, equity will be

enhanced. We believe the goal is to find the right balance between inhibiting as much discrimination as possible while utilizing rules that can be broadly understood and implemented and which encourage employers to establish and maintain qualified pension plans. We also believe that it is possible to substantially reduce the complexity of current law while still achieving virtually all of the policy objectives of current law.

We propose that, as Congress looks at this area in the upcoming months, it use the following test to guide it in determining which rules should be retained and which should be changed:
Is the incremental contribution to equity made by a rule outweighed by its incremental contribution to complexity of the law?

Although this test is easy to state, answering it in many cases will not be easy. In some cases, reduction of complexity will not involve a re-examination of the tax policy underlying the current rules. In others, tax policy re-examination will be required and may involve accepting, as a society, some incremental discrimination or enhanced equity beyond that which is currently provided. It may also involve accepting less flexibility on the part of taxpayers in the design and operation of tax-favored pension arrangements. These may not be easy for some to accept.

In applying this test, we would urge you to consider the complete elimination of rules which do not meet the test instead of trying to patch them up in ways that will only add more complexity. We also urge the use of design based rules whenever possible in order to avoid detailed testing rules which add to uncertainty and plan administration costs. Unless the complexity of the retirement rules is reduced, the trend is likely to be a weakened private pension system and increasing noncompliance—not intentional, but unintentional brought about by taxpayers' inability to understand what is expected of them under the law.

Taxation of Distributions

A. Rollovers

We strongly support allowing any distribution from a qualified plan, other than a required minimum distribution under Section 401(a)(9), to be eligible for rollover treatment. This will substantially simplify the taxation of distributions and distribution planning for a large number of taxpayers. It will also encourage retention of funds originally contributed to retirement plans for retirement purposes. We do not, however, believe that precluding the rollover of certain periodic distributions as provided in H.R. 2730 will simplify the law in this area. We believe that this is the type of provision whose contribution to complexity is outweighed by its contribution to equity.

Now that after-tax contributions can be made to Individual Retirement Accounts (IRAs), we see no substantial simplification goal served by continuing to preclude the rollover of after-tax employee contributions. Allowing the rollover of after-tax amounts would further encourage the retention of these amounts for retirement purposes. From a simplification point of view, there is a question whether after-tax IRA contributions substantially complicate the administration of IRAs and the taxability of distributions from IRAs. As long as they are allowed, however, we see no additional complexity created by allowing the rollover of employee after-tax contributions from a qualified plan.

B. Averaging

We support the repeal of five year averaging treatment for distributions from qualified retirement plans. This is an area of substantial complexity in current law and its elimination would not only simplify the taxation of distributions but would also encourage the retention of funds for retirement.

We are concerned with the retention of the definition of a "lump sum distribution" by some of the bills before the Subcommittee for purposes of the net unrealized appreciation rules. The primary simplification achieved by eliminating averaging treatment is the elimination of the definition of "lump sum distribution", not the elimination of the averaging computation. Retention of the definition of "lump sum distribution" in the law undercuts the substantial simplification that elimination of averaging achieves. We believe the definition should be eliminated for all purposes. If net unrealized appreciation continues to be excluded from

taxation, we suggest that the simplest system would be one in which any distribution of employer securities from a plan results in the exclusion of net unrealized appreciation.

We also believe that reasonable transition rules should be provided to allow taxpayers to adjust their retirement plans to take into account the repeal of averaging treatment and any other changes in the distribution rules. In this regard, we believe that taxpayers who were grandfathered under the 10 year averaging provision of the Tax Reform Act of 1986 should continue to be grandfathered until 1996. This would provide a 10 year period during which these individuals could adjust their retirement plans. We do not support a phase-out of the rules governing the taxation of distributions. In our view, allowing current law treatment for only a portion of distributions increases the complexity of decision making during the transition period.

C. Minimum Distributions (§401(a)(9))

We believe that §401(a)(9) can be simplified by: (1) limiting its scope to situations where there are opportunities for substantial tax deferral and (2) making the calculation of the minimum required distribution amount more straightforward. Of these two goals, we believe that the second is the more important and we are disappointed that none of the bills before the Subcommittee deal with this problem.

With respect to the first of these goals, we support limiting the application of §401(a)(9) to require distributions from qualified plans to commence April 1 of the year following the later of the year an employee turns age 70 or retires. We believe this rule should apply to 5% owners the same as other employees. If it is believed that distributions should be required to commence for certain owners before they retire, then we believe this exception should be targeted to those situations where the owners can exert substantial influence over a business, and the opportunity for tax deferral is significant. We would suggest that distributions be required to commence before someone retires if they are a 20% shareholder and the present value of their accrued benefit exceeds $750,000. With respect to IRAs, we believe distributions should be required to begin by April 1 of the calendar year following the year in which an IRA owner turns age 70.

With respect to the second of the above goals, the rules could be simplified by providing that at death, distributions be required to be paid over the life expectancy of the beneficiary beginning at the decedent's death. There would be no distinction between situations where an individual dies before or after their required beginning date. There would also be no distinction between types of beneficiaries as there is under current law. Second, the calculation of life expectancy should either be required to be recalculated annually or not allowed to be recalculated. The current election under which taxpayers can choose one method or the other is one that could be eliminated in an effort to simplify both the law and the retirement planning process. Third, design-based safe-harbors should be considered. For example, taxpayers commencing distributions at age 70 1/2 (or age 70) could be allowed to elect to receive a minimum annual distribution of 10% of their account balance on the December 31 preceding the year they turn 70 1/2 (or age 70). Once determined, this amount would remain fixed and would be required to be received annually until the account was depleted. A design-based safe-harbor of this type would result in an annual amortization of the account over approximately 16 years at 6.2% and would provide a simple alternative to the current regulations.

D. Trustee-to-Trustee Transfers

We strongly oppose requiring certain distributions to be made in the form of mandatory trustee-to-trustee transfers. In our view, this provision would add unneeded complexity both to the tax law itself and the process of administering a retirement plan. For example, under several of the bills before the Subcommittee, the portion of a distribution which represents an employee's after-tax contribution would not be required to be transferred while employer contributions and earnings would. This would require plans with employee contributions to make two distributions instead of one. One to the participant as a return of contributions and one to the transferee plan. It will also require two

distributions in most other cases, one to the transferee plan and a subsequent one to the participant. This will not simplify plan administration.

The purpose of this provision appears to be to encourage participants to leave their money in a qualified retirement plan until retirement. This is the same purpose of §72(t) of the Code which imposes an additional 10% income tax if amounts are withdrawn from a retirement plan prior to age 59 1/2. We believe that the incremental encouragement to save for retirement that a required trustee-to-trustee transfer provision would yield is outweighed by its incremental contribution to complexity. It is exactly this type of duplicative provision that most of the bills before the Subcommittee are designed to eliminate. In short, we believe that either a trustee-to-trustee transfer provision should be part of the Code or §72(t), but not both. Our view is that §72(t) is a simpler and more effective way to achieve this policy goal than is a mandatory trustee-to-trustee transfer provision, and would suggest increasing the rate of tax under §72(t) before enacting a mandatory trustee-to-trustee transfer provision.

With respect to mandating that all qualified plans provide participants with the ability to make elective trustee-to-trustee transfers, we similarly believe that this will not only complicate the law, but that it will increase confusion among participants. If enacted, it would become necessary to explain to all eligible participants not only what a trustee-to-trustee transfer is, but how it differs from a rollover. We doubt that many participants will easily grasp the subtlety implicit in these two concepts and this will create confusion and increase the cost of plan administration. In addition, trustee-to-trustee transfers would require the recipient plan to provide the protections afforded by section 411(d)(6). This could lead to even greater complexity in plan administration. For these reasons, we oppose the enactment of legislation that would require plans to provide participants with the opportunity to make trustee-to-trustee transfers on an elective basis.

Finally, we believe that if the rollover rules are liberalized as suggested in the bills before the Subcommittee, serious consideration should be given to restricting trustee-to-trustee transfers to plans maintained by the same employer. The rules governing trustee-to-trustee transfers have become a separate subset of the law. These rules are not in the Internal Revenue Code or the regulations but are found primarily in revenue rulings and private letter rulings and are largely duplicative of the rollover rules. We believe the time has come to re-examine the role of trustee-to-trustee transfers in the tax law.

E. Simplified Basis Recovery Rules

We support the provisions of H.R. 2730 designed to provide a simplified basis recovery method for purposes of annuity distributions.

F. In-Service Distributions for Rural Cooperative Plans

We support this provision since it would conform the rules of §401(k) plans maintained by rural cooperatives to those applicable to other §401(k) plans.

401(k) Plans

A. Actual Deferred Percentage Test

One of the most misunderstood and misapplied pension provisions of current law involves the actual deferral percentage test for 401(k) plans. This test was enacted at a time when highly compensated employees could elect to defer up to $30,000 annually under a §401(k) plan. It is aimed at preventing a 401(k) plan from discriminating against nonhighly compensated employees, and operates to supplant §401(a)(4). The potential for discrimination in a 401(k) plan has been dramatically reduced by the lowering of the elective deferral limitation in TRA 86 to $7,000 (indexed for cost of living). Performing the actual deferral percentage test is time consuming and expensive for a plan of any significant size. In addition, many plan sponsors have not accurately tested their plans for compliance with the ADP test on a timely basis. In our experience, the failure to timely and

accurately perform the ADP test is not caused by taxpayers' lack of desire to comply, it is a function of data gathering and processing.

We believe that the §401(k) rules should be amended: (1) to require that all employees with a requisite age and year(s) of service and not otherwise excluded under §410(b) be permitted to make deferrals under a 401(k) plan, (2) the actual deferral percentage test be repealed, and (3) employers be required to give notice annually to all eligible employees of their right to participate in the plan.

If the above is not feasible, we would reluctantly support the enactment of design based safe-harbors along the lines of H.R. 2641. We believe the three alternatives set forth in that bill would provide substantial flexibility to employers who want to avoid annual ADP testing.

In addition, we believe that if design based safe-harbors are adopted, the ADP test should also be improved by adopting one of the central concepts in H.R. 2641 and H.R. 2730—use of the prior year's average deferral percentage of nonhighly compensated employees in setting the limit on current year deferrals for highly paid employees.

We wish to strongly emphasize, however, that we believe the incremental contribution to equity brought about by the ADP test is strongly outweighed by its contribution to complexity. This test requires extensive data to be gathered and processed. The use of the prior year's data in computing current year contributions would not eliminate the need to collect and process this data. It would not eliminate computational errors or data gathering difficulties experienced by employers with multiple payroll departments. We believe that employers can be required to encourage participation in a 401(k) plan by requiring them annually or semi-annually to notify employees of their right to participate. The notice could be required to contain certain information designed to demonstrate the benefits of participation to nonhighly paid employees.

B. Tax Exempt Employers and State and Local Governments

We support extending 401(k) plans to both tax exempt employers and state and local governments in 1992.

Simplified Employee Pension Plans for Small Employers

We strongly support efforts to provide simplified retirement plans for small employers. Small employers have been affected disproportionately by the current complexity of the law and simplified arrangements are essential to the adoption and retention of retirement arrangements by small employers.

We believe that requiring one year of service in order to be eligible to participate in a SEP will simplify the design of these plans.

We support increasing the number of employees which may be eligible for a salary reduction SEP from 25 to 100.

We support eliminating the 50% participation requirement for salary reduction SEPs.

We believe that addition of the alternative test in H.R. 2641 will simplify the administration of certain SEPs.

We are concerned that requiring employers to contribute at least 2% (POWER Proposal) or 3% (H.R. 2730) of compensation in order to maintain a salary reduction SEP which is exempt from the ADP test will consign the adoption of these plans to very few employers. From a business perspective, many small employers do not adopt §401(k) plans because of the cost of administering the plan. These administration costs, which many small employers find unacceptable, do not usually even come close to approaching 2% of compensation. We do not believe that employers who are unwilling to adopt a §401(k) plan because the administration costs

are unacceptably high at less than 2% of compensation will be interested in adopting a salary reduction SEP which requires them to contribute 2% or more of compensation for all eligible participants in order to be exempt from the ADP test. We believe enactment of such a proposal would only add further complexity to the law with respect to a retirement alternative which will have very limited acceptability in the marketplace. We question whether its enactment would simplify the law for small employers or increase access to retirement plans by a significant number of employees.

Definitions

A. Leased Employees

We support replacing the "historically performed" test with a "direction or control" test. The current "historically performed" test leads to confusion and inconsistent application of the law by both taxpayers and the IRS. We are concerned, however, about introducing into the law a new concept which is apparently unrelated to a similar test used in the definition of whether someone is a common law employee. To the extent existing precedents can be used under this new test, we believe they would substantially simplify the law.

We also are concerned about an overly broad grant of regulatory authority to the IRS under the leased employee provisions. To the extent abuses arise, they should be dealt with under §414(o).

B. Highly Compensated Employees

In an effort to simplify plan administration, we believe that employers should know, to the greatest extent possible, who is "highly compensated" before a plan year begins. We believe that a "highly compensated" employee should be an employee:

(1) who earned more than $50,000 (indexed) during the preceding year, or

(2) who was a 5% owner during the current or preceding year.

Family Aggregation Rules

We strongly support H.R. 2641. We believe that neither current law nor the other proposals before the Subcommittee pass the test of having their incremental contribution to equity outweighed by their incremental contribution to complexity in this area.

Section 457 Plans

We support H.R. 2641. This would eliminate an area of controversy between taxpayers and the IRS and would simplify administration of the law.

Death Benefit Exclusion

We support repealing the $5,000 death benefit exclusion in the interest of simplification. Employers could still make payments of this nature upon death, but they would not be excluded from income taxation.

Minimum Participation

We support H.R. 2641 which would limit the application of §401(a)(26) to defined benefit plans and reduce the 50 employee requirement to 25 employees. We also support codification of the simplified testing method contained in that legislation.

VEBAs

We support H.R. 2641 and H.R. 2742. This proposal would provide clear guidelines as to whether certain arrangements qualify as VEBAs and would eliminate an area of controversy between taxpayers and the IRS.

Plans for Self Employed Individuals

We support elimination of the special aggregation rules for plans maintained by self-employed individuals. This would simplify the law and eliminate a trap for the unwary.

We also believe that the last two sentences of §4975(d) prohibiting loans from qualified plans to owner-employees should be eliminated.

Cost of Living Adjustment

We support the proposals to publish the various adjusted limits for qualified retirement plans prior to the beginning of the year. This would provide additional certainty in plan administration. We also support the rounding of these limits as set forth in H.R. 2730.

Half-year Requirements

We support H.R. 2730 and H.R. 2742 in eliminating the various half-year requirements currently in use in the tax law.

Contributions

We support the proposal in H.R. 2641 and H.R. 2742 that permits certain contributions to be made on behalf of disabled participants without violating section 415.

Retirement Age

We support the concept of establishing the normal retirement age as the social security retirement age.

PREPARED STATEMENT OF FREDERIC G. CORNEEL

Senator Boren and Subcommittee Members: I appreciate the opportunity to submit two proposals that would simplify the operation and ownership of S corporations. The first proposal would simplify estate planning for families owning S corporation shares by permitting, within very strict limits, ownership of such shares by discretionary trusts. The second proposal relates to the taxation of dividends paid by 80% owned subsidiaries of S corporations.

I am an attorney with a special interest in the taxation of family businesses and their owners. I am former Chairman of the Tax Section of the Massachusetts Bar Association and of the Small Business Committee and of the Committee on Standards of Tax Practice of the Tax Section of the American Bar Association. I recently completed a two-year term as a member of the Commissioner's (Internal Revenue Service) Advisory Group. However, I am not making these proposals on behalf of any of these organizations. I am the senior partner in the tax department of Sullivan & Worcester in Boston, Massachusetts. Our firm has clients who are owners of family corporations and other clients that function as trustees of trusts holding family corporation stock and who may compensate my firm for our efforts in connection with the proposals here submitted. However, quite aside from any benefit to particular clients, I believe that both of these proposals would simplify the ownership and operation of many S corporations and thus produce a substantial practical benefit, a benefit which I believe is unlikely to involve revenue loss.

From the time the Internal Revenue Code first authorized S corporations, it has restricted their ownership to U.S. individuals. Only gradually have these limitations been enlarged to permit limited trust ownership. The reluctance to permit trust ownership has been grounded in the concern that such ownership might be used to circumvent basic subchapter S principles. Therefore, generally speaking, under present law a trust can own S corporation stock only if all of the income allocable to the trust is currently taxed to a designated U.S. individual.

This limitation has made it impossible for commonly used discretionary family trusts to hold shares in S corporations. Such family trusts have become a frequently used device for that portion of the estate that does not pass to the surviving spouse. Rather than giving specific shares in the family trust to the surviving spouse, children and grandchildren, the modern family trust provides that it is established for the benefit of the entire family and the trustee is given discretion to distribute ("spray" or "sprinkle") income or principal to one or more members of the family, depending upon their needs and resources, or if there is no current need, to accumulate the income. Such arrangements provide needed flexibility to adjust distributions to situations that cannot be foreseen when the trust is established.

As indicated, current S rules preclude a spray trust from holding S stock and thus largely prevent the stock in the family business that is conducted as an S corporation from being part of the assets that may be flexibly employed for the benefit of the entire family. Also, qualified subchapter S trusts ("QSSTs") must currently distribute all of their income. In order to accommodate their estate planning goals to these requirements, some owners of S stock have established multiple trusts, one or more for each of a number of beneficiaries, and given the beneficiaries withdrawal rights which result in the trusts technically becoming grantor trusts not subject to the QSST requirements. In Private Letter Ruling 8342088, an unspecified number of shareholders of an S corporation set up twenty-six such trusts, which might be consolidated into thirteen on the happening of certain events. In Private Letter Ruling 9009010, one individual set up twenty-four such trusts (under seventeen separate trust instruments, one of which had eight separate shares). Surely a statute which results in such a multiplicity of trusts is in need of simplification.

A number of groups have recommended legislation to remove the subchapter S prohibition against trust ownership. While these proposals may well have merit, they go beyond the scope of simplification legislation, since they would implicate the basic structure of subchapter S. It is doubtless for these reasons that the authors of the S Simplification Bill did not include the trust proposals in their Bill.

In the context of the subchapter S Simplification Bill it may not be appropriate to consider changes in the basic principles of subchapter S. But what can and should be done is to simplify estate planning for the owners of subchapter S corporations by an amendment to the Code that permits discretionary family trust ownership and at the same time preserves the basic principles of subchapter S. The attached draft of legislation accomplishes this objective. Spray trust ownership would be permitted but only under these conditions:

1. The only permitted current beneficiaries, i.e. those who might in the discretion of the trustees receive distributions, would have to be individuals who are U.S. citizens or residents.
2. For purposes of the 35 shareholder limit, each permitted current beneficiary would count as a separate shareholder. Thus a family trust for the benefit of the widow, two children and three grandchildren would count as six shareholders.
3. To accomplish the purpose of the "only one class of stock" rule, namely to assure that all of the S corporation's income is currently taxed to an ascertained shareholder at a fixed rate, all of the S income received by the family trust would be taxed to the trust at the highest individual tax rate. The trust will have to pay this tax whether it accumulates or distributes the income and regardless of the tax bracket of the individual beneficiaries.

These rules are likely to result in higher income taxes paid on the S income if the stock is held by a discretionary family trust rather than outright by children or grandchildren who are not in the top tax bracket. Therefore, some families owning S stock may choose not to use spray trusts to hold S stock. But others will gladly accept the limitations and income tax consequences of the proposal in order to have the greater estate planning flexibility of a spray trust.

Based upon my own practice experience and that of others with whom I have discussed this proposal, I doubt that it will have a meaningful impact on revenue. The choice between a C corporation and an S corporation has not been determined primarily by clients' desire for discretionary trust ownership. The important factors barring S election related to the nature of the business (such as banking and insurance), the number of shareholders (more than 35), the nature of the shareholders (such as venture capital partnerships), the desire for more than one class of stock and the presence of wholly owned subsidiaries.

Where broad family participation in an S corporation is desired for estate planning purposes, stock is now issued to children, grandchildren or the limited types of trusts permitted by present law. A discretionary family trust is used for the family's other assets, but the benefits of a discretionary trust are foregone for the S stock—although, as indicated by the cited Private Rulings, complex substitutes for a simple discretionary trust may be attempted.

I believe it follows that if the proposal were enacted, the result would not be to increase significantly the number of S corporations. But those S owners who desired to provide for continuity of family ownership through use of a discretionary family trust would be able to place their S shares with such a trust, rather than using the other less flexible and frequently more complex arrangements referred to.

In summary, unlike other trust proposals, this proposal does not change any of the basic principles of subchapter S. Rather it permits the owners of subchapter S corporation stock to dispose of the family business in the same way as the balance of their assets without the need of separate and complex arrangements. Altogether, I believe that the proposal would make a significant contribution to facilitating the passage of ownership of a family business from one generation to the next and to simplifying the legal arrangements necessary for such passage, all without opening loopholes in subchapter S.

DIVIDENDS FROM SUBSIDIARIES

Under current law, S corporations may not own more than 80% of the shares of another corporation. Since either the nature of their business or their ownership prevents some corporations from being S corporations, a practice has developed among S corporations having C subsidiaries to have 21% of a subsidiary's stock held by parent company shareholders or employees. To eliminate the need for these complex arrangements, the pending S Simplification Bill (S. 1394/H.R. 2777) would permit S corporations to own up to 100% of the stock of a C corporation.

I believe that this provision in the Simplification Bill will be helpful to a number of S corporations. However, if it should pass, then it should be accompanied by a provision that would remove the dividends paid by these subsidiaries from the penalty regime currently applicable under sections 1362 (d) (3) and 1375 to the "excess net passive income" of S corporations that were formerly C corporations.

Under current law, if an S corporation that was formerly a C corporation has excess net passive income from dividends then that income is subject to what amounts to a triple tax—first to the C corporation that earned it, then to the S corporation which receives the dividend and simultaneously to the S corporation's individual shareholders. Further, if such excess net passive income occurs for 3 successive years, the corporation loses its qualification as an S corporation.

These limitations on excess net passive income are part of subchapter S in order to prevent tax avoidance by owners of a C corporation that has sold its business. If such a C corporation liquidated, the shareholders would have to pay a shareholder level tax on their gain. If the corporation continued as a personal holding company, it would be subject to the special rules and taxes applicable to such corporations. The penalty tax on excess net passive income is imposed to prevent shareholders of the C corporation from avoiding both the shareholder level tax on liquidation and the personal holding company tax on continued operation by electing subchapter S treatment for the on-going investment company.

Dividends from on-going operating C subsidiaries obviously do not involve the kind of tax avoidance that the excess net passive income rules are intended to eliminate. Indeed, for the law on the one hand to permit subsidiaries and on the other hand to penalize their dividends would merely create a trap for the unwary. There is attached hereto the draft of legislation that would appropriately supplement the subsidiary proposal in the S Simplification Bill but do so without opening the door to circumvention of the basic purpose of the excess net passive income rules.

Many thanks for your thoughtful consideration.

Proposed Code Amendments
for Trust as S Shareholder

1. Section 1361(c)(2)(A) is amended by adding thereto the following new clause (v):

"(v) A small business trust."

2. Section 1361(c)(2)(B) is amended by adding thereto the following new clause (v):

"(v) In the case of a trust described in clause (v) of subparagraph (A), each potential current beneficiary (as defined in section 1366(f)(3)(B)) shall be treated as a shareholder; except that if for any year there is no such potential current beneficiary, the trust shall be treated as the shareholder."

3. Section 1366 is amended by redesignating subsections (f) and (g) as subsections (g) and (h) respectively, and by adding to such section 1366 the following new subsection (f):

"(f) Taxation of S items of small business trust.

(1) In general. A tax shall be imposed on the S items of a small business trust, at the highest rate provided by section 1(c) as limited by section 1(h) or, if applicable, by section 55, as if such trust were an individual whose only income, gains, losses, deductions and credits were the S items of the trust, computed with the modifications provided in paragraph (2).

(2) Modifications. The modifications referred to in paragraph (1) are the following:

(A) The personal exemption or allowance in lieu thereof provided by sections 151 and 642(b) shall not be allowed.

(B) The standard deduction provided by section 63(c) shall not be allowed.

(C) The exemption amounts provided by section 55(d) shall not be allowed.

(3) Definitions. For purposes of this subsection--

(A) Small business trust. The term "small business trust" means any trust which

(i) is not a foreign trust;

(ii) does not have as a potential current beneficiary any person who is not an individual or who is a nonresident alien; and

(iii) elects to be subject to this subsection in the manner provided in paragraph (5).

(B) Potential current beneficiary. The term "potential current beneficiary" means each person who must, or might at the discretion of a fiduciary of a trust, receive a distribution from either principal or income of such trust for the current taxable year of such trust.

(C) S item. The term "S item" means

(i) any item of income, gain, loss, deduction or credit which must be taken into account by a shareholder of an S corporation solely by reason of subsection (a);

(ii) any gain or loss from the sale or other disposition of shares of an S corporation; and

(iii) to the extent provided in regulations, state and local taxes and trust administrative expenses properly allocable to items described in clauses (i) and (ii).

(4) Distribution of shares of S corporation. If shares of an S corporation are distributed to a beneficiary, any unused S items attributable to such shares shall be taken into account in computing the taxable income and tax liability of such beneficiary.

(5) Election.

(A) In general. The fiduciary of a trust may elect to have this subsection apply, provided that no election under section 1361(d)(2) is in effect for such trust.

(B) Time, manner and form of election. An election under this paragraph shall be made in such manner and form and at such time as the Secretary may prescribe.

(C) Election irrevocable. An election under this paragraph, once made, may be revoked only with the consent of the Secretary, and shall be in force for each taxable year of the trust in which the requirements of clauses (i) and (ii) of subparagraph (3)(A) are met.

(6) Tax to be in addition to other taxes. The tax imposed by this subsection for any taxable year of a trust shall be in addition to any other tax imposed by this chapter for such taxable year."

4. Section 641 is amended by adding thereto the following new subsection (d):

"(d) Exclusion of S items of small business trust.

(1) General rule. For purposes of this part, the taxable income and tax liability of a trust shall be calculated without taking into account the S items of a small business trust.

(2) Trust no longer owning shares of S corporation. Paragraph (1) shall not apply to any S items remaining after a trust ceases to hold shares of any S corporation and after application of section 1366(f)(4).

(3) Cross reference. For the taxation of S items of a small business trust, see section 1366(f)."

Section 1362(d)(3) is amended by adding at the end thereof the following new paragraph:

(F) SPECIAL RULE FOR DIVIDENDS FROM AFFILIATES. --

(i) IN GENERAL - Neither passive investment income nor gross receipts shall include dividends received by a corporation from any member of the same affiliated group as the corporation receiving such dividend (determined under section 1504 without regard to the exceptions contained in subsection (b) thereof) which is not an excluded member under clause (ii).

(ii) EXCLUDED MEMBERS - A corporation shall be treated as an excluded member if, during any one of its 3 taxable years ending with the year of such payment (or such shorter period as such corporation may have been in existence), such corporation had gross receipts more than 25 percent of which were passive investment income. The term "excluded member" does not include a bank (as defined in section 581), a financial institution to which section 591 applies, or an insurance company subject to taxation under section 801.

PREPARED STATEMENT OF WILLIAM G. DAKIN

This statement is submitted on behalf of the National Foreign Trade council ("NFTC") by William G. Dakin, Senior Tax counsel, Mobil corporation. The NFTC consists of some 500 corporations actively engaged in international trade.

Simplifying the foreign provisions of the Internal Revenue code is a priority for the NFTC and its member companies. I will first discuss why we think that most of the proposals made in Title III of S. 1394, while technically well drafted, would not accomplish much simplification for most U.S. multinational corporations. One proposal would be helpful, while another would be harmful. I will then discuss why we think that the proposals made in S. 936, the Foreign Tax Simplification Act of 1991, introduced by Senator Baucus on April 25, would reduce compliance costs without much revenue impact.

S. 1394, TITLE III

Subtitle A—Simplification of Treatment of Passive Foreign Corporations

The so-called "anti-deferral" provisions of the Code define whether income earned by foreign companies owned by U.S. individuals or by U.S. corporations will not be taxed until it is paid out as a dividend, or whether it will be taxed as it is earned by the foreign corporation, even though it is not actually paid out to the U.S. shareholder. The Explanation of S. 1394 correctly notes that the several antideferral regimes of present law were enacted at different times to achieve different policy objectives. Subtitle A of the Bill attempts to harmonize these regimes essentially by extending rules designed to tax individual investors on their stocks and bonds to foreign operating subsidiaries of U.S. business corporations. There is no explanation as to why the same rules are considered appropriate for such different classes of taxpayers, or whether the proposed changes would make U.S. business corporations more competitive or less competitive.

The drafters of Subtitle A deserve credit for doing a good technical job of the task they set for themselves. We believe that their proposals could be helpful to individual investors and to closely held businesses. The NFTC believes that subtitle A of the Bill would not produce meaningful simplification for many U.S. multinational corporations, however, because many of the rules that would be repealed or consolidated do not apply to publicly held companies. For example, the accumulated earnings tax has rarely, if ever, been applied to U.S. multinationals, and the foreign personal holding company rules apply only to corporations owned by five or fewer individuals. Repealing these provisions, while helpful to some taxpayers, would do little or nothing for U.S. multinational corporations.

On the other hand, the proposal to reduce the present PFIC gross income test from 75% to 60% would subject U.S. multinationals to current taxation of the income earned by their foreign subsidiaries in cases where deferral is now permitted. Limiting the high-tax exception would eliminate still more deferral. Eliminating deferral would not only create more complexity, but also have competitive implications. No foreign country has antideferral rules as strict as those of the United States. The anticompetitive impact of the Bill's proposals to erode deferral is not discussed in the Explanation.

We would all like to solve the PFIC problem. A simpler way to do it without adding new complexities and without adversely affecting competitiveness would be to exempt controlled foreign corporations from the PFIC rules because they are already covered by the subpart F rules. While not solving the problem for noncontrolled foreign corporations, this would nevertheless be a constructive step. We recommend relying on subpart F to tax the foreign subsidiaries of U.S. multinationals and combining the foreign personal holding company rules and the PFIC rules, etc., to tax the nonbusiness income of individuals.

Subtitle B—Treatment of Controlled Foreign Corporations

The NFTC supports the proposal to treat gain on sales of stock in lower-tier controlled foreign corporations as dividends, to the extent of the foreign corporation's retained earnings. The Explanation (p. 61) correctly observes that this would simplify the law by facilitating restructuring of foreign business operations. The law would be further simplified if deemed dividends were treated the same as actual dividends for all purposes of the Code, e. g., by permitting the "same country exception" from subpart F to the extent of any section 1248 gain. This would eliminate the need to do calculations one way for some purposes and another way for other purposes.

The NFTC opposes the proposal to deny taxpayers credit for the taxes they pay when previously taxed income is distributed to shareholders. Section 960(a) (3) of the

Code is elective. Taxpayers with substantial excess foreign tax credits do not need to claim additional credits under section 960(a) (3) when previously taxed income is distributed. Accordingly, there is no workload for them and nothing for the IRS to audit. Taxpayers who do not have excess credits are willing to do the work and are not complaining about it. Such taxpayers are entitled to use their additional credits at the time the income is taxed. Relegating such credits to a pool where they may be used later if at all would be unsatisfactory.

Subtitle C—Other Provisions

While the proposal to use an average rate for translating foreign taxes into U.S. dollars would be an improvement over post-1986 law, the NFTC would strongly prefer a return to the Bon Ami rule in lieu of the approach suggested in the Bill. The Bon Ami rule provided that foreign taxes were to be translated at the same rate and at the same time as the foreign income was translated, thereby preserving the correct foreign effective tax rate. The Bon Ami rule worked well for many years, is easy to apply and would reduce workload without any revenue impact. A "year of accrual" rule would be superior to the proposed "year of payment" rule if a return to Bon Ami is rejected.

S. 936—FOREIGN TAX SIMPLIFICATION ACT OF 1991

In response to Chairman Rostenkowski's announcement of February 7, 1990, the NFTC submitted numerous recommendations which may be found in *Written Proposals on Tax Simplification,* WMCP:101-27 (May 25, 1990), at pages 851-860. NFTC's further comments, submitted on April 16, 1991, are attached and incorporated by reference. Many business organization submitted similar ideas.

Five of these ideas are incorporated in S. 936, introduced by Senator Baucus on April 25. NFTC commends S. 936 to this Committee because it would provide genuine simplification and workload reduction for U.S. companies engaged in international trade. S. 936 addresses compliance problems which U.S. companies actually face as they engage in international trade. The proposed solutions are practical and enjoy broad-based business support. We urge that they be incorporated in any simplification bill which this committee may report out.

CONCLUSION

With respect to S. 1394, the NFTC recommends that the expansion of section 1248 be pursued and that section 960(a) (3) not be repealed. The NFTC urges that this Committee include the simplification ideas proposed by the business community, as exemplified by S. 936. The NFTC and its member companies offer their experience and expertise to this committee to accomplish meaningful simplification in the foreign area.

Although simplification would be a significant step forward, it should be recognized that there is still a great deal to be done to the U.S. tax laws to ensure the competitiveness of U.S. multinationals in their overseas operations.

PREPARED STATEMENT OF MATTHEW FINK

I am Matthew Fink, Senior Vice President and General Counsel of the Investment Company Institute. The Institute is the national association of the American investment company industry. Its membership includes 3,288 open-end investment companies ("mutual funds"), 214 closed-end investment companies and 12 sponsors of unit investment trusts. Its mutual fund members have assets of approximately $1.185 trillion, accounting for approximately 95 percent of industry assets, and have over 36 million shareholders.

The Institute appreciates this opportunity to testify in strong support of S. 530, which would simplify and modernize the taxation of mutual funds by repealing the so-called "30 percent test" of section 851(b) (3) of the Internal Revenue Code ("Code").

I. S. 530—REPEAL OF THE 30 PERCENT TEST

A. Background

To qualify for taxation as a regulated investment company ("RIC") under Subchapter M of the Code, a mutual fund must satisfy several tests, including the 30 percent test of section 851(b) (3). Under this provision, a fund generally must receive less than 30 percent of its gross income from the sale or disposition of securities held for less than 3 months.

The 30 percent test was included in the Code by the Revenue Act of 1936, which enacted the predecessor to Subchapter M. We have found no legislative history to explain the reasons for inclusion of the 30 percent test in that Act. It is most likely that the restriction imposed by the 30 percent test was consistent with a prudent investment philosophy as viewed in 1936, 55 years ago. However, the securities markets of the 1990's are vastly different from the markets of the 1930's, and what may have been prudent in 1936 may not be so today.

B. The Repeal of the 30 Percent Test Would Advance Tax Simplification

Repeal of the 30 percent test would advance the goal of tax simplification in several ways. First, mutual funds would not be forced to engage in tax-motivated transactions to ensure compliance with section 851(b) (3). Second, repeal would provide the moderate- income mutual fund investor with tax treatment comparable to that provided to the more wealthy, direct investor and to the investor in competing pooled investment vehicles, none of whom are subject to the 30 percent test. Finally, legal complexities and administrative burdens would be reduced if the 30 percent test were repealed. Each of these matters is discussed below.

1. Reduction in Tax-Motivated Transactions

Repeal of the 30 percent test would relieve mutual funds of the need to engage in tax-motivated transactions to ensure compliance with section 851(b) (3). Indeed, the 30 percent test can force a portfolio manager to act in a manner inconsistent with the best interests of fund shareholders. For example, in periods of market volatility, a surge in stock prices might make certain securities sales advisable, but if the securities have not been held for 3 months, section 851(b) (3) might preclude their sale. Similarly, a fund manager might be obliged to turn down an attractive tender offer for a security owned by the fund if it could result in a failure of the 30 percent test. Compliance with the 30 percent test can force a fund manager to sell securities that he might otherwise hold, so that sufficient gains on securities held for 3 months or more will be realized. The associated costs of these tax-motivated transactions are borne by fund shareholders.

The impediment to effective portfolio management created by the 30 percent test is widely recognized. In fact, one of Wall Street's most successful money managers cited the 30 percent test as the reason for abandoning plans to launch a RIC. Preferring to manage money in a non-RIC form, the manager said that the 30 percent test "makes it impossible for the public to get the best management for its money." [1]

Not surprisingly, the 55-year old test increasingly operates in a capricious and unexpected fashion. For example, the price volatility increasingly reflected in today's securities markets can cause a fund manager, who is acting in the best interest of shareholders, to violate the 30 percent test. One such incident involved a well-known fund portfolio manager who accurately predicted the market decline of 1987. Unfortunately, this manager's astute portfolio management produced sufficient less-than-three-month gains to cause the fund to fail to qualify under Subchapter M.[2]

Even one large gain, caused by an unexpected tender offer or a dramatic price increase of stock held for less than 3 months, could cause an unforeseen violation of the 30 percent test. Moreover, since the test applies to a fund's gross gains, losses cannot be used to offset those gains that create the 30 percent test problem.

2. Comparable Tax Treatment for Moderate-Income Investors

The moderate-income investor, who obtains the benefits of professional investment management and portfolio diversification by investing in a mutual fund, is disadvantaged by section 851(b)(3). The 30 percent test forces fund portfolio managers to make investment decisions for tax-related rather than investment-related reasons. By contrast, the wealthy investor who invests directly, often with the assistance of a professional money manager, is not subject to the trading restrictions imposed by the 30 percent test.

Repeal of the 30 percent test would also provide more comparable tax treatment for investors in mutual funds and investors in other pooled investment vehicles. For example, neither bank common tryst funds, bank collective investment funds nor insurance company pooled investment accounts, all of which compete with mutual funds, are subject to the restriction imposed on mutual funds by the 30 percent test.

[1] Wall Street Journal, March 16, 1989, sec. 3, p. 1, col. 3.
[2] Wall Street Journal, February 24, 1988, p. 27, col. 1.

3. Reduction in Legal Complexities and Administrative Burdens

Repeal of the 30 percent test would ease the administrative burdens imposed on mutual funds by eliminating the recordkeeping requirements associated with section 851(b) (3). Presently, funds must closely monitor their gross income, realized and unrealized gains and holding periods for securities for purposes of complying with section 851(b) (3). In addition, the increased use in recent years of new financial instruments has given rise to a number of complex questions regarding the circumstances under which the holding period of a security may be suspended or terminated for purposes of the 30 percent test. The administrative burdens of ensuring Subchapter M qualification would be substantially eased for funds investing in these instruments if the 30 percent test were repealed.

II. CONCLUSION

On behalf of the Investment Company Institute and its members, I would like to thank the members of this Subcommittee for the opportunity to present this testimony. I would be glad to respond to any questions you may have.

PREPARED STATEMENT OF JOHN J. FLAVIO, JR.

Good morning, Mr. Chairman and Members of the Subcommittee. My name is John Flavio, and I am Executive Vice President and Chief Financial Officer of TENERA, L.P., a publicly traded partnership providing engineering, environmental, management, and software services to electric utilities and industrial clients. I am testifying today as Chairman of the Board of the Coalition of Publicly Traded Partnerships, a trade association representing publicly traded partnerships, their general partners, and the law, accounting, and banking firms who work with them.

The Coalition strongly supports the efforts of this Committee to simplify reporting for large partnerships, eliminating what has been one of their greatest problems in raising capital--fear and loathing of the K-1 form on the part of investors. This has been a particular problem for publicly traded partnerships, because our investors tend to be those making small investments, who are less sophisticated than those investing in nontraded partnerships and are thus more deterred by complexity. In addition, we look forward to improved relations with the IRS now that they will be better able to ensure compliance at the partner level and to collect any additional taxes owed following a partnership audit.

The Coalition endorses S. 1394 overall, but we have found some areas that we believe need improvement or clarification. In addition, the Coalition believes that the legislation should address two areas of the tax code, sections 469(k) and 512(c), that add unnecessary complexity by establishing different and inconsistent rules for different types of large partnerships with respect to the application of the passive activity rules and the unrelated business income tax. These provisions discriminate against small investors and add to the burden of all investors, large and small. Changes must be made in these provisions in order to resolve the inconsistency and achieve true simplification as well as equity for all partnership investors.

Provisions Which Discriminate Against PTPs

One aspect of S. 1394 which the Coalition found disappointing was its continuation of two provisions in the tax code which discriminate against PTPs and their investors by applying rules which are different from and less favorable than those applied to nontraded partnerships. These provisions are the separate passive activity rule of section 469(k), which states that passive income from a PTP can only be offset against passive loss from the same PTP, and vice versa; and the special UBIT rule in section 512)(c)(2), which states that tax-exempt partners' share of PTP income will be treated as unrelated business income without the various exceptions provided in section 512(b) for income such as interest, dividends, and rents.

By treating different classes of large partnerships differently with little policy justification, these provisions retain unnecessary complexity in the law. They discriminate not only against publicly traded partnerships as opposed to nontraded partnerships, but also against small investors--the very taxpayers this bill is trying to help--as opposed to wealthier investors. Publicly traded partnerships attract small investors to a greater extent than other partnerships because the cost of PTP units is lower than that of interests in other partnerships and the liquidity of the units provides a ready means of retrieving their capital if necessary. As explained in further detail below, there is no policy reason to justify this complexity and discrimination.

The way that a partner's share of PTP income is treated under these two rules is not only discriminatory but inconsistent. Section 469(k) treats the PTP investor like a limited partner by making him go through the passive loss regime and, if the calculations result in net loss, suspending the loss. If the result is net income, however, it then turns around and treats it as portfolio income, as if it were a corporate dividend. Is it any wonder that PTP investors are confused?

Then in section 512(c)(2) the Code does another turnabout and says to tax-exempt investors that the income is not portfolio income after all; it is trade or business income from a partnership and must be taxed as unrelated business income. But, there is no lookthrough to the source of the income at the partnership level to see if it qualifies for one of the exceptions, as is done with other partnerships. *There is no consistent theory unifying these methods of taxing PTP income. Legislation that retains this sort of irrationality is not doing all it can to simplify the tax code.*

There are two ways that Congress could resolve the problems posed by these provisions and bring consistency to the treatment of PTP income. One would be to treat PTPs the same as other large partnerships by repealing sections 469(k) and 512(c)(2). Alternatively, Congress could go the other way and treat a partner's allocable share of net PTP income as dividend income for both passive activity and UBIT purposes.

Passive Activity Rules

Under section 469(k), partners in PTPs may only offset passive income from one PTP against passive loss from the same PTP. Net income is treated as portfolio income, while net loss is suspended and carried forward to future years. This places PTP investors at a significant disadvantage to other partnership investors: an investor with PTPs in his portfolio is far more likely to end up with suspended losses, either because his PTP is in a net loss situation or because he cannot use his PTP income to offset passive losses from other investments.

More to the point of this legislation, this distinction between PTPs and other partnerships makes the tax code more complex. PTPs require an entire separate section and another worksheet in the IRS passive loss instructions accompanying form 8582; they also are mentioned numerous times as exceptions to the general instructions--and after all that, the partner must report his PTP items on forms *other than* the 8582 form that is used for all other passive investments. As explained above, it is the small investor whom this legislation is trying to help that is most hurt by this discrimination and complexity.

The only justification for retaining complexity such as this in the Code is to make the Code more fair or to prevent abuse. Section 469(k), however, makes the Code less rather than more fair to the small investor. Furthermore, it is not needed to prevent any sort of abuse. The rationale for section 469(k) at the time it was enacted was that because PTPs were structured to generate income, investors would rush out to invest in them in order to use the income to soak up their tax shelter losses, defeating the purpose of the passive loss rules. Even at the time, this was a mistaken notion, and there is even less justification for it today, because:

1) PTPs were not the only partnerships generating net passive income in 1987; nontraded partnerships generated it as well. Because the passive loss rules have discouraged the structuring of partnerships to pass through net losses, even more nontraded partnerships are structured as passive income generators today.

2) The amount of *net* income allocated by a PTP to the average investor was and still is usually not enough to soak up large amounts of loss from other investments. Also, it should be remembered that in order to receive a given amount of passive income, the investor would have to make a capital investment of several times that amount.

It is in fact extremely ironic that Congress, which enacted the passive loss rules because of its concern over tax shelters generating large amounts of net loss, placed a heavy penalty in these rules on a class of partnerships which were established to generate net income for their investors and not to serve as tax shelters--and penalized them precisely

because they generated that income. The rationale advanced for section 469(k) does not justify the harm it causes the small investor. Investors should not be penalized for investing in those PTPs which were sanctioned by the 1987 law.

Unrelated Business Income Tax

The bill similarly maintains different rules for PTPs and other large partnerships in its handling of the unrelated business income tax. The legislation provides that a tax-exempt partner's distributive share of items will be reported separately to the extent needed to comply with section 512(c)(1), but leaves intact the separate rule for publicly traded partnerships in section 512(c)(2).

Section 512(c)(1) provides that a tax-exempt partner's allocated share of partnership income will be treated as unrelated business income; however, the various exceptions of section 512(b) (interest, rents, royalties, etc.) will apply. 512(c)(2), however, requires that *all* PTP income allocated to a tax-exempt partner be treated as unrelated business income, without any exception other than the $1,000 deduction.

This rule hurts PTPs in the capital markets. Tax-exempt investors are deterred by the prospect of having to file a return and perhaps pay tax, and other investors are wary of securities that cannot attract institutional investment. This indirectly affects the small investor who typically owns PTP units by holding the value of his units below the price they might achieve if they were not hindered in this manner. It also hurts small investors more directly: although PTPs are an attractive, income yielding vehicle which would otherwise be a good investment for IRAs, they cannot make such an investment without fear of subjecting the UBIT tax reporting requirements.

Like the passive loss rule in section 469(k), this provision was added to the Code in 1987 as part of the legislation establishing the rules defining which partnerships could be publicly traded without being taxed as corporations. They were enacted out of a fear, which we felt at the time was exaggerated, that unless PTPs were severely restricted, the corporate tax base would be eroded by corporations moving into partnership form.

The 1987 rules limiting the PTP form to a few industries which have traditionally raised capital through partnerships has ended any threat of "disincorporation" that might have existed, and there is no longer any reason (if there ever was) for distinguishing between publicly traded partnerships and other partnerships for purposes of the UBIT rules. Again, investors should not be penalized for investing in those PTPs which have been sanctioned by the 1987 law.

Alternative Solutions

The first possible solution to the complexity, discrimination, and inconsistency engendered by the current tax treatment of PTP income would be to simply repeal the two special rules enacted in 1987, section 469(k) and section 512(c)(2). This would bring simplicity and consistency by treating PTPs like other large partnerships for all purposes. A strong argument can be made that once a PTP earns partnership classification by meeting the income requirements of section 7704, it should then be treated as a partnership for all purposes of the Code rather than have corporate-like treatment in some areas and partnership treatment in others.

Consistency could also be achieved by separating PTPs out from other partnerships on a consistent basis and treating the partners' distributive share of net ordinary income as dividend income. The PTP would net the income and loss items included under paragraphs (1) and (2) of new section 772(a)--i.e., income and loss from passive activities and income and loss from other activities, *not* including capital gain--and report the result to its partners. If the result were a net loss, it would be suspended to be offset against future income as it is now. If net income resulted, however, it would be treated by the partner as dividend

would continue to be treated as tax deferred return of capital to the extent the partner's basis is zero or greater).

The result would be major simplification for PTP investors. All such investors would be freed of the necessity to wade through Form 8582 and its attendant instructions and worksheets. Tax-exempt investors, including individuals investing through IRAs, which constitute the bulk of tax-exempt investment in PTPs, would no longer have to be concerned about exceeding the $1,000 income threshold and having to file a Form 990. This should have little revenue effect. On the passive loss side there would be no real change in the treatment of net income, and we believe that there would probably be some revenue gain from increased compliance due to reduced investor confusion. On the UBIT side, little or no revenue is currently being raised from tax-exempt investors in PTPs, so no revenue loss would occur.

Possible legislative language for the two alternative remedies is included as an attachment at the end of this statement. The Coalition urges in the strongest possible terms that the complexity, unfairness, and inconsistency engendered by sections 469(k) and 512(c)(2) be addressed in this bill.

Due Date for Furnishing Information to Partners

Section 107 of the bill requires that large partnerships file information returns with their partners by the 15th day of the third month following the close of the partnership's taxable year, i.e., March 15 for partnerships operating on the calendar year. No provision is made for late filing due to circumstances beyond the control of the partnership. This is a serious oversight and one that we urge you to correct.

The Coalition sympathizes with the drafters' desire to provide partners with information well before they have to file their own returns. Our members make every effort to do this--after all, our investors have the option of disposing of their units if they do not like the way we treat them--and most of the time we succeed. In some cases, however, it will not be possible, for reasons not within the partnership's control, to furnish the information by March 15.

The basic problem with which all PTPs must deal is that a large portion of their units are held by brokers in street name, and the partnership is unable to perform the various calculations required and send out information returns to all partners until the broker has provided it with the necessary information on the beneficial owners of street name interests. Under Code section 6031(c) this information must be provided by brokers only once a year. The due date is the last day of the first month following the close of the partnership's taxable year, generally January 31.

The release of this information by the nominees is only the beginning of the process. It is then collected by a clearinghouse and transferred to magnetic tape, and only then sent to the partnership. Our experience has been that regardless of the fiscal year-end of the partnership receiving the information, the clearinghouses have failed to provide it before mid-February of the year following the close of the partnership's tax year. Once the partnership receives the information, it will have to do a significant amount of processing of its own.

Because of this lengthy process, and the fact that the information received from the brokers is not always timely and complete, even the most conscientious partnerships find that reporting by March 15 is not always possible, despite their best efforts. Another factor that may hinder a partnership from reporting by March 15 is being at the top of a tiered partnership structure: if partnership A owns an interest in partnership B, partnership A will not have the information it needs to process K-1s for its partners until it receives its K-1 from B.

For these reasons, the Coalition fears that if a strict March 15 date with no flexibility is enacted into law, the result will be a number of inaccurate K-1s being sent out on March 15. Partnerships with incomplete information will feel compelled to send out returns in order to avoid a penalty. Later the partnership, and consequently the partner, will have to file one or more amended returns, and the IRS will have to process them. Surely it would be more simple and efficient to allow the partnership enough time to get it right the first time.

We would like to remind the Subcommittee as well that while the simplified reporting system of S. 1394 will make reporting less complex for *partners*, it will not provide any simplification to the *partnerships*. To the contrary, it will add a great deal of complexity at the partnership level, as we will now have to perform a number of calculations that are left to the partners under current law. We are quite willing to accept this added complexity as the price of better investor relations--but to ask us to accept as well this additional burden and a shorter reporting period with no provision for extension does not make sense.

Let me emphasize again that as publicly traded entities which are dependent upon investor goodwill, we have every incentive to provide our investors with returns as quickly as possible. The Coalition urges that the due date be changed to March 31 rather than March 15--Coalition members have stated that having an extra two weeks to obtain and process information would significantly increase the accuracy of the returns. We also urge that partnerships which can show cause be allowed to file for a 90-day extension without penalty.

Payment of Post-Audit Tax, Interest, and Penalties by Partnership

The Coalition is pleased that S. 1394 provides partnerships with an option to either pay tax on a post-audit adjustment themselves or flow the amended income or loss amounts directly through to the partners. This was part of the Coalition's simplification recommendations. We recommended as well that unless the partnership has elected to pay the tax, interest and penalties should also be collected at the partner level rather than the partnership level. This is more consistent with general principles of partnership taxation, and avoids potential problems that may arise for partnerships that do not have the cash reserve to make these payments. While this is not a make-or-break issue for us, we urge the Committee to consider making this change.

In any case, the bill and the accompanying explanation have some technical gaps. First, the bill does not specify how the payment of tax by the partnership is to be accounted for. We assume from the language of the bill and accompanying explanation that the drafters are adopting for this purpose what the Treasury Department report on widely held partnerships[1] termed the "non-flowthrough" method, in which the understatement is not added to current year income and the tax paid is not credited to partners (since the partners cannot obtain a credit for the tax paid, it would be highly unfair to flow the understatement through to them). As suggested in the Treasury Report, provision should be made for use of basis adjustments to prevent double taxation of deficiencies or double benefit for overpayments--i.e., the partners would receive a basis adjustment for their share of the deficiency income, less tax paid by the partnership.[2] The legislation should also specify the manner in which partner level collection is to be reflected in the partners' capital accounts and bases.

While taxpayers may not deduct penalties on underpayments of federal income tax, they may deduct interest. Will the partnership be allowed a deduction for interest it pays on underpayments? Will this deduction be flowed through to the partners? How will

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[1]*Widely Held Partnerships: Compliance and Administration Issues*, U.S. Department of the Treasury, March 1990 (hereinafter "Treasury Report").

[2]Treasury Report at 71.

penalty payments be reflected at the partner level? If the partnership sets up a reserve fund for payment of possible interest and penalty on tax deficiencies, how will this be accounted for at the partner level? These points too need to be clarified.

Deferred Sale Treatment of Contributed Property

The Coalition is very pleased to have a legislative solution to a problem with which we have been grappling for some time, the difficulty of accounting for built in gain or loss of property contributed by a partner under the restrictions of the ceiling rule of Treas. Reg. §1.704-1(c)(2)(i). The substitution of the deferred sale approach for section 704(c) for large partnerships will eliminate a good deal of uncertainty for partnership tax managers.

One problem, however, is that this solution will apply prospectively only. Partnerships receiving contributed property between 1984 and 1992 are still left with a major problem. Many of these partnerships have resorted to use of curative allocations or a deferred sale approach, even though these have not been expressly authorized, in an effort to maintain fungibility of their units while remaining in compliance with section 704(c). The Coalition last year urged the Treasury Department to provide partnerships with the necessary authority for such solutions in regulations under section 704(c). We expressed the belief then that the legislative history of the Deficit Reduction Act of 1984, which states that "[i]t is anticipated that the regulations will permit partnership to agree to a more rapid elimination of disparity among partners than required by the new rules by substituting items not described in section 704(c) and vice versa,"[3] provided ample authority for Treasury to do so.

In our discussions with Treasury and IRS staff, however, we have been told that they doubt whether they have this authority and that, moreover, the 704(c) regulations are not currently a priority item on their agenda. The staff have indicated that they would be glad to have Congress solve this problem for them. We fear that the passage of this legislation may lessen further any urgency on the part of the Treasury Department to resolve the problem for pre-1992 contributions.

The Coalition therefore urges that S. 1394 provide a legislative solution for prior years as well as prospectively. We understand that the Committee may be reluctant to retroactively mandate specific approaches. One possibility would be legislative language stating that partnerships which have consistently used any reasonable method during the interim period will be deemed to be in compliance. Another possibility would to provide the Treasury Department with clear authority to apply a similar solution in its 704(c) regulations, and to instruct Treasury to issue those regulations in the near future.

Section 754 Election

Because so many publicly traded partnerships rely on the section 754 election to maintain the fungibility of their units, the retention of this election is an important element in the Coalition's support for the simplified system. We therefore welcome the provision that the amounts separately stated under new section 772(a) are to be adjusted to account for the 743(b) adjustment for each partner.

The legislation indicates that the adjustment is to occur at the partnership level, with the partner receiving a report of already adjusted income and loss items. Most PTPs currently follow this procedure, so that the 743(b) adjustment is done entirely at the partnership level and is a hidden calculation as far as the partners are concerned. Some of

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[3]H.R. Rpt. No. 432, Pt. 2, 98th Cong., 2nd Sess., 1209; S. Prt. No. 169. Vol. I, 98th Cong., 2nd Sess., 214-215.

our members, however, have indicated to us that they have always separately stated the adjustment to their partners and left it to them to adjust the income and loss items reported on the K-1. For some of these partnerships, their decision to make the 754 election was based on the ability to use this method. They feel that it would be a significant hardship if they were required to switch to performing the calculation at the partnership level and that it would be unfair to change the rules upon which their decision was based.

In order to accommodate these partnerships, the Coalition suggests allowing partnerships in existence as of the date of enactment of the bill to file an election with the IRS to continue reporting the 754 election separately. This would require the development of a method--perhaps a supplemental form--on which partners in such partnerships could account to the IRS for the difference between the amount reported on their returns and the amount reported on the partnership return. Currently partners in this situation report it on Form 8082 as an item for which the partnership treatment is inconsistent with the partner's treatment; however, the new audit system would no longer allow partners to report items inconsistently with the partnership return for any reason.

Burden of Maintaining Two Tax Systems

A Coalition member which is a small publicly traded partnership (about 300 partners; traded over the counter and not on any of the major exchanges) has expressed concern about the burden of maintaining separate tax reporting systems for general and large partners on the one hand and partners subject to the simplified system on the other. This partnership has stated that while this may not be a problem for large partnerships, it will impose a heavy financial burden on a partnership of their size. This Coalition member feels strongly that the new system should be elective for partnerships of its size.

Because most publicly traded partnerships are indisputably large partnerships, the issue of the burden that these provisions would impose on smaller partnerships is not one we have examined at great length. There may be a large number of nontraded partnerships with the same problem as this Coalition member, however, and we urge that this issue be looked at more closely before the bill is enacted. Specifying the number of partners appropriate to define a "large partnership" was one of the more difficult issues in drafting this legislation, and some of those involved in the process felt that the line should be drawn at 500 partners rather than 250. The concerns of this partnership suggest that making the simplified system elective for partnerships with 250 to 500 partners may indeed be the appropriate solution.

Conclusion

The Coalition commends the Subcommittee under the leadership of Senator Boren as well as full Committee Chairman Senator Bentsen and Ranking Minority Member Senator Packwood for their efforts to achieve greater simplicity for partnership investors. We would also like to express our appreciation for the process through which this bill was developed. The staffs of the Finance, Ways and Means, and Joint Tax Committees, as well as staff at the Treasury Department and the IRS, have been extremely open and responsive in the course of the development of this legislation, keeping us apprised as to how the bill was evolving and making a real effort to hear and respond to the concerns of those of us who spend our days dealing with the arcane reporting problems associated with partnership taxation. This is the way that legislation ought to be written, and all too often is not.

There are provisions in the bill which need clarification or which should be amended so as not to impose unfavorable changes on PTPs. Moreover, the bill needs to be amended to eliminate or modify provisions of the tax code that add unnecessary complexity while discriminating against investors in publicly traded partnerships. In general, however, the Coalition believes that this is a very worthwhile piece of legislation; one that can only be made better by the changes we suggest. We support the Tax Simplification Act and look forward to working with this Committee for its enactment.

ATTACHMENT A

SUGGESTED AMENDMENTS TO TAX SIMPLIFICATION ACT OF 1991
WITH REGARD TO A PARTNER'S DISTRIBUTIVE SHARE OF
INCOME FROM A PUBLICLY TRADED PARTNERSHIPS

ALTERNATIVE I: Repeal of Special Rules for Publicly Traded Partnerships

Section 201 of the Tax Simplification Act of 1991 is amended by adding at the end thereof the following new subsections:

"(c) SEPARATE APPLICATION OF PASSIVE ACTIVITY RULES REPEALED.

"(1) IN GENERAL. -- Section 469 of the Internal Revenue Code of 1986 is amended--

"(A) by striking out subsection (k).

"(B) by redesignating subsections (l) and (m) as subsections (k) and (l) respectively.

"(2) CONFORMING AMENDMENT. -- Subparagraph (E) of section 163(d)(4) is amended by striking out '469(m)' and inserting in lieu thereof '469(l)'.

"(3) EFFECTIVE DATE. --

"(A) IN GENERAL. -- The amendments made by this bill shall be effective for taxable years beginning after December 31, 1991.

"(B) LOSS DISALLOWED IN PREVIOUS YEARS. -- Any deduction or credit from an activity of a publicly traded partnership which was disallowed in a previous taxable year under section 469(k) and which has been carried forward to the first taxable year beginning after December 31, 1991 shall be treated as a deduction or credit allocable to such activity in such taxable year, and may be carried to subsequent taxable years as provided in section 469(b).

"(d) SPECIAL UNRELATED BUSINESS INCOME RULE REPEALED. --

"(1) IN GENERAL. -- Subsection (c) of section 512 of the Internal Revenue Code of 1986 is amended--

"(A) by striking out paragraph (2);

"(B) by striking out the words 'or (2)' in paragraph (3);

"(C) by redesignating paragraph (3) as paragraph (2).

"(2) EFFECTIVE DATE. -- The amendments made by this bill shall be effective for income and deductions of a partnership for taxable years beginning after December 31, 1991."

ALTERNATIVE 2: Treatment of PTP Income as Dividend

a) Proposed Code section 772(e) is amended by adding an "s" after the word "Rule" in the caption, by inserting following the comma in the third line "(i)", by striking the period at the end of the section, and by adding the following:

", and (ii) the net AMT adjustment shall be deemed to be zero."

b) Proposed Code section 772(f) is amended by adding at the end a new Section 772(f) to read as follows:

"(f) RULES FOR PUBLICLY TRADED PARTNERSHIPS

"(1) Treatment of Income as a Dividend. In the case of a partner of a publicly traded partnership as defined in paragraph (2) of this subsection:

"(i) the partner's distributive share of income under subsections (a)(1) and (a)(2) of this section shall be included in the gross income of the partner as a dividend, and

"(ii) the partner's distributive share of loss from the publicly traded partnership otherwise allocable to such partner under subsections (a)(1) or (a)(2) shall first be applied to reduce any income allocable to such partner under subsections (a)(1) or (a)(2), and any excess loss shall be suspended.

"A loss suspended pursuant to subparagraph (ii) of this paragraph (f) shall be allowed as a deduction with respect to such partner's distributive income from the partnership for the next succeeding taxable year. The amount of the reduction pursuant to the preceding sentence shall be limited to the amount of income allocated to the partner from the partnership for such year and any deduction not used as a result of such

limitation shall be treated as a loss suspended with respect to such partner pursuant to subparagraph (ii). Any loss of a partner suspended pursuant to subparagraph (ii) shall be decreased by any amounts described in section 734(b)(2) and 743(b)(2) that are taken into account by such partner, or by the transferee from such partner of an interest in the partnership. Any amount treated as a dividend pursuant to this paragraph shall not be treated as a dividend from a corporation for purposes of Part VIII of subchapter B of this Chapter (sections 241 et seq.).

"(2) Definition of publicly traded partnership.--For purposes of this section, the term 'publicly traded partnership' means a large partnership that:

"(i) is described in section 7704(b), and

"(ii) has an election under section 754 in effect for the taxable year.

"The term publicly traded partnership does not include any partnership which is described in section 773(b)(5)(B)."

(c) Sections 203 and 204 of the bill are redesignated as sections 204 and 205 respectively, and a new section 203 is added to read as follows:

"SECTION 203--AMENDMENT TO SPECIAL RULES RELATING TO PUBLICLY TRADED PARTNERSHIPS

"Section 469(k) is amended by changing the period at the end of clause (B) to '...' and adding a new clause (C) to read as follows:

'(C) such partnership is not described in section 772(f)(2).'"

PREPARED STATEMENT OF KENNETH W. GIDEON

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Administration on the tax simplification proposals currently under your consideration. My testimony today will address S. 1394, the Tax Simplification Act of 1991, and S. 1364, the Employee Benefits Simplification and Expansion Act of 1991. In addition, in accordance with your invitation to testify, I urge your favorable consideration of other proposals not included in these two bills, specifically in the areas of payroll tax deposits, the earned income tax credit, and pension coverage and portability.

As I stated earlier this year before the House Committee on Ways and Means, the Administration strongly supports simplification of our tax laws within the fiscal constraints of last year's budget agreement. Properly conceived and executed simplification can reduce the costs of tax administration and compliance, enhance both voluntary compliance and tax enforcement efforts, and improve taxpayer morale. When simplification efforts are successful, we believe that there should be efficiency gains as well. Simplification is not viable as a revenue-losing proposition, however, and the Administration will insist that the pay-as-you-go provision of the budget agreement be satisfied by any combination of simplification proposals ultimately adopted.

I particularly want to commend Chairman Bentsen and Senator Packwood for their sponsorship and support of the bi-partisan simplification bill, S. 1394. That bill and its House counterpart, H.R. 2777, were produced through the cooperative efforts of the committee staffs which deal with tax matters, the Treasury Department and the Internal Revenue Service. We believe the process used to develop these bills was constructive and has produced good draft legislation. We recognize that a number of modifications to the introduced legislation have been suggested by commentators. While I have not addressed these suggestions in my written testimony today given the need to set forth our basic position for the record and the significant volume of the statement required to accomplish that objective, we will review the record developed here and in the House and will work with the Committees and the staff to adopt meritorious suggestions. We look forward to working with this Committee to perfect these draft proposals and to enact them.

Before turning to S. 1394 and S. 1364, I will describe three additional proposals which we believe will simplify and improve the tax law while meeting the constraint of revenue neutrality.

A. PAYROLL TAX DEPOSITS

The Treasury Department shares with members of this Committee an interest in simplifying the current employment tax deposit system. We have previously indicated that the payroll tax provisions of H.R. 2775 would achieve simplification. Under that proposal, semi-weekly deposits would be required instead of eighth-monthly deposits as under the current system. Next-day deposits would continue to be required for liabilities of $100,000 or more. Employers with under $3,500 of quarterly liability would only be required to make one payment per quarter, and an employer would be able to determine whether it was eligible for this small employer exception at the beginning of each quarter. Also, the underpayment safe harbors for each deposit would be reduced from 5 percent under the current system to the greater of $150 or 2 percent.

Senator Baucus has made a similar payroll tax simplification proposal in S. 1610. This proposal would also require semi-weekly deposits. It would differ from H.R. 2775, however, in that: (1) small employers would be required to make monthly rather than quarterly deposits; (2) the threshold for treatment as a small employer would be $18,000 of quarterly liability; and (3) the minimum amount of permitted safe harbor underpayments would be $250.

S. 1610, like H.R. 2775, would further the goal of simplification. However, in its current form, we preliminarily estimate S. 1610 would result in a significant revenue loss over the 5-year budget period. Our current estimate is that the revenue loss would be about $2.2 billion if small employers were allowed to underpay each monthly deposit by up to $250. The loss would be about $0.6 billion if small employers were not allowed to use this safe harbor to underpay their monthly deposits.

These revenue losses could, however, be offset under S. 1610 if the threshold for small employer treatment (i.e., monthly deposit) were lowered. We currently estimate that revenue-neutrality could be achieved with a threshold of about $14,000, if safe harbors were not permitted for monthly deposits or, alternatively, with a threshold of about $8,000 if safe harbors were allowed. We question whether a safe harbor as large as $250 is needed by monthly depositors, and a significantly lower level would allow the monthly deposit threshold to be closer to the $14,000 level, thereby maximizing the number of eligible employers.

The Administration believes that S. 1610, if modified to be revenue-neutral, and the payroll tax provisions of H.R. 2775 merit serious consideration.

B. EARNED INCOME TAX CREDIT

The earned income tax credit (EITC) is a refundable tax credit available to low-income workers with children. The EITC consists of (i) a basic credit, which is adjusted for family size, (ii) a health insurance credit, and (iii) a supplemental credit for workers with a child under the age of one (the "young child" or "wee tots" credit). The Omnibus Budget Reconciliation Act of 1990 increased the basic credit rate and added the family size adjustment, the health credit, and the young child credit.

In 1991, the basic EITC rate is 16.7 percent of the first $7,140 of earned income for a worker with one qualifying child and 17.3 percent of that amount for a worker with two or more qualifying children. A worker with one child may receive a basic EITC of up to $1,192. For a worker with two or more children, the maximum basic credit is $1,235.

The young child credit increases the basic EITC rate by 5 percentage points. The maximum young child credit for 1991 is $357. A credit is also available to taxpayers who purchase health insurance that includes coverage for a qualifying child. In 1991, the health insurance credit is equal to 6 percent of the first $7,140 of earned income. However, the credit cannot exceed the actual amount of health insurance expenses. In 1991, the maximum health insurance credit is $428.

For 1991, the basic EITC is reduced by an amount equal to 11.93 percent of the excess of adjusted gross income (or, if greater, earned income) of more than $11,250. The phase-out rate for a family with two or more children is 12.36 percent.

Using the same income threshold, the young child credit and health insurance credit increase the phase-out rates respectively by 3.57 percentage points and 4.285 percentage points. The basic EITC and the supplemental credits are not available to taxpayers with adjusted gross incomes (or, if greater, earned income) of approximately $21,250. In 1992 and thereafter, the maximum amount of earnings on which the credit may be taken and the income level at which the phase-out range begins will be adjusted for inflation.

In 1992, the basic EITC rate will increase to 17.6 percent for a worker with one child and 18.4 percent for a worker with two or more children. The corresponding percentages for 1993 are 18.5 percent and 19.5 percent. For 1994 and subsequent years, the credit rates are 23 percent and 25 percent. The phase-out rates for families with one child are 12.57 percent in 1992, 13.21 percent in 1993, and 16.43 percent in 1994 and thereafter. For families with two or more children, these rates are 13.14 percent in 1992, 13.93 percent in 1993, and 17.86 percent in 1994 and thereafter.

Several "interaction rules" prevent a taxpayer from receiving the full benefit of the health insurance credit or the young child credit and other tax provisions.

1. Itemized deduction for medical expenses. The health insurance credit reduces the amount of expenses for which a medical expense deduction is allowed.

2. Deduction for health insurance expenses of the self-employed. Qualifying expenses for the self-employed health insurance deduction are similarly reduced by the amount of the health insurance credit.

3. Child and dependent care tax credit. A taxpayer may not claim both the young child credit and the child and dependent care tax credit with respect to the same child.

4. Exclusion for employer-provided dependent care assistance. Similarly, the same child cannot qualify the taxpayer for both the young child credit and the exclusion for employer-provided dependent care assistance.

We propose that the interaction rules described above be repealed. To offset the revenue losses due to this repeal, the basic EITC percentage rates would be reduced by .05 percent, and the phase-out rates would be reduced by .04 percent. The resulting rates are as follows:

	Credit percentage	Phase-out percentage
For 1992:		
1 qualifying child	17.55	12.53
2 or more qualifying children	18.35	13.10
For 1993:		
1 qualifying child	18.45	13.17
2 or more qualifying children	19.45	13.89
For 1994 and thereafter:		
1 qualifying child	22.95	16.39
2 or more qualifying children	24.95	17.82

The interaction rules create complexity in the EITC and will hinder compliance. Some taxpayers must complete numerous steps in order to calculate their credit amounts and tax liabilities.

For example, a taxpayer who is eligible for both the young child credit and the child and dependent care tax credit must calculate both credits to determine which provides the greater benefit. In making this comparison, the taxpayer must also account for the fact that the child and dependent care credit, unlike the young child supplement, is non-refundable and thus potentially less valuable than its face value. Workers receiving child care assistance through their employers will have to make similar comparisons. Because they will have to choose between the young child credit and the exclusion for employer-provided assistance during the tax year, these workers will have to base the computations on estimates of their annual income, child care expenditures and tax liabilities. In other cases, some taxpayers will have to depart from normal practice and complete the credit portion of their tax form (located at the end of the Form 1040) before calculating itemized deductions or the self-employed health insurance deduction.

Self-employed workers with health insurance expenses must perform particularly complicated calculations. The health insurance EITC is subtracted from the amount of expenses allowable for the self-employed health insurance deduction which in turn is used in deriving adjusted gross income (AGI). These computations are circular because the EITC, including the health insurance supplement, is based partly on AGI. The proposed Technical Corrections Act of 1991 (H.R. 1555 and S. 750) includes a provision that would resolve this circularity. Nonetheless, this provision would not eliminate the interaction between the two provisions. A taxpayer will still be required to calculate the self-employed health insurance deduction and AGI twice. As a first step, a taxpayer must calculate AGI as if the taxpayer were entitled to the full health insurance deduction. Using this "hypothetical" measure of AGI, the taxpayer would then compute the EITC, including the health insurance component. Next, the taxpayer must subtract the health insurance EITC from the amount of expenses allowable for the self-employed health insurance deduction in order to calculate "true" AGI. These calculations will require a separate 19-line worksheet to supplement the 2-page EITC schedule.

The interaction rules also limit the Internal Revenue Service's ability to compute the EITC for some taxpayers. In many cases, the Internal Revenue Service (IRS) can automatically determine the EITC if the taxpayer provides basic information on the first page of the EITC schedule. However, the IRS cannot determine the full EITC amounts for self-employed workers who claim both the health insurance credit and the self-employed health insurance deduction because it will not have sufficient information to compute the "hypothetical" AGI amount described above without reference to other data which may not be easy to obtain.

The Office of Tax Analysis estimates that about 500,000 taxpayers are subject to these interaction rules. Repealing these rules will cost about $24 million a year ($25 million a year if the self-employed health insurance deduction is extended beyond 1991). Although relatively few taxpayers are subject to these rules, all EITC recipients may be adversely affected by their complexity. The new EITC schedule will be accompanied by 2 or 3 pages of instructions, and many taxpayers may find it necessary to consult an IRS publication explaining the new credit. Although every effort is being made to keep this guidance as simple as possible, the complexity of the interaction rules may make it difficult for taxpayers to determine whether the rules apply. In the past, complex rules have contributed to high error rates in EITC payments. These high error rates prompted the adoption last year of simplified eligibility rules. Our proposal continues this effort.

To offset the revenue losses due to repeal of the interaction rules, we are proposing a very small reduction in the basic credit rates. Under the proposal, no taxpayer's credit would be reduced by more than $3.71 per taxpayer in 1992 while other credit recipients will benefit by elimination of the interactions.

C. PENSION SIMPLIFICATION, COVERAGE AND PORTABILITY

We are pleased that this Committee is seriously considering simplification of the tax laws relating to pensions. The Administration has concluded that improvements in pension coverage and pension portability can be achieved as part of the tax simplification effort. We believe that we can expand pension coverage, particularly in the small business sector, and enhance pension portability thereby strengthening the role of private pension plans in retirement income planning.

Over the course of the last year, the Administration has focused on these policy issues. Through the joint efforts of the Treasury Department and the Department of Labor, proposals to simplify the tax law governing retirement plans, to expand pension coverage, and to increase pension portability have been developed. These proposals were announced on April 30, 1991, by Secretary of Labor Martin.

The Administration's proposals have been crafted to accomplish these objectives within the constraint of revenue neutrality and, in total, do not lose revenue as the Office of Tax Analysis estimates of the Administration proposals demonstrate (Table I).

The Administration's proposals include the following:

1. Simplify and encourage tax-free rollovers. We propose to simplify and encourage tax-free "rollovers" of pension distributions into IRAs or qualified plans by allowing all plan distributions to be rolled over, except distributions which are made in the form of a life annuity or in installment payments over 10 years or more. The current law restrictions on rollovers of after-tax employee contributions and minimum required distributions would be retained. Plans would be required to offer employees an election to have distributions eligible for rollover treatment transferred directly to an IRA or other qualified plan that accepts such contributions. The favorable income tax treatment for pension distributions which are not rolled over -- the special averaging rules and the deferral of tax on the appreciation on employer securities -- would be repealed and the method for determining the taxable amount of pension annuities would be simplified. The six rules potentially applicable to a pension distribution would be simplified to a single rule providing that such distributions are currently taxed unless they are rolled over. However, our proposals do not contemplate that the thresholds for imposition of the excise tax on excess pension distributions will be changed.

2. Establish a new simplified employee pension program. Employers with 100 or fewer employees and no other retirement plan would be eligible for the new plan. Under the proposal, these employers would be relieved from testing for nondiscrimination if they make a base

contribution for each eligible employee of 2 percent of pay (up to a maximum base contribution of $2,000). Employees could elect to contribute $4,238 (one-half the limit on elective deferrals under 401(k) plans). In addition, the employer could make matching contributions of up to 50 percent of the employees' contributions.

3. Simplify the administration of 401(k) and other plans. The proposal would simplify the rules for testing whether 401(k) plans provide proportionate benefits to lower paid employees by using the prior year's experience. As a related matter, the proposal would also simplify the definition of "highly compensated employee" for purposes of the employee benefit provisions of the Code and repeal the complex family aggregation rules. In addition, the proposal would enhance the IRS master and prototype program under which affordable standardized plans can be offered.

4. Make 401(k) plans generally available. Section 401(k) plans would be extended to employees of tax-exempt organizations and State and local governments.

5. Adopt a uniform vesting standard. The vesting requirements for multiemployer plans would be conformed to the existing requirements for single employer plans.

We are pleased to see that most of the areas targeted by the Administration's proposals are included in S. 1364, as well as in other pension simplification proposals pending before the Congress.

D. S. 1394, THE TAX SIMPLIFICATION ACT OF 1991

The Appendix to this testimony presents the views of the Administration on the specific provisions of S. 1394. We generally support the bill although some adjustments will be required to achieve revenue-neutrality before enactment. The Office of Tax Analysis estimates that, in its current form, S. 1394 is nearly revenue-neutral, with a loss of $89 million in fiscal 1992 and $47 million over the 5-year budget period (Table II). Certain of the proposals in S. 1394 will achieve significant simplification, but with significant revenue cost. In these instances, we have qualified our support as being subject to an acceptable revenue offset.

E. S. 1364, THE EMPLOYEE BENEFITS SIMPLIFICATION AND EXPANSION ACT OF 1991

We are encouraged by the similarities among the Administration's pension proposals, S. 1364, and the other pension simplification proposals that have been introduced in the Congress. These proposals all target the same basic areas where simplification is needed and areas where increased coverage should be encouraged. As the Administration's proposals demonstrate, it should be possible to fashion a revenue-neutral package to simplify the pension tax laws and expand coverage. We are ready to work with the Congress to move from this general consensus to enacted legislation.

Our review indicates, however, that S. 1364 in its current form would lose approximately $16 billion in revenue over the 5-year budget period. The Administration must oppose pension legislation that loses revenue. In addition, as noted in more

detail in our comments on specific provisions, we have substantive policy concerns about certain provisions of the bill.

We believe, however, that simplification of the employee benefit provisions of the Code can be achieved within the parameters of the budget agreement. Simplification of these provisions, as well as expanded access to qualified retirement plans, is a desirable goal. Simplification legislation should not be a vehicle for altering fundamental retirement and tax policies. We also believe that such proposals should build on existing structures and thus minimize the complications inherent in any change to existing laws.

Our substantive comments on the provisions of S. 1364 are set forth in the remainder of my written statement.

TITLE I. NONDISCRIMINATION PROVISIONS

Definition of Highly Compensated Employees (Section 101)

Current law. The Code defines the term "highly compensated employee" to include any employee who during the current or preceding year (1) was a 5-percent owner, (2) earned over $90,803 (indexed) in compensation, (3) earned over $60,535 (indexed) in compensation and was in the top 20 percent of the employer's workforce by compensation, or (4) was an officer earning compensation over $54,482 (indexed) or was the highest paid officer, if no officer earned more than the stated amount. For the current year determination, only the 100 highest paid employees under this definition are taken into account. Current law permits certain employers to treat, on an elective basis, all employees earning over $60,535 (indexed) as highly compensated employees regardless of whether they are in the top 20 percent of the employer's workforce by compensation. In addition, for purposes of identifying highly compensated employees, certain family aggregation rules apply in the case of 5-percent owners and other highly compensated employees who are among the top 10 employees by compensation. Different family aggregation rules may apply for purposes of the limitation on compensation that may be taken into account under a qualified plan (section 401(a)(17)). These latter rules limit the family members required to be aggregated to the employee's spouse and lineal descendants under age 19.

Proposal. The proposal would redefine the term highly compensated employee to include only 5-percent owners and employees who earn over $60,535 (as indexed). If an employer had no highly compensated employees under this definition, then the one officer with the highest compensation would be treated as highly compensated, except for purposes of sections 401(k) and (m) (relating to elective deferrals, matching contributions and employee contributions). In addition, tax-exempt employers and state and local governmental employers would be exempt from the one-officer rule. The family aggregation rules would be limited to 5-percent owners.

Administration position. We support the proposal to simplify the definition of highly compensated employees. The elimination of the rules regarding officers and the top 20 percent of employees by compensation simplifies current law without sacrificing important policy objectives.

We oppose the exception to the one-officer rule that, under certain circumstances, would eliminate the requirement that at least one employee be treated as highly compensated. Such a

proposal effectively eliminates the nondiscrimination rules for certain employers without providing any other mechanism to assure broad-based coverage.

Finally, we believe that the family aggregation rules are a source of great complexity and create inequities for two-wage-earner families where both spouses work for the same employer. Accordingly, we support simplification of those rules. However, we believe the rules could be further simplified by repealing them altogether as set forth in the Administration proposal released in April.

Modifications of Cost-of-Living Adjustments (Section 102)

Current law. Cost-of-living adjustments to various dollar limitations are currently made under adjustment procedures similar to those used for adjusting benefits under the Social Security Act. These cost-of-living increases under the Code are adjusted generally by using the last calendar quarter of a year and a base period of the last calendar quarter of 1986. Under this procedure, cost-of-living adjustments to the limitations in the Code are announced after the beginning of the year in which they are effective.

Proposal. The proposal would require the cost-of-living adjustment to be based on increases in the applicable index as of the close of the calendar quarter ending September 30 of the preceding calendar year. The proposal would also require that dollar amounts, as adjusted, be rounded to the nearest $1,000 (or to the nearest $100 in the case of the limitations on elective deferrals and in the case of the minimum compensation amounts applicable to SEPs).

Administration position. We support the proposal. It would permit the publication of applicable limits before the beginning of a calendar year for which they will be in effect and hence should assist plan administrators and plan participants. Similarly, the use of rounding would ease administration and employee communications.

Election to Treat Base Pay As Compensation (Section 103)

Current law. Current law contains a definition of compensation for purposes, among others, of applying the nondiscrimination rules to qualified plans (section 414(s)). In addition to the basic statutory definition, the Secretary is authorized to provide alternative methods for determining compensation for these purposes. The temporary regulations implement this authority in two ways, most significantly by permitting employers to elect to use any reasonable definition of compensation subject to satisfaction of a nondiscrimination test. Basic or regular rate of pay is not specifically authorized under existing regulations.

Proposal. The proposal would provide employers with an election to determine an employee's compensation solely by reference to base pay. If the employer made the election, it would apply with respect to all employees and for all relevant purposes. The election would be revocable only with the consent of the Secretary.

Administration position. During the comment period for the existing temporary and proposed regulations under section 414(s), employers discussed the possible addition of rate of pay as an alternative method for determining compensation. Alternative methods for determining compensation must be nondiscriminatory.

We are carefully considering these comments for possible inclusion in the final regulations which we intend to publish in the very near future. We believe this can be accomplished under the existing regulatory authority and that legislation in this area will not be necessary. Moreover, we believe Congress should defer action until it has evaluated the final regulations. We are also concerned that the proposal would not require that the base pay definition meet any nondiscrimination standard.

Modification of Additional Participation Requirements (Section 104)

Current law. Qualified plans, including both defined benefit and defined contribution plans, are generally required to benefit the lesser of 50 employees or 40 percent of the employer's workforce.

Proposal. The proposal would exempt defined contribution plans from the minimum participation rules. The proposal would also modify the minimum participation rule by lowering the 50-employee threshold to 25 employees and by requiring an employer with 2 or more employees to cover at least 2 employees under the same plan. The bill would also permit employers to elect to have the new rules apply as if they had been included in the Tax Reform Act of 1986.

Administration position. We do not support the proposal. We doubt that it will be simplifying because it would generally permit employers to maintain a greater number of qualified plans with a smaller number of participants in each plan and will impose additional administrative burdens on the IRS. We particularly oppose the portion of the proposal that permits employers to elect a retroactive effective date.

Nondiscrimination Rules For Qualified Cash or Deferred Arrangements and Matching Contributions (Section 105)

Current law. Elective salary deferral contributions to a 401(k) plan are generally required to meet an actual deferral percentage (ADP) test. To satisfy the ADP test, the average of the deferral rates (expressed as a percentage of compensation) for each highly compensated employee eligible to participate in the plan generally may not exceed the greater of (1) 125 percent of the average of the deferral rates of all nonhighly compensated employees eligible to participate in the plan or (2) the lesser of (a) 200 percent of the average of the deferral rates of all nonhighly compensated employees eligible to participate in the plan, or (b) such average plus 2 percentage points. If a plan does not satisfy the ADP test for a year, excess deferrals by highly compensated employees must be either redistributed to them or recharacterized as after-tax contributions in order to retain the qualified status of the 401(k) plan. The distributions or recharacterizations are made on the basis of the respective portions of excess contributions attributable to each highly compensated employee.

If a plan permits after-tax employee contributions, or provides for employer contributions that are contingent on a participant's elective deferrals or after-tax employee contributions ("matching contributions"), the amount of such contributions generally must satisfy an actual contributions percentage (ACP) test. The ACP test is generally the same as the ADP test described above, except that it applies to matching and after-tax employee contributions rather than to elective deferrals. Rules analogous to the distribution rules under the

ADP test must also be followed if the ACP test is not satisfied. Restrictions are placed on the multiple use of the alternative limit (i.e., the 200 percent/2 percentage points test) in satisfying both the ADP test and the ACP test.

Proposal. The proposal would create certain safe harbors that would, in effect, deem either the ADP test or the ACP test, or both, to have been satisfied with respect to elective deferrals and matching contributions if the plan meets certain design and notice criteria. Under the bill, the ADP test would be deemed to have been satisfied if the plan either (1) provided matching contributions with respect to all nonhighly compensated employees equal to 100 percent of elective deferrals up to 3 percent of compensation and equal to 50 percent of elective deferrals between 3 and 5 percent of compensation or (2) provided nonelective contributions equal to at least 3 percent of compensation to all nonhighly compensated employees eligible to participate in the plan. In addition, certain alternative matching formulas would be allowed, subject to nondiscrimination requirements. Any contributions used to satisfy the safe harbor would be required to be fully vested and subject to the 401(k) restrictions on withdrawals. Furthermore, such contributions could not make use of the permitted disparity rules (section 401(l)). The safe harbor would also require the employer to provide notice, within a reasonable period before the beginning of a year, to all employees eligible to participate of their rights and obligations under the plan.

The ACP test would be deemed to have been satisfied with respect to matching contributions if the design and notice criteria relating to the ADP test were met and, in addition, (1) matching contributions were not made with respect to employee contributions or elective deferrals in excess of 6 percent of an employee's compensation, (2) the level of matching contributions did not increase with the level of employee or matching contributions, and (3) the rate of matching contributions at each level of compensation was no higher for highly compensated than nonhighly compensated employees.

Administration position. We oppose the provisions contained in the proposal providing alternatives to the ADP and ACP tests by allowing plans to satisfy nondiscrimination testing merely by making matching contributions available. This proposal represents a significant change in policy, not a simplification. We believe it would seriously erode current policies against discrimination in retirement plans because such a test would provide no assurance that benefits will be provided in fact to nonhighly compensated employees.

The current law ADP and ACP tests provide a clear incentive for employers to design a plan that is attractive to rank-and-file employees and to make every effort to communicate the plan to those employees, since the actual level of participation by those employees directly affects the permitted level of deferrals by highly compensated employees. By contrast, while the proposal that is under consideration at today's hearing would require notice of the plan to be given to eligible employees buttressed by penalties for failure to do so, it provides no affirmative incentive to provide benefits in excess of the statutory minimum. In fact, such a test is a disincentive to do so since, once the design-based criteria have been met, any additional participation by the nonhighly compensated employees will increase the cost of the plan to the employer.

As we have stated in the past, we believe that the principal sources of complexity in this area are not the basic ADP and ACP tests but rather the rules applicable to the distribution and recharacterization of excess deferrals and contributions. Thus,

we believe that simplification of these rules -- not abandonment of the fundamental policy underlying these nondiscrimination rules -- should be the simplification objective in this area.

Accordingly, the Administration's pension proposal contained modifications to the ADP and ACP tests. Under our proposal, the ADP test would be modified such that each eligible highly compensated employee individually would not be permitted to defer more than a specified percentage of the deferral rates for the eligible nonhighly compensated employees for the preceding plan year. Corresponding changes were proposed with respect to the ACP test. In addition, the multiple use test was proposed to be repealed and recharacterization of excess deferrals as after-tax employee contributions would no longer be permitted. We believe the approach taken in the Administration's proposal would make the results of the ADP and ACP tests more predictable and would significantly reduce, if not eliminate, the likelihood of excess contributions. An employer would no longer need to monitor the average deferrals for the nonhighly compensated employees and the highly compensated employees during the current plan year in order to avoid the complicated correction mechanisms. Instead, the maximum contribution percentage for each highly compensated employee would be known at the beginning of the plan year. By minimizing the potential for excess contributions, the most significant source of complexity in 401(k) plans will be eliminated.

The Administration proposals will provide a design-based basic plan for small employers while continuing to make 401(k) plans generally available. Given the large growth in the popularity of such plans in recent years and the very real benefits provided to a broad base of employees, we believe that the better approach is to simplify the current 401(k) incentive structure -- not abandon it.

TITLE II. DISTRIBUTIONS

Taxability of Beneficiary of Employees' Trust (Section 201)

Current law. Distributions from qualified plans and other tax-preferred retirement programs are generally subject to income tax upon receipt. Premature distributions, generally those made before age 59½, may also be subject to a 10-percent additional tax. A number of special rules may alter the general rule if applicable.

Rollovers. Current income tax and, if applicable, the additional tax on a distribution can be avoided if the taxable portion of an eligible distribution is "rolled over" to another qualified plan or Individual Retirement Account (IRA). Only certain distributions (generally distributions that are either "qualified total distributions" or "partial distributions") are eligible for rollover treatment. As only the taxable portion of a distribution is eligible for rollover treatment, after-tax employee contributions may not be rolled over.

Lump sum distributions. Certain lump sum distributions are eligible to be taxed under special rules. These rules generally result in a lower rate of tax than would otherwise apply to a distribution. In general, a lump sum distribution is a distribution within one taxable year of the balance to the credit of the participant which becomes payable on account of death, separation from service, or disability, or after attainment of age 59½.

A participant or beneficiary generally may be able to elect to use the 5-year forward averaging rules with respect to a lump sum distribution if the distribution is received after age 59½. Five-year forward averaging is calculated under the tax rates in effect for the year of the distribution, and the election is available with respect to one distribution in an employee's lifetime. If a lump sum distribution is received before 1992, the recipient may also be able to elect to have the portion of the distribution attributable to pre-1974 plan participation taxed at capital gains rates.

Participants who attained age 50 before January 1, 1986, have three additional options which may reduce the rate of tax on a distribution. First, instead of using the 5-year forward averaging rules, they may continue to use the 10-year forward averaging rules available before the Tax Reform Act of 1986. Second, they may use the 5-year or 10-year forward averaging rules even if they are under the currently prescribed age requirement (age 59½) when they receive a distribution, if all of the other requirements for using those rules are met. Finally, they may elect to have the entire portion of a lump sum distribution attributable to pre-1974 participation taxed at a 20 percent rate.

If a lump sum distribution includes securities of the employer corporation, the net unrealized appreciation (NUA) in the employer securities is generally not subject to tax until the securities are sold, unless the recipient elects to have the normal distribution rules apply. When the securities are sold, the NUA is treated as long-term capital gain. If a distribution is not a lump sum distribution, only the NUA attributable to the employee's own contributions may be excluded from income under these special rules.

Proposal. Under the proposal, the 5-year forward averaging rules would be repealed with respect to distributions received in taxable years beginning after 1992. The current law treatment of NUA and the special averaging rules available to participants who attained age 50 before January 1, 1986, however, would be retained.

The bill would also simplify the rollover rules and permit any distributions to be rolled over. The current law restrictions on rollovers of after-tax employee contributions and minimum required distributions would be retained.

Administration position. We believe that the qualified plan distribution rules are an excellent candidate for simplification. However, we do not believe that significant simplification in this area will be achieved if the NUA exclusion and the preferential treatment available to taxpayers who attained age 50 before January 1, 1986 are retained. The Administration proposal to simplify the distribution rules would provide a single simple rule for distributions -- that such distributions either can be rolled over and deferred or are currently taxable. While preserving and enhancing an easily accessible deferral mechanism (i.e., rollover IRAs), such a rule would eliminate the need to evaluate multiple, complex alternatives on receipt of a distribution. Given the 1986 changes in the basic structure of the individual tax rates and brackets, the highly complex rules for forward averaging, NUA and capital gains treatment are no longer needed. The liberalized rollover proposal that is also contained in the Administration proposal should encourage employees to preserve their retirement savings.

While the proposal in S. 1364 adopts certain of the provisions contained in the Administration proposal, it adopts far fewer than will be required to fund the other changes set

forth in the bill. The bill also loses significant revenue by permitting rollover of annuity payments. For these reasons, we oppose the proposal in its current form.

Qualified Plans Must Provide For Transfers of Certain Distributions To Other Plans (Section 202)

Current law. Current law places various restrictions on pre-retirement distributions from qualified plans. When a permissible distribution is made from a plan, it generally is made directly to the participant or beneficiary and is subject to income tax and, in the case of a premature distribution, a 10-percent additional tax. Under certain circumstances, the recipient of a qualified plan distribution can avoid current income taxation and any 10-percent additional tax by rolling the distribution over into another qualified plan or IRA. When making a distribution that is eligible for rollover treatment, plan administrators are required to provide a written explanation of the rollover rules to the recipient. The circumstances under which such rollovers are permitted under current law are limited, however, and the rules applicable to them are very complex. In addition, rollovers must be made within 60 days of the distribution. The burden of this complexity falls primarily on the individual participants.

Proposal. The bill would require qualified plans to make "applicable distributions" in the form of direct trustee-to-trustee transfers to an IRA or a qualified defined contribution plan that accepts such transfers as designated by the distributee. Applicable distributions would generally include any distributions permitted to be made by a plan over $500 that would have been subject to the 10-percent additional tax on early distributions if they have been distributed directly to the participant or beneficiary. Thus, exceptions to the required transfer provisions would be provided for certain distributions, including any distribution after the employee attains age 55 and distributions of employee contributions. The plan would be required to provide a method for designating the transferee plan where the distributee does not make a designation or where the transfer to the designated plan is not practical. The plan trustee would be required to provide a written notice to the participant of the transfer requirements and of the amount of the transfer. Similar rules would apply in the case of annuity plans and tax-sheltered annuities.

Administration position. We support the Administration proposal under which qualified plans would be required to give participants the option of having distributions that are eligible for rollover treatment transferred directly to an eligible transferee plan specified by the participant. We believe that it would accomplish the objectives of the similar provision in the bill without imposing a mandatory transfer not always desired by the plan participant. The Administration proposal would facilitate the rollover of pension benefits and the preservation of such benefits for retirement purposes without imposing any significant additional burdens on employers. Given the availability of a better approach as described, we do not support the proposal in the bill in its current form.

The Pension Benefit Guaranty Corporation (PBGC) has advised us that the mandatory rollover requirement is not feasible for plans for which it is trustee.

Required Distributions (Section 203)

Current law. Under current law, distributions under most tax-preferred retirement arrangements must begin by no later than April 1st of the calendar year following the calendar year in which the participant attains age 70½, regardless of when the participant retires.

Proposal. The proposal would amend current law to return to the rule in effect prior to the changes made by the Tax Reform Act of 1986 and permit minimum required distributions to be delayed until retirement in the case of participants working after age 70½ provided an actuarial adjustment is made if no other benefits are accruing. Current law would continue to apply to 5-percent owners. Governmental plans and church plans would be exempt from the provisions retaining current law in specified instances and from the provision requiring actuarial adjustment.

Administration position. We would not oppose allowing a delay in required distributions until actual retirement except with respect to 5-percent owners, provided there is an acceptable revenue offset and that the actuarial adjustment required in the case of delayed distributions is fair and realistic. However, we oppose exempting governmental and church plans from the actuarial adjustment requirement. Employees covered under those plans should be entitled to the same protections as employees covered under other plans.

TITLE III. MISCELLANEOUS PROVISIONS

Treatment of Leased Employees (Section 301)

Current law. Section 414(n) of the Code provides that, for purposes of certain retirement and welfare benefit provisions of the Code, a leased employee is treated as an employee of the recipient of the leased employee's services. In order to be treated as a leased employee, a person must not be a common-law employee of the recipient and, in addition, must meet three requirements. First, the person must provide services to the recipient pursuant to an agreement between the recipient and a third-party leasing organization. Second, the person must provide the services to the recipient on a substantially full-time basis for at least one year. And, third, the services must be of a type historically performed by common-law employees in the business field of the recipient. Proposed regulations under section 414(n) were issued in 1987.

Proposal. The bill would eliminate the third requirement that the services be of a type historically performed by common-law employees in the business field of the recipient. In place of the "historically performed" standard, the proposal would substitute a requirement that the services be performed under the "control" of the recipient. The proposals generally would be retroactive to 1983.

Administration position. We would not oppose the objective of the proposal if effective prospectively and if an acceptable revenue offset is provided. We understand the intent is to limit section 414(n) to the abuses Congress originally sought to target when it enacted the section in 1983. As we have previously stated, we intend to withdraw those portions of the proposed regulations relating to the "historically performed" standard under section 414(n). We have deferred such action, however, pending Congressional revision of the standard to be applied in new regulations.

We believe that any new standard adopted by Congress should be clear in its application to specific cases. In this regard, we suggest that detailed examples in the legislative history be provided to demonstrate the intended application of the standard. "Control" in this context should not be determined by reference to employment tax concepts and should reflect the realities of the relationship, not merely its form.

Elimination of Half-Year Requirements (Section 302)

Current law. A number of employee benefit provisions, such as those relating to permissible and required distributions from qualified retirement plans, are based on the attainment of age 59½ or age 70½.

Proposal. Under the proposal, the half-year requirements would be eliminated so that each reference to age 59½ would become one to age 59 and each reference to age 70½ would become one to age 70.

Administration position. We do not oppose this proposal, although we question whether requiring such a change in plans would in fact be simplifying.

Plans Covering Self-Employed Individuals (Section 303)

Current law. Special employer aggregation rules apply to certain self-employed owner-employees participating in a tax-qualified retirement plan and controlling more than one business. The control group rules applicable to all employers under section 414(b) and (c) also apply to businesses controlled by self-employed owner-employees.

Proposal. The proposal would eliminate the special employer aggregation rules for self-employed owner-employees and would leave the generally applicable control group rules in place.

Administration position. We do not oppose the proposal provided an acceptable revenue offset is provided. The generally applicable control group rules should be sufficient to ensure against possible abuses with respect to plans maintained by self-employed owner-employees.

Full Funding Limitation of Multiemployer Plans (Section 304)

Current law. Under current law, an employer may generally make deductible contributions to a qualified defined benefit plan (including a multiemployer plan) subject to certain limitations, including the full funding limitation. The full funding limitation is generally the excess, if any, of the lesser of (1) 150-percent-of-current-liability or (2) the accrued liability (including normal cost) under the plan over the lesser of (i) the fair market value of the plan's assets or (ii) the value of the plan's assets determined under section 412(c)(2). Valuations of plan assets and liabilities are required at least annually.

The Secretary of the Treasury is granted regulatory authority to adjust the 150-percent figure to take into account the respective ages or lengths of service of the participants. In addition, the Secretary is granted regulatory authority to provide alternative methods based on factors other than current liability for the determination of the full funding limitation. The Secretary is to exercise this regulatory authority only in a revenue neutral manner. Because any such change would, by

necessity, adversely affect some taxpayers and benefit other taxpayers, the Treasury Department has concluded that it will not exercise this authority unless directed by the Congress to do so.

Proposal. In the case of multiemployer plans, the proposal would amend current law to return to the rules in effect prior to the changes made by the Pension Protection Act of 1987. Thus, the 150-percent-of-current-liability prong of the calculation of the numerator of the full funding definition would be eliminated and valuations of multiemployer plans would be required only every 3 years.

Administration position. We oppose the proposal. A complete waiver for multiemployer plans of the 150-percent-of-current-liability prong of the full funding limitation involves substantial revenue loss. We do not believe that an exception to the generally applicable funding rules should be provided simply because the plan is a multiemployer plan.

Affiliation Requirements for Employers Jointly Maintaining a Voluntary Employees' Beneficiary Association (Section 305)

Current law. Under Treasury regulations, a voluntary employees' beneficiary association (VEBA) is not tax exempt under section 501(c)(9) of the Code if it benefits employees who do not share an employment-related common bond. An employment-related common bond generally exists only among employees of the same employer (or affiliated employers), employees covered by a collective bargaining agreement, members of a labor union, or employees of unaffiliated employers doing business in the same line of business in the same geographic locale. The IRS has interpreted the same geographic locale requirement as prohibiting a VEBA from covering nonunion employees of unaffiliated employers located in more than one state or metropolitan area. The same geographic locale requirement was held to be invalid by the 7th Circuit in Water Quality Ass'n Employees' Benefit Corp. v. United States, 795 F.2d 1303 (1986).

Proposal. The proposal would exempt VEBAs maintained by unaffiliated employers from the same geographic locale requirement if they (1) are in the same line of business, (2) act jointly to perform tasks which are integral to the activities of each of the employers, and (3) act jointly to such an extent that the joint maintenance of a voluntary employees' beneficiary association is not a major part of the employers' joint activities.

Administration position. We oppose the proposal in the bill; however, as discussed below, we would consider a more limited change to the VEBA rules. The same geographic locale requirement helps target the tax benefits available under section 501(c)(9) to organizations with the greatest need for support. The VEBA tax exemption was initially intended to benefit associations formed and managed by employees of a single employer or of small local groups of employers, to provide certain welfare benefits to their members in situations where such benefits would not otherwise have been available. Congress was concerned that such associations might not be viable without a tax exemption. By contrast, larger associations covering employees of unrelated employers in different geographic areas are more likely to be viable even without a tax exemption, and the benefits they provide are more likely to be able to be provided through commercial insurance.

The fact that unaffiliated employers would be required under the proposal to conduct certain joint activities does not address these concerns. Moreover, we are concerned that the nature and required level of joint activities under the proposal are so unclear that the exemption will apply to a large group of employers. This would have serious revenue consequences and, in addition, would undermine those provisions of the Code that prescribe the treatment of insurance companies.

Although we oppose the proposed exemption from the geographic locale requirement for the reasons stated above, we understand that the one-state or metropolitan area rule may be too restrictive in states or metropolitan areas with too few employees in the same industry to form an economical multiple-employer VEBA. An alternative to the proposal in the bill would be to limit VEBAs to a three-contiguous-state area, or a larger area if the Secretary determined that the employer group in the three-state area was too small to make self-insurance economical. If an acceptable revenue offset were provided, we would not oppose such a modification.

Treatment of Governmental Plans (Section 306)

Current law. Benefits payable under qualified defined benefit plans generally are limited to the lesser of $90,000 (indexed) or 100 percent of compensation (section 415). A number of circumstances may give rise to required adjustments to these limitations, including situations where benefits commence before age 62, in the case of a governmental plan, or where there is less than 10 years of service or participation in the plan. Under a special transition rule, government plans are permitted to elect to have pre-1988 limits apply with respect to qualified participants.

The basic definition of compensation under current law used to determine the limits on contributions and benefits is defined to conform as closely as possible to total taxable income received from the employer. Thus, salary reduction amounts excluded from an employee's gross income are not taken into account in determining compensation for this purpose.

Excess benefit plans of governmental employers providing benefits for certain employees in excess of the section 415 limitations on benefits and contributions under qualified plans are subject to the provisions of section 457, which include an annual cap on benefits of $7,500 (or, if less, 33-1/3 percent of compensation).

Proposal. The proposal would exempt benefits under governmental plans from the 100 percent of compensation limitation. The proposal would also exempt certain survivor and disability benefits under governmental plans from the adjustment for pre-age 62 commencement, and from the participation and service adjustments generally required to be made to the section 415 limitations on benefits.

For purposes of determining the limits on contributions and benefits under a governmental plan, the proposal would include certain salary reduction amounts in compensation. The proposal would exempt governmental excess benefit plans from the provisions of section 457. Finally, the proposal would permit a revocation of an election to have the pre-1988 limitations apply to qualified participants.

While the general effective date of the proposal is taxable years beginning after the date of enactment, the bill provides

that plans are treated as satisfying the requirements of section 415 for all taxable years beginning before the date of enactment.

Administration position. We oppose the proposal creating an exception to the 100 percent of compensation limitation. The proposal would violate the long-standing policy against permitting benefits payable under qualified defined benefit plans to exceed 100 percent of compensation and does not present an appropriate case for making an exception to that policy.

We oppose the proposal creating a broad exception for survivor and disability benefits under governmental plans. We note, however, that certain pre-retirement survivor and disability benefits under governmental plans are not generally subject to the limitations on contributions and benefits under the current IRS interpretation.

We oppose the proposal to include salary reduction amounts in compensation for purposes of determining the limits on contributions and benefits under governmental plans. The proposal is inconsistent with the general policy that amounts excluded from gross income should not be taken into account for this purpose.

We oppose the excess benefit plan proposal. The scope of the proposal is narrowly drafted to cover only excess benefit plans maintained by one limited group of those employers subject to section 457.

We oppose the provision deeming all governmental plans to have satisfied the limits on contributions and benefits for all prior years. The proposal is in effect a retroactive repeal of those limits.

Modifications of Simplified Employee Pensions (Section 307)

Current law. Under current law, an employer may establish a simplified employee pension (SEP) that accepts elective salary reduction contributions. In order for a salary reduction SEP (SARSEP) to qualify, the employer generally may have no more than 25 nonexcludable employees, at least 50 percent of all nonexcludable employees must elect to make such contributions, and the deferral percentage of each eligible highly compensated employee must not exceed 125 percent of the average deferral percentage of all eligible nonhighly compensated employees (the "ADP" test). If an employer maintains a SEP or a SARSEP, the plan generally must be provided to all employees who are age 21 or older, who have performed service for the employer in at least 3 out of the last 5 years and who have received over $363 (indexed) in compensation.

Proposal. The proposal would permit employers with up to 100 nonexcludable employees to set up current law SARSEPs and would eliminate the 50-percent participation requirement. In addition, the proposal would exempt a SARSEP from the otherwise applicable ADP test if one of the design-based safe harbors provided under the bill with respect to 401(k) plans were adopted. Finally, the proposal generally would require SEPs of all types to cover every employee with at least 1 year of service.

Administration position. We oppose the proposal to eliminate the 50-percent participation test and to create an exemption from the ADP test applicable to SARSEPs without requiring any base contribution. The effect would be to eliminate any requirement that pension coverage be actually provided (as opposed to made available) to nonhighly compensated

employees. Absent actual coverage of a broad base of employees, we believe that the substantial tax expenditure provided for pension arrangements cannot be justified.

In the Administration's pension proposal, we recommended a new vehicle for employers with 100 or fewer employees and no other retirement plan. Under our proposal, a base contribution would be made for each eligible employee of 2 percent of pay (up to a maximum base contribution of $2,000). Employees could elect to contribute up to one-half the limit on elective deferrals applicable to 401(k) plans and employers could make a 50 percent matching contribution. The minimum contribution concept embodied in the Administration's proposal would free small businesses from the burdens of experience-based testing, while at the same time ensuring broad-based coverage of nonhighly compensated employees.

Contributions on Behalf of Disabled Employees (Section 308)

Current law. An employer may make certain nonforfeitable contributions to a tax-qualified defined contribution plan on behalf of any disabled participant who is not highly compensated if an election is made.

Proposal. The proposal would permit nonforfeitable contributions to be made on behalf of highly compensated disabled participants for a fixed or determinable period and would waive the election requirement, if contributions were made on behalf of all disabled participants.

Administration position. We would not oppose the proposal if it were modified to insure that the provision does not operate in a manner that discriminates in favor of highly compensated employees and if an acceptable revenue offset is provided. We are concerned that, as presently drafted, contributions during disability could be provided for under a plan during years when the only disabled participants are highly compensated and such provisions could then be deleted in subsequent years when the only disabled participants were nonhighly compensated.

Distributions Under Rural Cooperative Plans (Section 309)

Current law. Distributions from 401(k) plans may be made upon attainment of age 59½, and distributions from profit-sharing plans may be made in certain events, including attainment of a stated age. Distribution from pension plans (including money purchase pension plans) generally must not commence until retirement.

Proposal. The proposal would permit distributions after attainment of age 59 from a money purchase rural cooperative plan which includes a 401(k) plan. Such distributions would not be limited to the 401(k) portion of the plan. The proposal is made retroactive, generally to 1987.

Administration position. We oppose the proposal insofar as it creates a retroactive special exception for a limited group of tax-qualified plans. We do not oppose the proposal if effective prospectively. However, we note that there would appear to be no impediment under current law for the rural cooperative plans to be converted to profit-sharing plans under which distributions upon the attainment of a stated age would be permissible.

Reports of Pension and Annuity Payments (Section 310)

Current law. Persons maintaining or administering certain tax-favored retirement arrangements are required to file reports

in the nature of information returns regarding the arrangements with the IRS and with the participants, owners, or beneficiaries under the arrangements. Under current law, failure to file the reports is subject to specific penalties rather than the generally applicable penalty for failure to file information returns.

Proposal. Under the proposal, failure to file reports regarding tax-favored retirement arrangements that are in the nature of information reports would be subject to the generally applicable penalty for failure to file information returns.

Administration position. We support this proposal because conforming the information-reporting penalties that apply with respect to pension payments to the general information-reporting penalty structure will simplify the overall penalty structure through uniformity and provide more appropriate information-reporting penalties with respect to pension payments.

Tax-Exempt Organizations Eligible For Section 401(k) Plans (Section 311)

Current law. The Tax Reform Act of 1986 precluded tax-exempt employers from adopting 401(k) plans for their employees. Certain existing plans (*i.e.*, plans adopted by tax-exempt employers before July 2, 1986) were grandfathered.

Proposal. Under the proposal, tax-exempt employers would be permitted to adopt 401(k) plans for their employees.

Administration position. We support the proposal subject to an acceptable revenue offset. We see no policy basis for precluding tax-exempt employers from adopting 401(k) plans for their employees. We believe this is also true with respect to State and local government employers as evidenced by the Administration proposal to expand 401(k) plans to those employers as well. There are, however, revenue costs associated with both proposals which have prevented enactment of these proposals in the past. If the Committee does not utilize the revenue-raising provisions proposed by the Administration, these cost constraints may again prevent implementation of this desirable change. We believe this is an appropriate way to encourage expanded pension coverage and to remove an exception to the general availability of 401(k) plans.

Date for Adoption of Plan Amendments (Section 312)

Current law. Plan amendments must generally be made by the end of the plan year in which the amendments are effective, although later amendments may be made if the remedial amendment period extends that date.

Proposal. The proposal would provide that any plan amendments required by the legislation would not be required to be actually made before the 1993 plan year, provided the plan is operated in accordance with the amendment and the amendment is made retroactive.

Administration position. We do not support this proposal. Absent appropriate circumstances, we believe a delayed date for actual plan amendments creates serious difficulties in the proper administration and operation of plans.

TABLE I

REVENUE ESTIMATES OF ADMINISTRATION'S PENSION PROPOSALS

	(billions) 1992	1992-96
Distributions from Qualified Plans	.6	3.0
Cash or Deferred Arrangements (401(k) Plans)	-.1	-.6
Extend 401(k)'s to Tax-exempts	-*	-.2
Extend 401(k)'s to State and Local Governments	-.1	-1.2
Salary Reduction Simplified Employee Pensions	-.1	-.8
Definition of Highly-Compensated Employee	*	.3
Repeal of Family Aggregation Rules	-*	-.1
Multi-Employer Vesting	-*	-.1
Total	.3	.3

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* Less than $50 million

The estimates assume an effective date of 1/1/92.

Department of the Treasury
Office of Tax Analysis

September 9, 1991

TABLE II

REVENUE ESTIMATE OF S. 1394
BY TITLE

	(millions) 1992	1992-96
Title I -- Individual tax provisions	-3	-41
Title II -- Large partnership provision	+3	+183
Title III -- Foreign provisions	+22	+87
Title IV -- Other income tax provisions	-103	-260
Title V -- Estate & gift tax provisions	-*	-*
Title VI -- Excise tax provisions	-11	-31
Title VII -- Administrative provisions	+3	+15
Totals	-89	-47

Department of the Treasury
Office of Tax Analysis

September 9, 1991

APPENDIX TO STATEMENT OF KENNETH W. GIDEON

This appendix presents in detail the views of the Administration on S. 1394, the Tax Simplification Act of 1991. The provisions are covered in the order in which they appear in S. 1394.

TITLE I. INDIVIDUAL TAX PROVISIONS

1. Rollover of Gain on Sale of Principal Residence: Rules Relating to Multiple Sales Within Rollover Period (Section 101)

Current law. No gain is recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his principal residence within a specified period of time. This replacement period generally begins 2 years before and ends 2 years after the date of sale of the old residence. In general, nonrecognition treatment is available only once during any 2-year period. In addition, if during the replacement period the taxpayer purchases more than one residence which is used as his principal residence within 2 years after the date of sale of the old residence, only the last residence so used is treated as the new replacement residence. However, if residences are sold in order to relocate for employment reasons, two special rules apply: first, the number of times nonrecognition treatment is available during a 2-year period is not limited; second, if a residence is sold within 2 years after the sale of the old residence, the residence sold is treated as the last residence used by the taxpayer and thus as the only replacement residence.

Proposal. Gain would be rolled over from one residence to another residence in the order the residences are purchased and used, regardless of the taxpayer's reasons for the sale of the old residence. In addition, gain could be rolled over more than once within a 2-year period. Thus, the rules that formerly applied only if a taxpayer sold his residence in order to relocate for employment purposes would apply in all cases.

Administration position. The Administration supports this provision. The provision simplifies the application of section 1034 by amending it to provide a single set of rules for rollover of gain on the sale of a principal residence.

2. Due Dates for Estimated Taxes of Individuals (Section 102)

Current law. Individual estimated taxes for a taxable year must be paid in four installments, the due dates of which are April 15, June 15, and September 15 of that year and January 15 of the following year.

Proposal. The due date for the second installment of estimated tax would be changed from June 15 to July 15.

Administration position. We do not support this proposal. It entails a cost to the government, which would receive the second installment of estimated tax at a later date (thereby foregoing investment earnings on the funds or incurring interest expense on additional borrowings) and would have to revise tax forms and processing capabilities to accommodate the change. The proposal would not meaningfully simplify the law. The intervals between due dates for installments of individual estimated taxes

would remain uneven; the 2-month interval that currently exists between the first (April 15) and second (June 15) installments would be replaced by a 2-month interval between the new second (July 15) and third (September 15) installments.

3. Payment of Tax by Credit Card (Section 103)

Current law. Payment of taxes may be made by checks or money orders, to the extent and under the conditions provided by regulations.

Proposal. The bill would permit payment of taxes by checks, money orders and other commercially acceptable means that the Secretary of the Treasury deems appropriate (including payment by credit card) to the extent and under the conditions provided by regulations. In addition, the Secretary would be given the authority to contract with financial institutions for credit card services at rates that are cost beneficial to the Government.

Administration position. The Administration supports these grants of authority. Allowing taxpayers to use credit cards to make tax payments would provide them with an additional option for payment that they have in most other debtor/creditor relationships. The proposal also allows flexibility to permit other commercially acceptable forms of payment.

4. Election to Include Child's Income on Parent's Return (Section 104)

Current law. The net unearned income of a child under 14 years of age is taxed at the marginal rate of the child's parents. If the child's gross income is solely from interest and dividends and is more than $500 and less than $5,000, the parents may elect to report the child's gross income in excess of $1,000 on their return. If the election is made, in addition to the tax on the augmented income, the parents pay the lesser of $75 or 15 percent of the excess of the child's gross income over $500. For purposes of the alternative minimum tax (AMT), the AMT exemption of a child under the age of 14 is limited to the sum of the child's earned income and the greater of $1,000 or the unused parental minimum tax exemption.

Proposal. The dollar amounts relating to the election to include the child's income on the return of the parents would be indexed for inflation. In addition, the $1,000 amount used to determine the amount of the child's AMT exemption would be indexed for inflation.

Administration position. The Administration supports this provision. Adjusting for inflation for purposes of the election will prevent inflation from eroding the availability of the election over time. Because the election reduces the need to file separate returns for young children, preserving the availability of the election simplifies the filing process.

5. Certain Foreign Tax Credits for Individuals (Section 105)

Current law. In order to compute the foreign tax credit, a taxpayer computes foreign source taxable income, and foreign taxes paid, in each of the applicable separate foreign tax credit limitation categories. In the case of an individual, this requires the filing of Form 1116, designed to elicit sufficient information to perform the necessary calculations.

Proposal. On an elective basis, the proposal would eliminate the need for individual taxpayers with less than $200 in creditable foreign taxes to file a Form 1116 or to allocate and apportion expenses to their passive foreign source income reported on a Form 1099. In order to permit the simplified calculation, an electing taxpayer's credit would be limited to the lesser of 25 percent of such passive foreign source income or the total foreign taxes paid.

Administration position. We support this proposal. The bill would simplify the foreign tax credit computations for individuals claiming small amounts of credits.

6. Certain Personal Foreign Currency Transactions (Section 106)

Current law. When a U.S. taxpayer having the U.S. dollar as his functional currency makes a payment in a foreign currency, gain or loss (referred to as "exchange gain or loss") arises from any change in the value of the foreign currency relative to the U.S. dollar between the time the currency was acquired (or the obligation to pay was incurred) and the time that the payment is made. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for Federal income tax purposes. Exchange gain or loss can arise where foreign currency has been acquired for personal use.

Proposal. The bill would exempt from taxation exchange gains not exceeding $200 realized by individuals on the disposition of foreign currency in personal transactions. Losses on such transactions are not allowed under current law.

Administration position. We support this proposal. Taxpayers located abroad generally must conduct their affairs in the local currency. Under current law, taxpayers may be required to recognize exchange gains on dispositions of foreign currency in personal transactions. We agree that, in de minimis cases, this imposes unreasonable administrative demands on taxpayers, and that the insignificant amount of revenue collected from such transactions does not justify this administrative burden.

7. Due Date for Furnishing Information to Partners (Section 107)

Current law. Partnerships are required to furnish an information return (Schedule K-1) to each person who is a partner for any partnership taxable year on or before the day on which the return for such taxable year is required to be filed (April 15 for a calendar year partnership).

Proposal. A large partnership (which is a partnership with 250 or more partners or any partnership subject to the simplified reporting rules for large partnerships proposed in H.R. 2777) would be required to furnish information returns to its partners by the 15th day of the third month following the end of its taxable year (March 15, for a calendar year partnership).

Administration position. We support this proposal insofar as it applies to simplified Schedules K-1 issued by large partnerships as described in §201 of the bill. Information returns that are received on or shortly before April 15 are difficult for individuals to use in preparing their returns or computing their payments that are due on that date. It may thus be appropriate to accelerate this date in the case of large partnerships whose tax treatment is being modified (in Title II of this bill) in order to simplify the tax consequences of an

investment in the partnership. We question, however, whether this requirement should be extended to partnerships which remain subject to detailed Schedule K-1 reporting or to Schedule K-1's issued to excluded partners of large partnerships.

8. Exclusion of Combat Pay from Withholding Limited to Amount Excludable From Gross Income (Section 108)

Current law. Gross income does not include certain pay of members of the Armed Forces. If enlisted personnel serve in a combat zone during any part of any month, military pay for that month is excluded from gross income. Special rules apply if enlisted personnel are hospitalized as a result of injuries, wounds, or disease incurred in a combat zone. In the case of commissioned officers, these exclusions from income are limited to $500 per month of military pay.

There is no income tax withholding with respect to military pay for a month in which a member of the Armed Forces is entitled to the combat pay exclusion. With respect to enlisted personnel, this income tax withholding parallels the exclusion: there is a total exemption from income tax withholding and total exclusion from income. With respect to officers, however, the withholding rule is not parallel: there is total exemption from income tax withholding, although the exclusion from income is limited to $500 per month.

Proposal. The proposal would make the income tax withholding exemption rules parallel to the rules providing an exclusion from income for combat pay.

Administration position. We support this proposal. The current differences between the withholding rules and the exclusion rules with respect to combat pay can lead to underwithholding on the pay of taxpayers (primarily officers) and could cause hardship at the time of the filing of their tax returns.

9. Simplified Income Tax Returns (Section 109)

Current law. The Treasury Department and the Internal Revenue Service (IRS) continually study ways to simplify reporting for individuals, both itemizers and nonitemizers.

Proposal. The bill would require the Secretary (or his delegate) to take such actions as may be appropriate to expand access to simplified individual income tax returns and otherwise simplify the individual income tax returns. The bill would mandate that the Secretary (or his delegate) submit a report no later than 1 year after enactment on such actions.

Administration position. We do not oppose this proposal. It mandates that the Treasury Department and the IRS continue existing and continuous activities to evaluate tax forms to make them easier to understand and to improve compliance. We do not believe a formal study should be required.

10. Rural Letter Carriers (Section 110)

Current law. A taxpayer may elect to use a standard mileage rate in computing the deduction allowable for business use of an automobile. Under this election, the taxpayer's deduction equals the standard mileage rate multiplied by the number of miles driven for business purposes, and is taken in lieu of deductions

for depreciation and actual operation and maintenance expenses. If the taxpayer is an employee, the deduction is subject to the 2-percent floor on miscellaneous itemized deductions.

If the taxpayer's employer reimburses the taxpayer under an accountable plan for his actual expenses, the reimbursement is excluded from the taxpayer's income. A plan is accountable if it meets requirements of business connection, substantiation, and returning amounts in excess of expenses. Rather than requiring an employee to substantiate the actual amount of his expense, the employer can provide a mileage allowance. If a mileage allowance is paid at a rate not in excess of the standard mileage rate, the reimbursement is excluded from the taxpayer's income. If the mileage allowance is paid at a rate in excess of the standard mileage rate, the excess is included in the taxpayer's income (and is subject to reporting and withholding).

An employee of the U.S. Postal Service may use a special mileage rate equal to 150 percent of the standard mileage rate in computing the deduction for business use of an automobile in performing services involving the collection and delivery of mail on a rural route.

Proposal. The bill would repeal the special mileage rate for U.S. Postal Service employees. In its place, the bill would provide that the rate of reimbursement provided by the Postal Service to rural letter carriers under their 1991 collective bargaining agreement is considered to be equivalent to their actual expenses. This rate can be increased in the future by no more than the rate of inflation. The bill also would provide that the reimbursements are exempt from the accountable plan requirements.

Administration position. The Administration does not oppose the proposal insofar as it treats the reimbursements for automobile expenses provided to rural letter carriers as being equal to their actual expenses. The Administration believes, however, that the reimbursements should be subject to the accountable plan requirements. These requirements do not impose an undue burden on the Postal Service or rural letter carriers.

11. Exemption From Luxury Excise Tax For Certain Equipment Installed On Passenger Vehicles For Use By Disabled Individuals (Section 111)

Current law. The 1990 OBRA imposed a 10-percent excise tax on the portion of the retail price of a passenger vehicle that exceeds $30,000. The tax also applies to the installation of parts and accessories within 6 months of the date the vehicle is purchased.

Proposal. The bill would provide that the luxury excise tax does not apply to a part or accessory that is installed on a passenger vehicle after its purchase in order to enable or assist an individual with a disability to operate the vehicle or to enter or exit the vehicle by compensating for the effect of the disability. The tax would continue to apply to the portion of the retail price of the vehicle that exceeds $30,000, even if the purchaser is disabled and/or intends to make modifications to the vehicle that under the proposal would be exempt from the tax.

Administration position. We support the proposal. We would modify the proposed language slightly in order to clarify that Congress intends the proposal also to apply to structural or mechanical modifications to a vehicle that make the vehicle usable by a disabled person but that may involve the removal or rearrangement, rather than the addition, of parts.

We understand that the proposal is not intended to exclude from the luxury tax accessories such as cruise control, adjustable steering columns, power-adjustable seats, or power windows, door locks, mirrors or sunroofs that are commonly available as optional equipment from the manufacturer or dealer and that might assist any driver in operating the vehicle.

TITLE II. TREATMENT OF LARGE PARTNERSHIPS

A. General Provisions

1. Partnership Reporting System (Section 201)

Current law. A partnership generally is treated as a conduit for Federal income tax purposes. As a conduit, a partnership pays no tax. Instead, each partner takes into account a distributive share of the partnership's items of income, gain, loss, deduction, or credit. The character of an item allocated to a partner is the same as if it had been directly realized or incurred by the partner. The taxable income of a partnership to be allocated to the partners is computed in the same manner as that of an individual except that no deduction is permitted for personal exemptions, foreign taxes, charitable contributions, net operating losses, certain itemized deductions, or oil and gas percentage depletion. Some elections affecting the computation of taxable income derived from a partnership are made by the partnership, while others are made by each partner. The various limitations affecting the computation of taxable income and tax liability generally apply at the partner level, rather than at the partnership level.

Under the current reporting rules, each partnership must file a Form 1065, Partnership Return of Income, for each taxable year. The return is accompanied by a Schedule K-1 for each partner, reporting the partner's share of allocable tax items of the partnership, and other specified information. A copy of the Schedule K-1, or a suitable substitute, is furnished to each partner for use in reporting the items on the partner's income tax return. A partnership must separately state on each Schedule K-1 the partner's distributive share of each of several tax items that are specifically enumerated in the tax law. In addition, the K-1 must separately state the partner's distributive share of any partnership item that, if separately taken into account by the partner, could result in an income tax liability that differs from the liability that would result if the item were not stated separately.

In addition, section 704(c) and the "ceiling rule" thereunder require partnerships to take into account, in computing income, loss, gain and deduction, the difference between the contribution date basis and fair market value of property contributed to the partnership. The ceiling rule causes complexity and may preclude fungibility of interests in a large partnership. Second, current law provides that a constructive termination of a partnership for tax purposes occurs if, within a 12 month period, interests representing more than 50 percent of partnership profits and capital are sold or exchanged. In order to avoid constructive terminations, which can have negative effects, many large partnerships keep detailed records of transfers and impose transfer restrictions on their partners.

Proposal. The bill modifies the tax treatment of a large partnership (generally, a partnership with at least 250 partners) and its partners. Under the bill, as a general matter, the taxable income of a large partnership is computed in the same

manner as that of an individual except that the number of items that would be reported to the partners is much more limited. As under current law, a large partnership would not be allowed a deduction for personal exemptions, net operating losses, or certain itemized deductions. All limitations and other provisions affecting the computation of taxable income or any credit (except for the at risk, passive loss and section 68 itemized deduction limitations, and any other provision specified in regulations) would be applied at the partnership and not the partner level. Thus, for example, any investment interest of the partnership would be limited at the partnership level, and any carryover would be made at that level. All elections affecting the computation of taxable income or any credit would be made by the partnership. Except where inconsistent with the large partnership provisions, the rules of subchapter K would apply to large partnerships under the new system.

The bill provides that each partner takes into account separately the partner's distributive share of the following items: (1) taxable income or loss from passive loss limitation activities; (2) taxable income or loss from other activities (e.g., portfolio income or loss); (3) net capital gain to the extent allocable to passive loss limitation activities and other activities; (4) net alternative minimum tax adjustment separately computed for passive loss limitation activities and other activities; (5) general credit; (6) low-income housing credit; (7) rehabilitation credit; (8) for certain partnerships, tax-exempt interest; and (9) for certain partnerships, foreign tax credit information.

Thus, the bill would significantly reduce the number of potential items to be reported by large partnerships to their partners. We believe that in most cases the actual number of items to be reported would be no more than six. In order to accomplish that simplification, the bill would require changes in the treatment of certain items as explained in more detail below.

Capital gains. Under the bill, capital gains and losses of large partnerships would be netted at the partnership level. A partner in a large partnership would take into account separately his distributive share of the partnership's net capital gain. However, any excess of net short-term capital gain over net long-term capital loss would be consolidated with the partnership's other taxable income and would not be separately reported to the partners. Also, any excess of capital losses over capital gains would not be separately reported to partners; rather, that excess would be carried over indefinitely at the partnership level for use against future capital gains. A large partnership would not be allowed to offset any portion of capital losses against ordinary income.

The partnership's net capital gain would be allocated to passive loss limitation activities to the extent of net capital gain from sales and exchanges of property used in connection with such activities. Any excess would be allocated to other activities.

A large partnership's section 1231 gains and losses would be netted each year at the partnership level. Net gain would be treated as long-term capital gain and would be subject to the rules described above. Net loss would be treated as ordinary loss and consolidated with the partnership's other taxable income.

The netting approach provided in the bill for capital gain and loss and section 1231 gain and loss ensures that the basic rules for items are maintained, while simplifying reporting by

placing most of the computational and compliance burden at the partnership level. Absent such an approach, additional items would have to be reported on the simplified 1099-K.

Deductions. The bill contains two special rules for deductions. First, unlike current law, miscellaneous itemized deductions are not separately reported to partners. Instead, an amount equal to 70 percent of those deductions is disallowed at the partnership level; the remaining 30 percent amount is allowed at the partnership level in determining taxable income. The allowable deduction amount is not subject to the 2 percent floor at the partner level. The 70 percent disallowance is intended to approximate the effect of the current law 2 percent floor at the partner level with respect to partnership deductions.

Second, also unlike current law, charitable contributions would not be separately reported to partners under the bill. Instead, the charitable contribution deduction would be allowed at the partnership level in determining taxable income, subject to the limitations that apply to corporate donors.

Credits in general. Under the bill, most credits, instead of being separately reported to the partners (as under current law), are consolidated at the partnership level into a general credit and then reported to partners as a single general tax credit item. As a general matter, the general credit includes all credits other than the low-income housing credit and the rehabilitation credit. A partner's distributive share of general credit would be taken into account as a current year general business credit. Thus, for example, the credits for clinical testing expenses and the production of fuel from nonconventional sources would be subject, at the partnership level, to the current law limitations on the general business credit. The refundable credit for gasoline used for exempt purposes would be allowed to the partnership, and thus would not be separately reported to partners.

In recognition of their special treatment under the passive loss rules, the low-income housing and rehabilitation credits would be separately reported to partners as under current law.

The bill imposes credit recapture at the partnership level and would determine the amount of recapture by assuming that the credit fully reduced taxes. Such recapture is applied first to reduce the partnership's current year credit, if any; the partnership is liable for any excess over that amount. Under the bill, the transfer of an interest in a large partnership (by a partner other than an excluded partner) would not trigger recapture of any credit.

Foreign tax credit. Elections, computations and limitations regarding the foreign tax credit generally would be made under the bill at the partnership level. Once determined at the partnership level to be allowable, the foreign tax credit would be reported to the partner as a general credit. For purposes of applying foreign tax credit limitations, the partnership would be treated as an individual subject to tax at a 25 percent rate. Excess credits could be carried forward at the partnership level but could not be carried back. The partner's distributive share of all items of income, gain, loss, or deduction would be treated as derived from sources within the United States.

Current law rules relating to the foreign tax credit would apply if the partnership were to elect to have them apply or if 25 percent or more of the gross income of the partnership during a taxable year were derived from sources outside the United

States. In either case, the foreign tax credit would not be subjected to limitations at the partnership level or folded into the general credit. Instead, the partnership would separately report to its partners their respective shares of the partnership's foreign taxes, the source of partnership income, and the other partnership items the partners would need to compute the foreign tax credit at their level. As under current law, income from the partnership generally would be treated by the partners as passive for separate limitation purposes.

Tax-exempt interest. Under the bill, interest on a State or local bond would be treated as taxable (and thus not separately reported) unless at the end of each quarter of the taxable year at least 50 percent of the value of partnership assets consists of State or local bonds the interest on which is exempt from taxation. This rule reflects the judgment that apart from large partnerships organized for the purpose of holding State or local bonds, most large partnerships hold relatively small or no investments in those bonds.

Unrelated business taxable income. The bill retains current law treatment of unrelated business taxable income. Thus, a tax-exempt partner's distributive share of partnership items would be taken into account separately to the extent necessary to comply with the rules governing such income. The bill does not alter the rule that all income from a publicly traded partnership continues to be treated as unrelated business taxable income.

Passive losses. Under the bill, each partner in a large partnership would take into account separately the partner's distributive share of the partnership's taxable income or loss from passive loss limitation activities. The term "passive loss limitation activity" means any activity which involves the conduct of a trade or business (including any activity treated as a trade or business under section 469(c)(5) or (6)) and any rental activity. A partner's share of a large partnership's taxable income or loss from passive loss limitation activities would be treated as an item of income or loss from the conduct of a trade or business which is a single passive activity, as defined in the passive loss rules. Thus, a large partnership would not be required to separately report items from separate activities.

Each partner in a large partnership also would take into account separately under the bill the partner's distributive share of the partnership's taxable income or loss from activities other than passive loss limitation activities. Such distributive share is treated under the bill as an item of income or expense with respect to property held for investment. Thus, portfolio income (e.g., interest and dividends) is reported separately and is reduced by portfolio deductions and allocable investment interest expense.

Alternative minimum tax. Under the bill, AMT adjustments and preferences would be combined at the partnership level. A large partnership would report to partners a net AMT adjustment separately computed for passive loss limitation activities and other activities. In determining a partner's AMT income, the partner's distributive share of any net AMT adjustment would be taken into account instead of making separate AMT adjustments with respect to partnership items. Except as provided in regulations, the net AMT adjustment would be determined by using the adjustments applicable to individuals, and would be treated as a deferral preference for purposes of the section 53 minimum tax credit.

REMICs. For purposes of the tax on partnerships holding residual interests in REMICs, all interests in a large partnership would be treated as held by disqualified organizations. Thus, a large partnership holding a residual interest in a REMIC would be subject to a tax equal to the excess inclusions multiplied by the highest corporate rate.

Deferred sale treatment for contributed property. For all partners contributing property to a large partnership (including partners otherwise excluded from application of the large partnership rules, as described below), the bill replaces section 704(c) with a "deferred sale" approach. Under the bill, a large partnership would be treated as if it had purchased the contributed property from the contributing partner for its fair market value on the date of the contribution. The partnership, therefore, would take a contribution date fair market value basis in the property. The contributing partner's gain or loss on the contribution (the "precontribution gain or loss") would be deferred until the occurrence of specified recognition events. In general, the character of the precontribution gain or loss would be the same as if the property had been sold to the partnership at fair market value by the partner at the time of contribution. The contributing partner's basis in his partnership interest would be adjusted for precontribution amounts recognized under the provision. These adjustments generally would be made immediately before the recognition event.

The provision effectively would repeal the ceiling rule for large partnerships, *i.e.*, the amount of precontribution gain or loss recognized by the contributing partner under the provision is not limited to the overall gain or loss from the contributed property recognized by the partnership, and the amount of depreciation allowable to the partnership is not limited to the contributing partner's precontribution basis in the property.

Under the bill, certain events occurring at either the partnership or partner level cause recognition of precontribution gain or loss. For example, the contributing partner's disposition of his partnership interest or the partnership's disposition of the contributed property, as a general matter, would cause recognition. Loss would not be recognized, however, by reason of a disposition to a person related (within the meaning of section 267(b)) to the contributing partner. Depreciation or amortization of the contributed property by the partnership also would cause recognition.

The contributing partner would recognize precontribution gain or loss as the partnership claims amortization, depreciation, or depletion deductions with respect to the property. The amount of gain (or loss) recognized would equal the increase (or decrease) in the deduction attributable to changes in basis of the property occurring by reason of its contribution. Any gain or loss so recognized would be treated as ordinary.

The contributing partner also would recognize precontribution gain or loss if the partnership disposes of the contributed property to a person other than the contributing partner. If such property were distributed to the contributing partner, its basis in the hands of the contributing partner would equal its basis immediately before the contribution, adjusted for any gain or loss previously recognized on account of the deferred sale. No adjustment is made to the basis of undistributed partnership property on account of a distribution to the contributing partner.

A contributing partner also would recognize precontribution gain or loss to the extent that the partner disposes of the

partner's partnership interest other than at death. Such partner also would recognize precontribution gain or loss to the extent that the cash and fair market value of property (other than the contributed property) distributed to him exceeds the adjusted basis of his partnership interest immediately before the distribution (determined without regard to any basis adjustment under the deemed sale rules resulting from the distribution).

Section 754 election. The bill does not alter the rule that a large partnership may elect to adjust the basis of partnership assets with respect to transferee partners. The computation of a large partnership's taxable income is made without regard to the section 743(b) adjustment. As under current law, the section 743(b) adjustment is made only with respect to the transferee partner. In addition, a large partnership is permitted to adjust the basis of partnership property under section 734(b) if property is distributed to a partner, as under current law.

Terminations. The bill provides that a large partnership does not terminate for tax purposes solely because 50 percent of its profits and capital interests are sold or exchanged within a 12-month period.

Partnership allocations. The provisions of the bill do not affect the flexibility afforded to large partnerships to allocate tax items to their partners in any manner that has substantial economic effect or otherwise meets the requirements of section 704 of the Code.

Definition of large partnership. Under the bill, a "large partnership" is any partnership that has 250 or more partners during a taxable year. Any partnership treated as a large partnership for a taxable year would be so treated for all succeeding years, even if the number of partners falls below 250. The Secretary would be given authority to adopt regulations that would provide, however, that if the number of persons who are partners in any taxable year falls below 100, the partnership would cease to be treated as a large partnership. A partnership with at least 100 partners could elect under the bill to be treated as a large partnership. The election would apply to the year for which made and all subsequent years and could not be revoked without the Secretary's consent.

A large partnership would not include any partnership if substantially all of its activities involve the performance of personal services by individuals owning, directly or indirectly, interests in the partnership, or if 50 percent or more of the value of the partnership's assets consists of oil or gas properties as described below.

Treatment of excluded partners. In general, the large partnership rules would not apply to an excluded partner's distributive share of partnership items. An excluded partner is a partner (1) owning more than a 5 percent partnership profits or capital interest at any time during the taxable year, or (2) materially participating in the partnership's activities during the year and holding any interest which is not a limited partnership interest. Any partner treated as an excluded partner for a taxable year is so treated for all succeeding years. In determining whether a partner is an excluded partner, the treatment on the large partnership's tax return binds the partnership and the partner, but not the Secretary.

Treatment of partnerships holding oil or gas properties. Because of the rules relating to the percentage depletion deduction, the current treatment of oil and gas income of a partnership is difficult to approximate under the simplified

reporting provisions of the bill. Therefore, the large partnership rules do not apply to a partnership if at least 50 percent of the value of its assets consist of oil or gas properties at any time during the taxable year. In addition, the rules do not apply to any item attributable to any partnership oil or gas property. However, an oil or gas partnership can elect to be treated as a large partnership. Further, partnerships owning oil or gas properties but which otherwise qualify as large partnerships (i.e., because less than 50 percent of their assets consist of oil or gas properties) can elect to apply the large partnership rules to items attributable to their oil or gas properties. If an election is made: (1) depletion is computed without regard to percentage depletion, (2) any partner who is an integrated oil company is treated as an excluded partner, and (3) any partner who holds a working interest in an oil or gas property (either directly or through an entity which does not limit the partner's liability) is treated as an excluded partner with respect to such interest. The election applies to the year for which made and all subsequent years and cannot be revoked without the Secretary's consent.

Regulatory authority. The Secretary of the Treasury is granted authority to prescribe such regulations as may be appropriate to carry out the purposes of the provisions.

Administration position. The Administration supports the bill's provisions modifying and simplifying the income reporting system for large partnerships. If the bill's simplified reporting regime is enacted, partners would receive a Form 1099-K that is much simpler and less intimidating than the present Schedule K-1. See Exhibit 1 attached. We anticipate that the IRS would require large partnerships to use a standard version of Form 1099-K. The ultimate result should be better compliance and lower costs to taxpayers. In addition, the new system would facilitate IRS matching of the information reported by a large partnership to its partners' returns. The ability to match information would be improved because (1) in most cases the number of items reported to each partner would be reduced, (2) each partner would be required to report each partnership item consistently with the partnership return, and (3) the bill would provide authority to the IRS to require each large partnership to provide Form 1099-K data to the IRS by magnetic media (see discussion below). With improved ability to monitor compliance, we believe the administration of large partnerships would be more efficient and fair. In addition, the adoption of the deferred sale rule for contributions of property and the elimination of the constructive termination rule will improve the tax rules applicable to large partnerships.

2. Large Partnership Audit System (Section 202)

Current law. Large partnerships currently are subject to the unified audit and litigation rules of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The TEFRA rules are generally applicable to partnerships with more than 10 partners. Prior to TEFRA, regardless of the size of the partnership, adjustments to a partnership's items of income, gain, loss, deduction, or credit had to be made in a separate proceeding for each partner. When a partnership had partners located in different audit districts, actions against the partners of the partnership would frequently be brought in several different jurisdictions and sometimes would result in conflicting outcomes. The TEFRA audit rules were enacted to facilitate uniform results in audits of partnerships.

Under the TEFRA rules, a partner must report all partnership items consistently with the partnership return or must notify the IRS of an inconsistency. If a partner fails to report any partnership item consistently with the partnership return without notifying the IRS, the IRS may make a computational adjustment and immediately assess any additional tax that results.

The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. But the IRS must still assess any resulting deficiency against each of the taxpayers who were partners in the year in which the understatement of tax liability arose.

Any partner of a partnership can request an administrative adjustment or a refund for his own separate tax liability. Any partner also has the right to participate in partnership-level administrative proceedings. As a general matter, there is no effective partnership level settlement process because each partner has the ability to enter into a separate settlement agreement.

The TEFRA rules establish the tax matters partner (TMP) as the primary representative of a partnership in dealing with the IRS. The TMP is a general partner designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year. If no TMP is designated, and it is impractical to apply the largest profits interest rule, the IRS may select any partner as the TMP.

The IRS generally is required to give notice of the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to all partners whose names and addresses are furnished to the IRS. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to partners whose profits interests are less than 1 percent.

After the IRS makes an administrative adjustment, the TMP (and, in limited circumstances, certain other partners) may file a petition for readjustment of partnership items in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court.

The IRS generally cannot adjust a partnership item for a partnership taxable year if more than 3 years have elapsed since the later of the filing of the partnership return or the last day for the filing of the partnership return.

Proposal. The bill would enact a new audit system for large partnerships. The bill defines "large partnership" the same way for audit as for reporting purposes (generally partnerships with at least 250 partners) except that large oil and gas partnerships which are excepted from the proposed reporting requirements are nonetheless subject to the proposed audit system.

A partnership adjustment generally would flow through to the partners for the year in which the adjustment takes effect. Thus, an adjustment that takes effect in a taxable year would be reflected in the distributive shares of partnership items of income, gain, loss, deduction, or credit allocated to the partners for that year. The adjustments generally would not affect prior year returns of any partners (except in the case of adjustments under section 704 of the Code with respect to partners' distributive shares). An adjustment will be offset by any related adjustment in a later year.

In lieu of flowing an adjustment through to its partners, the partnership may elect to pay an imputed underpayment. The imputed underpayment generally is calculated by netting the adjustments to the income and loss items of the partnership and multiplying the net amount by the highest individual or corporate tax rate. A partner may not file a claim for credit or refund of his allocable share of payment.

Under the bill, the partnership, rather than the partners individually, is liable for any interest and penalties that result from a partnership adjustment. Interest is computed for the period beginning on the return due date for the adjusted year and ending on the earlier of the return due date for the partnership taxable year in which the adjustment takes effect or the date the partnership pays the imputed underpayment. Penalties (such as accuracy-related and fraud) are determined on a year-by-year basis (without offsets) based on an imputed underpayment. All accuracy-related penalty and waiver criteria (such as reasonable cause, substantial authority, etc.) are determined as if the partnership were a taxable individual. Accuracy-related and fraud penalties are assessed and accrue interest in the same manner as if asserted against a taxable individual.

If a partnership ceases to exist before a partnership adjustment takes effect, the former partners are required to take the adjustment into account, as provided by regulations. Regulations are also authorized to the extent necessary to prevent abuse and to enforce the audit rules in circumstances that present special enforcement considerations. These situations would include partnership bankruptcy or a transfer of a partner's interest before an expected adjustment takes effect in order to avoid or reduce the tax liability that would result from the adjustment.

A partner is not permitted to report any partnership items inconsistently with the partnership return, even if the partner notifies the IRS of the inconsistency. The IRS could treat a partnership item that was reported inconsistently by a partner as a mathematical or clerical error and immediately assess any additional tax against that partner.

As under current law, the IRS could challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Unlike current law, however, partners will have no right individually to participate in settlement conferences or court proceedings or to request a refund. The bill requires each large partnership to designate a partner or other person to act on its behalf. If a large partnership fails to designate such a person, the IRS is permitted to designate any one of the partners as the person authorized to act on the partnership's behalf. Under the bill, a large partnership would be permitted to designate a replacement for the person so designated by the IRS.

Unlike current law, the IRS is not required to give notice to individual partners of the commencement of an administrative proceeding or of a final adjustment. Instead, the IRS is authorized to send notice of a partnership adjustment to the partnership itself by certified or registered mail. The IRS could give proper notice by mailing the notice to the last known address of the partnership, even if the partnership had terminated its existence. As under current law, an administrative adjustment could be challenged in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court. However, only the partnership, and not the partners individually, can petition for a readjustment of partnership items.

Absent an agreement to extend the statute of limitations, the IRS generally cannot adjust a partnership item of a large partnership more than 3 years after the later of the filing of the partnership return or the last day for the filing of the partnership return. Special rules apply to false or fraudulent returns, a substantial omission of income, or the failure to file a return. The IRS would assess and collect any deficiency of a partner that arises from any adjustment to a partnership item subject to the limitations period on assessments and collection applicable to the year the adjustment takes effect.

Administration position. The Administration supports the simplified audit system for large partnerships proposed by S. 1394 because the system would provide a more efficient system to assess and collect tax deficiencies attributable to large partnerships and their partners. While we believe that the TEFRA rules continue to be appropriate for small and medium size partnerships, the emergence of large partnerships has strained the ability of the IRS to maintain a meaningful audit presence in this area. Consequently, a revised system designed for large partnerships is appropriate.

3. Magnetic Media Reporting (Section 203)

Current law. Under section 6011(e), the IRS has authority to require the filing of tax information in magnetic media or other machine-readable format, but only if the person files at least 250 "returns" during the year. Schedules K-1 are not returns, and accordingly the IRS may not require the use of magnetic media filing by large partnerships.

Proposal. Amend section 6011(e) to give the IRS authority to require filing in magnetic media or other machine-readable format for all partnerships with at least 250 partners.

Administration position. The Administration supports this provision. The IRS should have the authority to require magnetic media filing by partnerships with many partners. Other filers of large numbers of information returns are already required to file in this manner.

4. Effective Date (Section 204)

Proposal. The changes proposed in section 201-203 of S. 1394 with respect to large partnership reporting, large partnership audit procedures, and magnetic media reporting are proposed to be effective for partnership years ending on or after December 31, 1992.

Administration position. Given the significant changes proposed for large partnerships, sufficient lead time must be provided after enactment for the IRS and large partnerships to implement the legislation. We believe the effective date proposed will be sufficient if the proposals are enacted this year.

B. Partnership Proceedings Under TEFRA

As discussed above, TEFRA created unified audit and litigation procedures that are applicable to most partnerships. The TEFRA partnership provisions represented a significant positive change in the way that audits and litigation relating to partnerships and their partners were conducted. Thus, we are in favor of retaining these provisions with respect to partnerships that are not large partnerships under the bill and would

otherwise fall within the scope of the TEFRA rules. Based upon the experience of the IRS in administering the TEFRA partnership provisions, however, we recognize that certain changes should be made to clarify and improve the procedures. Thus, with one exception relating to effective dates described below, the Administration supports the technical corrections and other simplifying amendments to the TEFRA partnership provisions that are contained in the bill. We believe that these changes will improve the operation and administrability of the TEFRA partnership provisions, which will benefit the partners in the partnerships as well as the IRS.

This section of the Appendix provides specific comments on the various amendments to the TEFRA partnership provisions that are contained in the bill. For the sake of convenience, some of the proposals have been grouped together and will be discussed under a common heading. Consequently, the proposals will not necessarily be addressed in the order that they appear in the bill.

1. Treatment of Partnership Items in Deficiency Proceedings (Section 211)

Current law. Adjustments to TEFRA partnership items must be made in a proceeding separate from a proceeding to adjust a taxpayer's nonpartnership items. While the two types of proceedings are separate, the result in one will affect the result in the other. Prior to the Tax Court's opinion in Munro v. Commissioner, 92 T.C. 71 (1989), it was IRS practice to compute deficiencies by assuming that all TEFRA items were correctly reported on the taxpayer's return. This practice proved unsatisfactory in situations where the taxpayer is oversheltered, i.e., where the losses claimed from TEFRA partnerships are so large that they offset any proposed adjustments to nonpartnership items, because no deficiency could arise from a non-TEFRA proceeding. Hence, when faced with this situation in Munro, the IRS issued a notice of deficiency to the taxpayer that presumptively disallowed the taxpayer's TEFRA partnership losses for computational purposes only. The Tax Court in Munro disapproved of the methodology used by the IRS to compute the deficiency and held that partnership items included on a taxpayer's return must be completely ignored in determining whether a deficiency exists that is attributable to nonpartnership items.

The opinion in Munro creates problems for both the IRS and taxpayers. In most of the cases that are either in litigation or under audit, net losses from TEFRA partnerships are claimed and used to partially offset income from non-TEFRA sources. Since under normal circumstances the TEFRA proceeding progresses more slowly than the deficiency proceeding, computing the deficiency under Munro will result in a greater deficiency being asserted in the deficiency proceeding than would have been asserted under IRS practice prior to the Munro opinion. Furthermore, while the methodology for computing deficiencies prescribed by Munro may solve the problem presented by the oversheltered situation, it creates a similar problem for the IRS in cases where a taxpayer's income is primarily from a TEFRA partnership and the IRS seeks to adjust nonpartnership items such as medical expense deductions, home mortgage interest deductions or charitable contribution deductions. Since under Munro the income would have to be ignored for purposes of the non-TEFRA proceeding, there would be no deficiency.

Proposal. The bill overrules the Munro case and provides a rule to allow the IRS to return to its prior practice of

computing deficiencies by assuming that all TEFRA items whose treatment has not been finally determined were correctly reported on the taxpayer's return.

With respect to Munro-type cases, the bill provides a declaratory judgment procedure in the Tax Court for adjustments to an oversheltered return. An oversheltered return is a return that shows no taxable income and a net loss from TEFRA partnerships. In such a case, the IRS is authorized to issue a notice of adjustment with respect to non-TEFRA items, notwithstanding that no deficiency would result from the adjustments. However, the IRS may only issue such a notice if a deficiency would have arisen in the absence of the net loss from TEFRA partnerships.

The Tax Court is granted jurisdiction to determine the correctness of such an adjustment. Although no tax would be due upon such a determination, a decision of the Tax Court would be treated as a final decision, which would afford both the taxpayer and the IRS the right to pursue an appeal.

Administration position. We support this proposal. The approach required by the Tax Court in Munro causes problems for the IRS as well as taxpayers and is unworkable as a practical matter. The computations required by the Munro opinion are an administrative burden for the IRS because they are more complex and time consuming than normal deficiency computations. In addition, the effect of Munro in a typical case may be to deprive the taxpayer of a prepayment forum. As a policy matter, this result is an inappropriate and unintended consequence of an opinion dealing with a relatively unusual fact pattern. Overruling Munro and providing a declaratory judgment procedure constitute an appropriate solution.

2. Partnership Return to be Determinative of Audit Procedures (Section 212)

See discussion under Boundary Issues below.

3. Statute of Limitations (Section 213)

Current law.

(a) Untimely petition. Section 6229(d) provides in pertinent part that the running of the statute of limitations shall be suspended for the period during which an action may be brought under section 6226 and, if an action is brought during such period, until the decision of the court becomes final, and for 1 year thereafter. In a deficiency case, on the other hand, section 6503(a) provides in pertinent part that if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, the period of limitations on assessment and collection shall be suspended until the decision of the Tax Court becomes final, and for 60 days thereafter. As a result of this difference in language, the running of the statute of limitations in a TEFRA case will only be tolled by the filing of a timely petition,whereas in a deficiency case the statute of limitations is tolled by the filing of any petition, regardless of whether the petition is timely. Consequently, if an untimely petition is filed in a TEFRA case, the statute of limitations can expire while the case is still pending before the court.

(b) Bankruptcy. A partner's partnership items convert to nonpartnership items upon the filing of a petition naming the partner as a debtor in a bankruptcy proceeding. Section 6229(f) provides that the period for assessing tax with respect to items

that convert to nonpartnership items shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6503(h) provides for the suspension of the limitations period during the pendency of a bankruptcy proceeding. However, this provision only applies to the limitations period provided in sections 6501 and 6502. Since the limitations period pertaining to converted items is governed by section 6229(f), there is some uncertainty concerning whether the suspension of the limitations period provided by section 6503(h) applies with respect to partnership items that convert to nonpartnership items by reason of the filing of a petition naming the partner as a debtor in a bankruptcy proceeding. As a result, the limitations period may continue to run during the pendency of the bankruptcy proceeding, even though the IRS is prohibited from making an assessment against the debtor because of the automatic stay imposed by section 362(a) of the Bankruptcy Code.

Likewise, if the IRS is unaware that the TMP has gone into bankruptcy, the IRS may mistakenly accept and rely on a consent to extend the statute of limitations on behalf of all partners in the partnership that was executed by the bankrupt TMP, which may be determined to be invalid because the debtor's status as TMP was automatically terminated by the filing of the bankruptcy petition. Hence, the IRS may be precluded from assessing any tax attributable to partnership item adjustments with respect to any of the partners in the partnership because of its detrimental reliance on a facially valid statute extension that subsequently proved to be invalid.

Proposal. With respect to untimely petitions, the bill amends section 6229(d) to make the language more consistent with section 6503(a). As a result, the TEFRA statute of limitations will be suspended by the filing of any petition, regardless of whether it is timely, as is the case with respect to the deficiency procedures.

With respect to the bankruptcy of a partner, the bill adds a provision similar to section 6503(h) to clarify that the statute of limitations is suspended during the pendency of a bankruptcy proceeding involving a partner in a TEFRA partnership.

Administration position. We support both of these proposals, subject to one reservation. As drafted, the provisions are retroactive to 1982. As a general rule, we do not favor retroactive legislation. Thus, we believe that the bankruptcy suspension provision should be effective for bankruptcy petitions filed after the date of enactment. However, it should be emphasized that this provision merely clarifies existing law and that no inference should be drawn from the prospective effective date regarding the applicability of the existing bankruptcy suspension provision to TEFRA cases. The untimely petition provision should similarly be prospective.

The provision regarding the suspension of the statute of limitations upon the filing of an untimely petition is a correction that is needed to close a gap in the statute. Similarly, the provision regarding the suspension of the statute of limitations upon the filing of a petition naming a partner as a debtor in a bankruptcy proceeding provides a much needed clarification of a very important issue. The ambiguity under current law makes it difficult for the IRS to adjust partnership items that convert to nonpartnership items by reason of a partner going into bankruptcy. In addition, the uncertainty often compels the IRS to seek relief from the automatic stay from the bankruptcy court so that the IRS can make an assessment with respect to the converted items. This provision will obviate the need for such action.

In addition, we believe that the bill should contain a provision dealing with the bankrupt TMP problem described above. This is of major concern to the IRS. In light of the growing number of bankruptcy filings, it is feared that this problem will occur with increasing frequency. To alleviate this problem, we recommend that the bill be amended to provide that, unless the IRS is notified of a bankruptcy proceeding in accordance with regulations, the IRS can rely on a statute extension signed by a person who would be the TMP but for the fact that said person was in bankruptcy at the time that the person signed the agreement. Thus, this proposal would place the burden on the partnership or the debtor to notify the IRS of any bankruptcy proceeding that involves the TMP. Otherwise, notwithstanding any other law or rule of law, any statute extensions granted by the bankrupt TMP shall be binding on all of the partners in the partnership.

4. Boundary Issues (Sections 212 and 214)

Current law. As noted above, adjustments to TEFRA partnership items must be made in a proceeding that is separate from a normal deficiency proceeding. When the IRS commences an audit, it must determine which procedure to use. This determination can be very technical and difficult to make, and the consequences of an incorrect choice can be severe. If the IRS applies the wrong procedure, the statute of limitations applicable to the correct procedure may have expired by the time that the problem is discovered. The situations giving rise to this problem are generally described as presenting "boundary issues."

A boundary issue arises in the context of the small partnership exception contained in section 6231(a)(1)(B). Pursuant to that section, the partnership audit provisions do not apply to a partnership that has 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and each partner's share of each partnership item is the same as that partner's share of every other partnership item. Several pitfalls exist in applying this provision. Specifically, if an incorrect determination is made regarding whether there were ever more than 10 partners in the partnership at any one time during the year, or whether a person is a nonresident alien, or whether the same share rule is met during the year, the IRS may inadvertently apply the wrong procedures.

Proposal. The bill contains two provisions that are designed to alleviate boundary issue problems. Under the first provision, the IRS is permitted to rely on the partnership return to determine whether the TEFRA partnership procedures or the deficiency procedures should be followed. The second provision modifies the small partnership exception by eliminating the same share requirement and replacing the natural person requirement with a requirement that each partner must be an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner.

Administration position. Permitting the IRS to rely on the partnership's return to determine the proper procedure to apply should make it easier for the IRS to administer the tax laws by reducing the circumstances where the IRS must act at its peril in making what is often a difficult determination. A partnership should be permitted to have a C corporation as a partner or to specially allocate items without jeopardizing its qualification for the small partnership exception to the TEFRA rules. On the other hand, we believe that it is critical to retain the prohibition against a partnership having a flow-through entity such as another partnership, S corporation or trust as a partner for purposes of being excepted from the TEFRA procedures.

5. Partial Settlements (Section 215)

Current law. Section 6231(b)(1)(C) provides that the partnership items of a partner for a partnership taxable year shall become nonpartnership items as of the date the IRS enters into a settlement agreement with the partner with respect to such items. Under section 6229(f), the limitations period for assessing any tax attributable to converted items shall not expire before the date which is 1 year after the date on which the items become nonpartnership items. This rule creates a problem in situations where a settlement agreement is entered into with respect to some but not all of the issues in the case. The reason for this is that a 1 year assessment period will apply with respect to the settled items whereas the remaining items will be governed by the normal assessment period under section 6229(a). If issues are settled at several different stages of the proceeding, the problem can become severe.

Proposal. The bill provides that if a partner and the IRS enter into a settlement agreement with respect to some but not all of the partnership items in dispute for a partnership taxable year, the period for assessing any tax attributable to the settled items would be determined as if such agreement had not been entered into. Consequently, the limitations period that is applicable to the last item to be resolved for the partnership taxable year shall be controlling with respect to all disputed partnership items for the partnership taxable year.

Administration position. We support this provision. Under the bill, the limitations period that is applicable to the last item to be resolved for the partnership taxable year shall be controlling with respect to all disputed partnership items for the partnership taxable year. Thus, there will only be one statute of limitations to track and the IRS should only have to make one computation of tax with respect to each partner's investment in the partnership for the taxable year.

6. Administrative Adjustment Requests (Section 216)

Current law. Section 6227(a) provides that a partner may file a request for an administrative adjustment of partnership items within 3 years after the later of the date of the filing of the partnership return or the last day for filing the partnership return (determined without regard to extensions), but before the IRS mails a notice of final partnership administrative adjustment to the TMP. In contrast, section 6511(c), which applies with respect to a non-TEFRA case, provides that if an agreement is entered into under section 6501(c)(4) to extend the period for assessment, the period for filing a claim for credit or refund or for making a credit or refund if no claim is filed, shall not expire prior to 6 months after the expiration of the period within which an assessment may be made pursuant to the agreement under section 6501(c)(4). There is no comparable provision for extending the time for filing refund claims with respect to partnership items subject to the TEFRA partnership rules.

Proposal. The bill provides a rule for extending the time for filing refund claims with respect to partnership items subject to the TEFRA partnership provisions that is similar to the one in section 6511(c).

Administration position. We support this provision. The proposal is favorable to taxpayers and makes the TEFRA rules more consistent with the non-TEFRA rules. This should eliminate a

trap for the unwary who mistakenly believed that, if the TEFRA statute of limitations was extended, they had additional time to file a request for administrative adjustment.

7. Innocent Spouse (Section 217)

Current law. Under section 6013(e), an innocent spouse may be relieved of liability for tax, penalties and interest if certain conditions are met. However, it is unclear whether existing law provides the spouse of a partner in a TEFRA partnership with a judicial forum to raise the innocent spouse defense with respect to any tax or interest that relates to an investment in a TEFRA partnership.

Proposal. The bill provides both a prepayment forum and a refund forum for raising the innocent spouse defense in TEFRA cases.

Administration position. We support this provision. We believe that it is appropriate to allow innocent spouse relief in TEFRA cases if the person would otherwise qualify for such relief.

8. Determination of Penalties at the Partnership Level (Section 218)

Current law. Section 6231(a)(3) limits the definition of partnership items to those items required to be taken into account under any provision of subtitle A. Since penalties are contained in subtitle F, they cannot be partnership items. Instead, penalties are treated as affected items that require partner-level determinations. As a result, under section 6230(a)(2), penalties may only be asserted against a partner through the application of the deficiency procedures following the completion of the partnership-level proceeding.

Proposal. The bill provides that the applicability of penalties shall be determined as part of the partnership-level proceeding and that the deficiency procedures will not apply to such a determination. However, the bill allows partners to raise any partner-level defenses in a refund forum.

Administration position. We support this provision. Penalty-only cases have created a significant burden for the IRS and have the potential of significantly increasing the Tax Court's inventory. Moreover, the requirement of conducting a separate proceeding with each partner greatly increases the likelihood of disparate treatment. Hence, the major goals of the TEFRA partnership provisions -- administrative and judicial economy and consistent treatment of partners -- are frustrated by separate penalty proceedings. The IRS believes that determining partnership-item adjustments and the penalties that are attributable to those adjustments in a single proceeding should greatly simplify the audit and litigation procedures for TEFRA partnerships. In the vast majority of cases, this proposal will eliminate the need to conduct affected item proceedings.

9. Jurisdiction of the Courts (Section 219)

Current law.

(a) Tax Court jurisdiction to enjoin premature assessments. Section 6225(a) provides a restriction on assessment and collection of any tax attributable to any partnership item during the 150-day period within which a petition could be filed in response to the mailing of a notice of

final partnership administrative adjustment to the TMP by the IRS, and if a petition is filed in the Tax Court within the 150-day period, until the decision of the court becomes final. Section 6225(b) provides that, if any assessment or collection activity is taken in violation of the restriction described above, such premature action may be enjoined in the proper court. Current law is unclear regarding whether the Tax Court is a proper court for purposes of this section.

(b) Jurisdiction of courts to consider statute of limitations with respect to partners. Under sections 6226(c) and (d), in order for a partner other than the TMP to be eligible to file a petition for readjustment of partnership items or to participate in an existing proceeding, the period for assessing any tax attributable to the partnership items of that partner must not have expired. Since such a partner would only be treated as a party to the action if the statute of limitations with respect to that partner was still open, current law is unclear whether the partner would have standing to assert that the statute of limitations had expired with respect to themselves.

(c) Jurisdiction of Tax Court to determine overpayments attributable to affected items. Pursuant to sections 6511(g), 6512(a)(4), and 7422(h), the normal rules with respect to refunds in a non-TEFRA context do not apply with respect to overpayments attributable to partnership items. Instead, the rules set forth in sections 6227, 6228, and 6230(c) and (d) are controlling. Current law is ambiguous with respect to whether the rules that are applicable to overpayments attributable to partnership items also apply to overpayments attributable to affected items.

Proposal. The bill provides that the Tax Court has jurisdiction to enjoin premature assessment or collection activity but only in cases where it otherwise has jurisdiction over the partnership item adjustments giving rise to the tax liability at issue. The bill also clarifies that the Tax Court does have overpayment jurisdiction in an affected item proceeding. In addition, the bill permits a partner to be treated as a party to a partnership action solely for the purpose of litigating the statute of limitations question with respect to themselves and grants jurisdiction to the court that otherwise has jurisdiction over the action to consider the matter.

Administration position. We support these proposals. These proposals are all intended to clarify points that are unclear or ambiguous under current law and are akin to technical corrections.

10. Premature Petitions (Section 220)

Current law. Under section 6226(a), the TMP is given the exclusive right to file a petition for a readjustment of partnership items within the 90-day period after the issuance of a notice of final partnership administrative adjustment by the IRS. If the TMP does not file a petition within the 90-day period, section 6226(b) permits notice partners to file a petition within the succeeding 60-day period. Section 6226(b) also provides ordering rules for determining which action goes forward and provides for the dismissal of other actions if more than one petition is filed during the 60-day period.

If a petition is filed by a person other than the TMP during the 90-day period, that action is dismissed. Thus, if the TMP does not file a petition during the 90-day period and no timely and valid petition is filed during the succeeding 60-day period,

judicial review of the adjustments set forth in the notice of final partnership administrative adjustment is foreclosed and the adjustments are deemed to be correct.

Proposal. The bill provides that in cases where the TMP does not file a petition within the 90-day period, if a petition is filed by a notice partner within the 90-day period and no valid and timely petition is filed within the succeeding 60-day period, then the premature petition shall be treated as if it were filed on the last day of the 60-day period.

Administration position. We support this provision. Unlike the situation in a deficiency case, there is no opportunity to seek judicial review under the TEFRA partnership provisions at a later date if a premature petition is dismissed and no valid and timely petition is filed during the 90-day or 60-day periods. We believe that dismissal of the premature petition under these circumstances is too harsh a result, although the rule should not encourage the filing of premature petitions. We believe that a proper balance is struck by reinstating a premature petition where the action would otherwise be dismissed, and that a premature petition should be treated as if it were filed on the last day of the 60-day period so as to take away any incentive to file early in an attempt to gain priority under the ordering rules set forth in section 6226(b).

11. Appeal Bonds (Section 221)

Current law. Section 7485(b) provides for the filing of a bond to stay assessment and collection during the pendency of an appeal in a TEFRA case. The amount of the bond is to be fixed by the Tax Court based upon its estimate of the aggregate amount of the deficiencies attributable to the partnership items to which the decision that is the subject of the appeal relates.

Proposal. The bill clarifies that the amount of the bond should be based on the aggregate liability of the parties to the action rather than of all the partners in the partnership. In addition, the bill makes it clear that the amount of the bond is to be based upon an estimate rather than on a precise calculation.

Administration position. We support this proposal. Current law is unclear concerning how the amount of the bond should be fixed by the Tax Court. By emphasizing that the amount of the bond should be based on an estimate and clarifying whose liabilities are to be covered by the bond, the Tax Court's job with respect to fixing the amount of the bond should be simplified. In this regard, we strongly believe that the amount of the bond should cover the aggregate liability of the parties to the action as opposed to merely the liability of the person posting the bond. Allowing each partner to post a separate bond for their respective liability would create a significant administrative burden for the IRS.

12. Restricted Interest (Section 222)

Current law. Section 6601(c) provides that, where a taxpayer executes a waiver of the restrictions on assessment of a deficiency under section 6213(d) and notice and demand for payment of such deficiency is not made by the IRS within 30 days after the filing of the waiver, interest will be suspended from the period immediately after the 30th day until the date of the notice and demand. The restricted interest provision is generally not applicable to TEFRA cases.

Proposal. The bill makes the restricted interest provision applicable to computational adjustments resulting from settlement agreements relating to partnership items.

Administration position. Extending the benefits of section 6601(c) to TEFRA cases that have been settled will make the computation of interest in deficiency cases and TEFRA cases more uniform. In addition, the proposal will make it simpler for the IRS to do interest computations in such cases, which under current law must frequently be done manually since interest is suspended only with respect to some aspects of a TEFRA case but not other parts of the case. Under this proposal, the restricted interest provision will apply with respect to the entire case.

TITLE III. FOREIGN PROVISIONS

1. Deferral of Tax on Income Earned Through Foreign Corporations and Exceptions to Deferral (Sections 301-305)

Current law. Under current law, a U.S. investor in a foreign corporation that earns passive income is potentially subject to six separate and distinct regimes that are designed to prevent him from improperly deferring his U.S. tax on income that is likely to bear little or no foreign tax. One of these regimes -- the Passive Foreign Investment Company (PFIC) regime -- itself consists of three separate sets of rules, because of taxpayer elections available to alter the timing and method of tax. These regimes are not only numerous; they are also complex and redundant. They impose excessive burdens on both taxpayers and the government in determining the correct U.S. tax liability for foreign-earned passive income. Two of the regimes were designed primarily to attack non-business-related accumulations by domestic corporations; they impose a penalty tax at the corporate level. The other four regimes were targeted specifically at accumulations by foreign corporations and apply at the shareholder level. These various regimes were enacted over a period of 60 years and are not adequately coordinated.

Proposal. The bill would consolidate the anti-deferral rules applicable to foreign corporations earning substantial amounts of passive income.

Administration position. We support the proposal in the bill as a substantial simplification of the current statutory scheme. Under the bill, taxpayers will no longer have to contend with the overlap and inconsistencies among the multiple regimes. Instead, shareholders will be taxed under a single integrated regime which provides one of three methods of tax, depending on the extent of U.S. ownership of the foreign corporation and whether its stock is publicly traded.

The single regime applies to passive foreign corporations (PFCs). A PFC is defined in a way that eliminates overlap and potential inconsistencies between the current PFIC and foreign personal holding company regimes. All shareholders of U.S.-controlled PFCs, and large shareholders and electing small shareholders of foreign-controlled PFCs, will be taxed currently under the existing Subpart F rules. This will cover most if not all of U.S. corporate participation in multinational enterprises. Non-electing small shareholders of foreign-controlled PFCs will pay tax annually on a "mark-to-market" basis if their PFC stock is publicly traded, and will be taxed under rules similar to the so-called "interest charge" rules of the current PFIC regime if their PFC stock is not publicly traded.

This proposal has been criticized recently by some commentators as failing to provide adequate simplification. I believe that these criticisms are misguided to the extent that they are aimed at defeating the proposal altogether. The statutory rules that the proposal would replace are extremely complex. It is not likely that they could be replaced by a provision that is not also complex. The literature on the interaction of the different anti-deferral regimes under current law is replete with complaints about the confusing interaction between these different regimes. The proposal addresses many of these complaints.

This is not to say, however, that the proposal cannot be improved. Many of the comments address technical concerns which we will work with the Committee to resolve. Still other criticize the proposals because they do not effect a fundamental revision in underlying policies. We question whether the benefits of simplification should be rejected given the uncertainties and delays inevitable in a more fundamental reexamination.

2. Modifications to Provisions Affecting Controlled Foreign Corporations (Section 311-313)

Current law. A United States shareholder is taxed currently on its pro rata share of a controlled foreign corporation's (CFCs) Subpart F income and is allowed a corresponding increase in its basis in the CFCs stock. When the CFCs earnings attributable to such Subpart F inclusions are later distributed, the dividends are excluded from the shareholder's income to avoid double taxation of the previously taxed amounts. A shareholder receiving the distributions is permitted to make special adjustments to allow it to claim credits for foreign taxes paid with respect to the distribution. If the United States shareholder sells its stock in the CFC, all or a portion of the gain on the sale may be recharacterized as a dividend; to the extent so recharacterized, the foreign tax credit rules apply, in many respects, as if the shareholder had received an actual dividend from the CFC.

Proposal. The bill contains a number of amendments to the rules for taxing U.S. shareholders of CFCs. In general, these amendments are aimed at reducing the possibility of excessive taxation of foreign earnings. In one instance the amendments would repeal (subject to transition rules) a provision that imposes substantial recordkeeping requirements on foreign corporations and their shareholders while conferring what appears to be a relatively minor benefit.

Administration position. We support these proposals as further implementing the existing general policy under Subpart F that the income of a CFC, having once been taxed to its United States shareholders, should not be taxed again. We note that the proposals give discretion to the Secretary in certain cases to take administrative or other concerns into account in implementing the proposals through the issuance of regulations. Although the proposed repeal of section 960(a)(3) may increase the tax burden on certain income earned through a CFC, we believe that this increased burden is likely to be minor (especially in view of the transition rules) and is outweighed by the substantial reduction in complexity.

3. Translation of Foreign Taxes into U.S. Dollar Amounts (Section 321)

Current law. Section 986(a) requires foreign taxes, paid in a foreign currency, to be translated into U.S. dollars for purposes of claiming a foreign tax credit at the exchange rate on the date of tax payment. Many U.S. multinationals have complained that the "date of payment" rule imposes a significant administrative burden, without promoting any substantial U.S. tax policy interest. The burden arises from the taxpayer's need, in many cases, to determine the foreign exchange rate for a very large number of separate tax payments made in different currencies on different dates, and then maintain appropriate records for these payments and exchange rates.

Proposal. The bill would give the Secretary the authority to permit use of an average exchange rate for an appropriate period, determined by regulation, rather than the exchange rate on the specific payment date.

Administration position. We support the bill's solution to this problem. Use of an average rate may not always be appropriate -- for example, in hyperinflationary currencies. The bill will permit us to write regulations providing sensible answers to practical problems, without reopening the policy debate settled by the 1986 Tax Reform Act.

4. Foreign Tax Credit Limitation Under the Alternative Minimum Tax (Section 322)

Current law. A U.S. taxpayer claiming a foreign tax credit must compute its taxable income from foreign sources as well as its overall, or worldwide, taxable income. Moreover, this computation must be done for each of several foreign tax credit "baskets" of income. To compute its foreign source taxable income within each of these baskets, the taxpayer must allocate and apportion its expenses. This procedure is complex and time-consuming, but it is fundamental to the correct operation of the foreign tax credit rules. In addition to these computations, a taxpayer may also be required to compute its foreign tax credit for alternative minimum tax purposes. Since taxable income for AMT purposes is different from taxable income for regular tax purposes, this requires a recomputation of foreign source taxable income, and therefore a reallocation and apportionment of expenses, in each of the foreign tax credit baskets.

Proposal. The bill would simplify the AMT foreign tax credit computation by permitting the taxpayer to elect to use its regular, rather than its AMT, foreign source taxable income in each of the baskets.

Administration position. We support the proposal. In many cases we believe that there will not be significant differences between a taxpayer's regular versus its AMT foreign source taxable income in the different baskets. Where there may be significant differences, the taxpayer need not elect the new rule. In this regard, it is important to note that the election must be made once, for all future taxable years. This is an appropriate limitation: it will prevent taxpayers from engaging in costly and complex computations of both AMT and regular foreign source taxable income each year to determine whether the election, in that year, would be cost effective.

TITLE IV. OTHER INCOME TAX PROVISIONS

A. S Corporations

1. Determination of Whether an S Corporation Has One Class of Stock (Section 401)

Current law. A corporation is not a small business corporation, and therefore cannot elect S corporation status, if the corporation has more than one class of stock. Differences in voting rights are disregarded in determining if a corporation has more than one class of stock and debt instruments meeting the requirements of a safe harbor are not treated as a second class of stock. The Code and legislative history do not provide any other guidance as to what may or may not constitute a second class of stock.

Proposal. A corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. The determination of whether the outstanding shares of a corporation confer identical rights is made taking into account rights arising under the corporate charter, activities of incorporation or by-laws, legal requirements, administrative actions, and any agreements that are legally enforceable under state law. The provision does not limit IRS ability to properly characterize S corporation transactions for Federal income tax purposes.

Administration position. The Administration supports this provision. The provision clarifies the intended scope of the one class of stock requirement. New proposed regulations consistent with this provision have recently been issued.

2. Authority to Validate Certain Invalid Elections (Section 402)

Current law. S corporation status is not automatic for qualifying corporations. All of the shareholders of a small business corporation must consent to the election of the corporation to be an S corporation. The election may be made by a small business corporation for any tax year at any time during the preceding tax year or at any time on or before the 15th day of the third month of the current tax year. Any late election made after the 15th day of the third month is treated as an election for the following tax year. Moreover, where an election timely made during the current tax year is invalid for that year because one or more of the shareholders failed to consent to the election, or because the corporation had too many shareholders, an ineligible shareholder, or more than one class of stock, the election will be treated as having been made for the following tax year if the impediment is removed.

Proposal. The IRS would be given authority to waive the effect of an invalid election caused by the inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents. The IRS would also be authorized to validate an untimely election where the untimeliness is due to reasonable cause.

Administration position. The Administration supports this provision. It would allow the IRS to provide an administrative remedy for untimely or invalid elections in appropriate circumstances.

3. Treatment of Distributions by S Corporations During Loss Year (Section 403)

Current law. The total amount of a shareholder's portion of the losses and deductions of an S corporation may be taken into account by the shareholder only to the extent that the total does not exceed the basis of his stock and the basis of indebtedness owed to the shareholder by the corporation. Any loss or deduction that is disallowed may be carried over indefinitely.

Distributions by an S corporation generally are treated as a nontaxable return of capital to the extent of a shareholder's basis in his or her stock. The shareholder's stock basis is reduced, but not below zero, by the tax-free amount of the distribution. Any distribution in excess of the shareholder's basis is treated as a capital gain.

The basis of each shareholder's stock in an S corporation is increased by his or her pro rata share of certain items of income and decreased by his or her pro rata share of certain items of loss and deduction. Current law is unclear as to whether adjustments to basis for income, loss and deduction items must take place before or after adjustments for distributions. If the loss and deduction items reduce basis more than the income items increase basis, making such adjustments to basis before adjustments to basis are made for distributions would reduce the amount of the distributions that would be a tax-free return of capital. Such a result would be inconsistent with the partnership rules which provide that for any taxable year a partner's basis is first increased by items of income, then decreased by distributions, and finally decreased by losses.

A similar characterization problem arises with respect to distributions by S corporations with accumulated earnings and profits. Distributions by such corporations are treated: (1) as a nontaxable return of capital to the extent of the corporation's "accumulated adjustments account" (essentially the aggregate taxable income of the corporation for all years beginning after 1982 to the extent that such taxable income has not been distributed to shareholders), (2) as a dividend to the extent of the S corporation's accumulated earnings and profits, (3) as a nontaxable return of capital to the extent of the remaining basis of the shareholder's stock, and (4) as capital gain. For purposes of determining the effect of a distribution for any taxable year, adjustments reflecting the corporation's items of income, loss and expenses are made to the accumulated adjustments account in a manner similar to the adjustments required to be made to the shareholders' stock basis.

Proposal. The proposal would clarify that adjustments to basis for distributions during a year are made before adjustments to basis for items of loss. Accordingly, the extent to which losses may be taken into account for a taxable year would be determined after the tax status of distributions has been determined.

In addition, if for any year an S corporation's items of loss and expense exceed its items of income, the adjustments that would otherwise be made to the accumulated adjustments account are disregarded in determining the effect of distributions made during the taxable year. This rule affects only distributions made by S corporations with accumulated earnings and profits.

Administration position. The Administration supports this provision. It would harmonize the basis adjustment provisions relating to partnership interests and S corporation stock and would provide a measure of certainty to shareholders of S corporations regarding the tax treatment of distributions made during loss years.

4. Treatment of S Corporations as Shareholders in C Corporations (Section 404(a))

Current law. An S corporation in its capacity as the shareholder of a C corporation is treated as an individual for purposes of subchapter C. In a private letter ruling, the IRS has interpreted this rule as preventing the tax free liquidation under section 332 and 337 of a C corporation subsidiary into an S corporation because a C corporation cannot liquidate tax-free when owned by an individual shareholder. However, the result desired by the taxpayer can be achieved on a tax-free basis by either having the S corporation purchase the C corporation and having the C corporation merge into the S corporation after the purchase or by having the S corporation lend money to its shareholders to purchase the C corporation who would then merge the C corporation into the S corporation.

Proposal. The bill would repeal the rule that treats an S corporation in its capacity as a shareholder of a C corporation as an individual.

Administration position. The Administration supports this provision. It would remove a trap for the unwary by treating the liquidation of a C corporation into an S corporation in the same manner as the merger of a C corporation into an S corporation or a conversion from C to S status. As is currently the case when a C corporation merges into an S corporation, the built-in gains of the liquidating C corporation would be subject to the built-in gains tax provisions of section 1374.

5. S Corporations Permitted to Hold Subsidiaries (Section 404(b))

Current law. Under current law, an S corporation may not be a member of an affiliated group of corporations. This limitation prevents an S corporation from owning stock in another corporation that possesses 80 percent or more of both the total voting power and value of the outstanding stock of the corporation.

Proposal. An S corporation would be allowed to own any amount, based on voting, value, or both, of the stock of a C corporation. In order to avoid the complexity of the consolidated return regulations, the S corporation parent would not be permitted to file a consolidated return with its subsidiaries.

Administration position. The Administration supports this provision if an acceptable revenue offset is provided. The current law restriction has caused many corporations either knowingly or inadvertently to terminate their S status or to adopt complex corporate structures to circumvent the restriction. The proposal achieves the desired objective of current law by directly preventing S corporations from filing consolidated returns.

6. Elimination of Pre-1983 Earnings and Profits of S Corporations (Section 404(c))

Current law. Prior to 1983, a corporation electing subchapter S status for a taxable year increased its accumulated earnings and profits to the extent that its undistributed earnings and profits for the year exceeded its taxable income. As a result of changes made in 1982 by the Subchapter S Revision Act, S corporations do not have earnings and profits for any year beginning after 1982. Under current law, a shareholder is

required to include in income the pre-1983 accumulated S corporation earnings and profits when it is distributed by the corporation.

Proposal. If a corporation is an S corporation for its first taxable year beginning after December 31, 1991, the accumulated earnings and profits of the corporation (if any) as of the beginning of that year will be reduced by the accumulated earnings and profits that were accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Thus, any remaining earnings and profits of such a corporation would be solely attributable to taxable years for which an S election was not in effect.

Administration position. The Administration does not oppose this provision. We understand that the amounts being eliminated from earnings and profits are generally very small and do not justify the recordkeeping burden they create.

7. Determination of Shareholder's Pro Rata Share Where Disposition of Entire Interest (Section 404(d))

Current law. In general, the tax items passed through an S corporation to its shareholders are allocated among the shareholders on a per day, per share basis. If a shareholder terminates his or her interest in the corporation, the S corporation, with the consent of all persons who were shareholders at any time during the taxable year, may elect, for purposes of allocating tax items, to close the books of the corporation on the date of the termination of the shareholder's interest in the corporation.

Proposal. The bill would mandate that an S corporation close its books for purposes of allocating items of income on the termination of a shareholder's interest.

Administration position. The Administration supports this provision. It would assure a shareholder terminating his interest in an S corporation that his share of the corporation's income will not be affected by events occurring after the termination of his interest in the corporation.

8. Treatment of Items of Income in Respect of a Decedent Held By an S Corporation (Section 404(e))

Current law. Income items that would have been receivable by the decedent had he lived, and that are receivable by his estate or beneficiaries, are taxed to the estate or beneficiaries when received and retain the same character they would have had in the hands of the decedent. Such income is referred to as income in respect of a decedent (IRD).

Property which may produce IRD is not entitled to a basis step-up. IRD generated with respect to such property is not subject to income tax when received by the decedent's estate or beneficiaries. Under the partnership regulations, a partnership interest acquired from a decedent does not receive a basis step-up to the extent the fair market value of the interest reflects items of IRD. Thus, the IRD rules cannot be circumvented by contributing an IRD item to a partnership before death and receiving a full fair market value step-up for the partnership interest on the partner's death. There is no parallel provision for S corporation stock, however.

Proposal. The basis step-up at death for S corporation stock would be denied to the extent the fair market value of the stock represents IRD.

Administration position. The Administration supports this provision. It would prevent potential avoidance of the IRD rules by dropping items of IRD (*e.g.*, an installment note) into an S corporation prior to death. The provision would be parallel to the existing rule for determining the basis of a decedent's partnership interest.

B. Accounting Provisions

1. *Look-Back Method For Long-Term Contracts* (Section 411)

Current law. Income from long-term contracts generally must be reported under the percentage of completion method of accounting (PCM). Under PCM, expected contract profit is recognized ratably, as costs are incurred, over the term of the contract. PCM includes look-back rules intended to compensate for deferral or acceleration of contract income resulting from use of expected (rather than actual) contract profit. Under the look-back rules, if actual contract profit is greater or less than expected profit, the taxpayer must pay, or is entitled to receive, interest. Look-back interest is computed when a contract is completed based on differences between expected and actual contract profits in each taxable year of the contract. It must be recomputed if contract profit changes because additional contract revenues or costs are taken into account after completion. Taxpayers are allowed (but not required) to discount post-completion adjustments to contract revenues and costs back to their value as of contract completion.

The rate used in computing look-back interest is the section 6621 overpayment rate. This overpayment rate equals the applicable Federal short-term rate plus 2 percentage points. The applicable Federal short-term rate is adjusted quarterly by the IRS. For any year of the contract, look-back interest runs from the due date of the return for that year without extensions (March 15 in the case of a calendar year corporate taxpayer) until the due date of the return for the year that the look-back is applied. Thus, to compute look-back interest for a particular year of the contract, a taxpayer is required to use 5 different interest rates for each 12-month period ending after the due date of the return for that year up through the return due date for the year that the look-back method is applied.

Proposal. The bill contains three proposals for simplifying the look-back method. The first two proposals would permit taxpayers to make a combined election under which they are not required to compute look-back interest for a contract, or to recompute look-back interest based on adjustments to contract price and costs, in certain de minimis cases. The third proposal would reduce the number of different interest rates that must be used to compute look-back interest.

If a taxpayer makes the election, the first proposal would provide that look-back interest is not computed for a long-term contract if the amount of deferral or acceleration of income from using estimates is not substantial. Thus, look-back interest is not computed if, for each year of the contract prior to the year of completion, the cumulative taxable income (or loss) from the contract as of the end of that year, determined using estimated contract price and costs, is within 10 percent of the cumulative taxable income (or loss) as of the end of that year using actual contract price and costs.

In addition, if a taxpayer makes the election, the second proposal would provide that look-back interest is not recomputed as a result of an adjustment to contract price or costs in a year after contract completion if the adjustment is not substantial. Thus, look-back interest is not recomputed because of an adjustment in a year after completion if the cumulative taxable income (or loss) from the contract as of the end of that year is within 10 percent of the cumulative taxable income (or loss) from the contract as of the most recent year in which the taxpayer was required to compute or recompute look-back interest (or would have been required to do so if the de minimis test provided by the first proposal had not been met).

The third proposal would generally fix the rate for calculating look-back interest for a 12-month period beginning on the due date of the taxpayer's return at the section 6621 rate for the calendar quarter that includes that date. Thus, in computing look-back interest for a particular contract year, the taxpayer would be required to use only one interest rate (rather than 5 different rates) for each 12-month period ending after the return due date for that year up through the return due date for the year that the look-back method is applied (determined without regard to extensions).

All three proposals apply to contracts completed in taxable years ending after the date of enactment.

Administration position. We support these proposals if an acceptable revenue offset is provided. Each responds to specific taxpayer concerns about the administrative burdens imposed upon taxpayers under current law. As we stated on other occasions we do not oppose de minimis rules similar to those that would be provided by the first two proposals. We believe that all three of these proposals would reduce the administrative burden imposed by the look-back method without undermining its purpose.

2. Uniform Cost Capitalization Rules (Section 412)

Current law. Generally, the uniform capitalization rules require taxpayers producing real or tangible property or acquiring property for resale to include in inventory the direct costs of the property and the indirect costs that are allocable to the property. Taxpayers are permitted to use various reasonable methods to determine the indirect costs that are allocable to production or resale activities, including certain simplified allocation methods provided in Treasury regulations.

Proposal. The proposal would authorize (but not require) Treasury to issue regulations providing for a simplified method for determining what part of the costs of administrative, service, or support functions or departments must be capitalized as part of the cost of property that a taxpayer produces or sells. The regulations, if issued, would permit allocation of these costs to production or resale activities by multiplying the total costs of any such function or department for the current taxable year by an historical ratio. The ratio would be the ratio of the total of such function or department's allocable costs that were allocable to property produced or acquired for sale during a "base period" to the function or department's total costs during the base period. The explanation prepared to accompany the proposal states that regulations, if issued, would provide that the base period could begin no earlier than 4 taxable years prior to the taxable year for which the simplified method is used. Although the proposal would be effective for taxable years beginning after the date of enactment, taxpayers could not use the simplified method for any taxable year beginning before Treasury publishes regulations.

Administration position. We do not oppose the proposal because it authorizes rather than requires such regulations. The Administration supports the goal of making compliance with the uniform capitalization rules less burdensome for taxpayers. However, we are not certain that we can devise rules which will adequately protect the fisc from loss due to distortion of income while meaningfully simplifying taxpayers' administrative burdens. We would not expect to propose regulations under this authority unless we were convinced, after appropriate investigation, that the regulations could meet a revenue neutrality constraint.

C. Minimum Tax Provisions

1. Corporate Minimum Tax Depreciation Preference (Section 421)

Current law. In computing the AMT depreciation deduction for personal property, taxpayers are generally required to use the 150 percent declining balance depreciation method over the ADR life of the property set forth in section 168(g). In computing adjusted current earnings (ACE), corporate taxpayers are generally required to compute the ACE depreciation deduction using the straight-line method over the ADR life.

Proposal. Under the proposal, corporate taxpayers generally would be required to use the 120 percent declining balance depreciation method in computing both AMT and ACE depreciation deductions for personal property placed in service in taxable years beginning after December 31, 1990 (using the same ADR recovery periods generally used for both AMT and ACE purposes under current law). The proposal would also permit corporate taxpayers to elect to calculate regular tax depreciation deductions using the same 120 percent declining balance method and recovery periods used in computing AMT and ACE depreciation deductions.

Administration position. We support the proposal provided an acceptable revenue offset is provided. We believe the proposal significantly simplifies the corporate AMT computation. Although the proposal loses revenue, there are some isolated instances in which taxpayers would be disadvantaged by the proposal (e.g., taxpayers with both current and cumulative negative ACE adjustments).

2. Treatment of Built-in Losses for Purposes of the Corporate Alternative Minimum Tax (Section 422)

Current law. For ACE purposes, if a corporation with a net unrealized built-in loss undergoes an ownership change, the adjusted basis of each asset must be restated to its fair market value immediately before the ownership change. This adjustment results in a permanent loss of asset basis for ACE purposes and creates an added complexity for certain taxpayers in computing AMT liabilities.

Proposal. The proposal would repeal the ACE asset basis restatement rule.

Administration position. We support the proposal provided an acceptable revenue offset is provided. Under current law, section 382 limitations apply to net operating losses and net unrealized built-in losses under both the regular tax and AMT systems. However, the ACE asset basis restatement rule results in needless complexity and inconsistency by departing from the general section 382 limitations which apply for regular tax and

AMT purposes. The proposal would significantly reduce the recordkeeping requirements for affected taxpayers and provide for consistent application of the section 382 limitations to net unrealized built-in losses under each of the separate regular tax, AMT, and ACE systems.

D. Tax-Exempt Bond Provisions

1. Repeal of $100,000 Limitation on Unspent Proceeds Under 1-year Exception from Rebate (Section 431)

Current law. A tax-exempt bond is not subject to the arbitrage rebate requirement if all of the proceeds of the issue (other than proceeds in a reasonably required reserve and replacement fund and in a bona fide debt service fund) are spent for the governmental purpose of the issue within 6 months of the date of issue of the bond. In the case of non-private activity bonds and qualified 501(c)(3) bonds, the 6-month period is extended to 12 months if no more than the lesser of 5 percent of the proceeds of the issue or $100,000 is unspent after the first 6 months and such unspent amount is spent within the next 6 months.

Proposal. The condition that no more than the lesser of 5 percent or $100,000 remain unspent after 6 months would be changed to a requirement that no more than 5 percent of the proceeds remain unspent after 6 months.

Administration position. We support this proposal. We believe that this proposal will simplify compliance with this exception to arbitrage rebate without compromising tax policy with respect to the arbitrage rebate requirement.

2. Exception From Rebate for Earnings on Bona Fide Debt Service Fund Under Construction Bond Rules (Section 432)

Current law. Non-private activity bonds and qualified 501(c)(3) bonds issued to finance construction projects are exempt from the arbitrage rebate requirement if the bond proceeds are spent at specified percentages in 6-month intervals over a 24-month period beginning on the date of issue of the bonds. An issuer complying with the requirements of this exception under certain circumstances is still required to pay arbitrage rebate on arbitrage earnings attributable to a bona fide debt service fund.

Proposal. Earnings on a bona fide debt service fund, with respect to a bond issue that meets the spend-down requirements of the 24-month arbitrage rebate exception, would not be subject to the arbitrage rebate requirement.

Administration position. We support this proposal. We believe that this proposal will simplify compliance with the arbitrage rebate requirement and that it is consistent with the policy behind the 24-month arbitrage rebate exception.

3. Automatic Extension of Initial Temporary Period for Construction Issues (Section 433)

Current law. After the termination of the initial temporary period, bond proceeds invested at a yield materially higher than the yield on the bonds pursuant to such temporary period must generally be invested at a yield not in excess of the bond yield plus .125 percent.

Proposal. With respect to bonds issued to finance non-private activity construction projects, the initial temporary period would be automatically extended 1 year if, as of the end of the initial temporary period, the issuer had spent at least 85 percent of the bond proceeds available for construction and the issuer reasonably expected to spend the remaining bond-construction moneys within the following 12-month period.

Administration position. We do not oppose this proposal. We agree that subjecting bond proceeds to yield restriction and rebate requirements at the same time is duplicative and that simplification in this area is desirable. We believe that the proposal made last year by the Congressional staffs -- to allow issuers to rebate arbitrage in lieu of restricting yield on investments under appropriate circumstances -- continues to be the most promising approach. We suggest that this rebate-in-lieu-of-yield restriction proposal be given further consideration as a means of simplifying the problem addressed by the current proposal. We would, however, request that the Treasury be given regulatory authority to require yield restriction when necessary in order to discourage arbitrage-motivated transactions.

4. Aggregation of Issues Rules Not to Apply to Tax or Revenue Anticipation Bonds (Section 434)

Current law. The IRS in certain private letter rulings has treated multiple issues of bonds issued within 31 days of each other by the same issuer as being a single debt obligation for purposes of applying tax rules with respect to tax-exempt bonds. Tax and revenue anticipation notes (TRANs) are short-term borrowings by a governmental unit issued for the purpose of financing near-term cash flow deficits.

Proposal. The aggregation of TRANs with other non-private activity bond issues of an issuer would be prohibited regardless of when the TRANs was issued.

Administration position. We do not oppose this proposal. We believe that this clarification will simplify compliance with relevant Federal tax requirements without compromising Federal tax policy in this area.

5. Authority to Terminate Required Inclusion of Tax-Exempt Interest on Return (Section 435)

Current law. Section 6012(d) of the Internal Revenue Code requires that every person required to file a Federal income tax return for the taxable year must include on such return the amount of tax-exempt interest received or accrued during the year.

Proposal. The Secretary of the Treasury would be given authority to exempt taxpayers from reporting tax-exempt interest pursuant to section 6012(d) of the Code in any case in which the Secretary determines that the disclosure of such interest is not useful for tax administration.

Administration position. We do not support this proposal. Given the need for this data in tax administration, we see little likelihood that this authority could be exercised to reduce issuer compliance burdens in any significant way.

6. Repeal of Expired Provisions (Section 436)

Current law. A special exception to the arbitrage rebate requirement applicable to certain issues of qualified student loan bonds expired on December 31, 1988.

Proposal. Since the provision is no longer of any effect it would be repealed as deadwood.

Administration position. We support this proposal. The provision is no longer needed.

E. Revocable Trust Provision

Certain Grantor Trusts Treated As Estates (Section 441)

Current law. Many taxpayers use revocable trusts as substitutes for wills to avoid the costs of probate, for reasons of privacy and other nontax purposes. When a revocable trust becomes irrevocable on the grantor's death and thereafter effectively functions as an estate, it is taxed as a trust and is unable to take advantage of certain provisions of the Code that are available to estates but not trusts.

Proposal. The bill would amend section 7701 by adding a definition of an "estate". Under the provision, an estate is defined to include a pourover revocable trust, or, if there is no will, a trust that is primarily responsible for debts and administration expenses. Such a trust would not be treated as an estate for purposes of determining the trust's personal exemption or taxable year or for gift, estate or generation-skipping tax purposes. Treasury would have regulatory authority to prescribe additional exceptions. Such a trust would be treated as an estate for taxable years that begin within 3 years and 9 months of the decedent's death.

Administration position. The Administration does not oppose this provision of the bill. The purpose of the provision is to eliminate several of the tax disincentives to using funded revocable trusts as substitutes for wills. The bill would simplify planning by reducing the tax considerations in deciding whether to use a revocable trust.

F. Other Provisions Relating to Partnerships

1. Timing Rules for Inclusion and Deduction of Partnership Guaranteed Payments (Section 442)

Current law. Under section 707(a) a partner who engages in a transaction with a partnership other than in his capacity as a partner is treated as if he were not a member of the partnership with respect to the transaction. Examples of such transactions include loans of money or property by the partnership to the partner or by the partner to the partnership, the sale of property by the partner from the partnership, the purchase of property by the partner from the partnership, and the rendering of services by the partnership to the partner or by the partner to the partnership. Transfers of money or property by a partner to a partnership as contributions, or transfers of money or property by a partnership to a partner as distributions, are not transactions within the purview of section 707(a).

Under section 707(c), the payments made by a partnership to a partner for services or for the use of capital (i.e., "guaranteed payments") are considered as made to a person who is not a partner to the extent the payments are determined without regard to the income of the partnership. Guaranteed payments are considered as made to one who is not a member of the partnership only for purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses).

Section 267 sets forth certain timing rules relating to deductions for losses, expenses and interest arising from transactions between related taxpayers. As a general matter, section 267(a)(2) provides that in transactions between related parties, payments are deductible by a taxpayer only when they are includible in the income of the person to whom payment is made. Section 267(e) extends this rule to transactions between partnerships and their partners except with respect to a partnership's guaranteed payments. Instead, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted the payments.

Proposal. The bill would defer the deduction of a guaranteed payment by a partnership until the year in which it is includible in the partner's income. Thus, the bill conforms the timing rule for guaranteed payments to the timing rule for payments made to a partner acting in a capacity other than as a member of the partnership.

Administration position. The Administration supports this proposal. It is desirable to have the same timing rule for payments made by a partnership to a partner either as payments made not in the partner's capacity as a partner or as guaranteed payments, since these types of payments can be difficult to distinguish from each other.

2. Closing of Partnership Taxable Year With Respect To Deceased Partner (Section 443)

Current law. A partner reports his share of items of income, gain, loss, deduction, and credit on his return for the year in which or with which the partnership's year ends. The taxable year of a partnership closes with respect to a partner who sells or exchanges his entire interest in the partnership, or whose entire interest in the partnership is liquidated other than by reason of death. Thus, a partner who sells his entire interest reports his share of partnership items for the year that includes the date of sale on his income tax return for the year that includes the date of sale (and not on his return for the year in which the partnership's year would normally have ended). Because the partnership's year does not end by reason of the death of a partner, a decedent-partner's share of partnership items for the partnership year that includes his death is reported on the estate's return rather than on the decedent's final return. However, the partnership's year would close with respect to the decedent-partner if his entire interest is sold pursuant to a buy-sell agreement existing at the time of death. In such a case, the decedent-partner's share of partnership items for the partnership year that includes his death would be reported on his final return rather than the estate's return.

Proposal. The bill would provide that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation, or otherwise.

Administration position. We support this proposal. The year closing result should not be dependent on the presence of a buy-sell agreement.

G. Corporate Provision

Clarification of Amount of Gain Recognized by a Secu[illegible]er in a Reorganization (Section 444)

Current law. In general, a holder of corporate stock or securities who exchanges them for other stock or securities in a corporate reorganization or "spin-off" does not recognize gain even if the holder realizes gain because the value of the stock or securities received exceeds the holder's basis in the stock or securities given up. This general rule does not apply, however, if the principal amount of securities received exceeds the principal amount of securities given up. In this case, any gain realized on the exchange is recognized up to the fair market value of the excess principal amount. It is not clear how the "principal amount" of a security surrendered or received in a reorganization is measured for this purpose. Under the original issue discount (OID) rules of current law, however, that portion of the stated principal amount of a bond that exceeds the issue price of the bond is treated as unstated interest that is included in income by the holder and deductible by the issuer over the term of the bond.

Proposal. The proposal would coordinate the "excess principal amount" rule with the OID rules of current law. Thus any portion of the stated principal amount that is treated as unstated interest under the OID rules would not be treated as principal for purposes of determining how much gain is recognized in a reorganization. Instead, the issue price of the securities received, and the adjusted issue price of the securities surrendered, would be treated as their principal amount. In contrast to current law, under which the amount of gain recognized is based on the fair market value of the excess principal amount of the securities received, the proposal would not require determination of the fair market value of this excess.

Administration position. We support this proposal. It will provide similar tax treatment for exchanges that are similar in economic substance.

TITLE V. ESTATE AND GIFT TAX PROVISIONS

1. Waiver of Right of Recovery for Certain Marital Deduction Property (Section 501)

Current law. A marital deduction is allowed for estate and gift tax purposes for qualified terminable interest property (QTIP) that passes to a spouse. The property is generally includible in the estate of the spouse beneficiary. The estate of a spouse beneficiary of a QTIP trust has a right of recovery against the person receiving the trust property for estate taxes attributable to the inclusion of the trust in the spouse's gross estate. The right of recovery may be waived by the spouse beneficiary in his or her will.

Proposal. The bill would provide that the right of recovery may be waived by the spouse beneficiary only by a specific reference to section 2207A.

Administration position. The Administration does not oppose this proposal. The proposal does not affect the substantive right of the surviving spouse to waive the right of recovery. By establishing a clear test for what constitutes an

effective waiver under section 2207A, the provision should prevent the inadvertent waivers that sometimes occur under current law.

2. <u>Inclusion in Gross Estate of Certain Gifts Made Within Three Years of Death</u> (Section 502)

<u>Current law</u>. Generally, transfers made within 3 years of death are not includible in the transferor's gross estate. However, the transfer within 3 years of death of certain retained rights with respect to previously transferred property causes the entire property to be includible in the transferor's gross estate. This inclusion rule applies to transfers made from a revocable trust within 3 years of the transferor's death. This may cause, among other things, annual exclusion gifts made from the revocable trust during that period to be includible in the transferor's gross estate.

<u>Proposal</u>. The bill would amend section 2038, which deals with revocable transfers, to ensure that transfers made from an individual's revocable trust within 3 years of the individual's death are not includible in the individual's gross estate. The bill would also restate section 2035, which generally deals with the inclusion in the gross estate of property transferred within 3 years of death, for greater clarity without substantive change.

<u>Administration position</u>. The Administration does not oppose this provision of the bill. Funded revocable trusts are created by individuals for a variety of legitimate, nontax planning purposes. The inability to use the revocable trust as a vehicle for making annual exclusion gifts without estate tax exposure is a significant tax disadvantage to the use of such trusts.

3. <u>Definition of Qualified Terminable Interest Property</u> (Section 503)

<u>Current law</u>. A marital deduction is allowed for estate and gift tax purposes for a QTIP passing to a spouse. For property to qualify as QTIP, the beneficiary spouse must have a qualifying income interest for life in the transferred property; <u>i.e.</u>, must be entitled to all the income from the property, payable at least annually. Proposed Treasury regulations provide that income accrued or accumulated between the last income distribution date and the date of the spouse's death does not have to be payable to the spouse or the spouse's estate for the spouse to have a qualifying income interest for life. In <u>Estate of Howard</u>, 91 T.C. 329 (1988), <u>rev'd</u>, 910 F.2d 633 (9th Cir. 1990), the Tax Court held that this "stub period" income must be payable to the spouse's estate or be subject to the spouse's general power of appointment for the spouse to have the requisite income interest. Although the <u>Howard</u> decision was reversed on appeal, it is unclear how the Tax Court would rule if the question arises in a case appealable to another circuit.

<u>Proposal</u>. The bill would provide that an income interest would not fail to be a qualifying income interest for life solely because the stub period income is not payable to the spouse's estate or subject to the spouse's general power of appointment. If the marital deduction is allowed, however, such income would be includible in the spouse's estate.

<u>Administration position</u>. The Administration supports this provision of the bill. The codification of the proposed Treasury regulation will eliminate the need for the closing agreement procedure now used by the IRS to permit taxpayers who have relied

on the proposed regulation to claim the marital deduction while protecting the government against the potential whipsaw of avoiding subsequent inclusion of the trust property in the spouse's estate on the grounds that the deduction was improperly allowed.

4. Requirements for Qualified Domestic Trust (Section 504)

Current law. Generally, property passing to a noncitizen surviving spouse does not qualify for the marital deduction unless it passes in a qualified domestic trust (QDT). Distributions of principal from such a trust to the surviving spouse are subject to estate tax. When originally enacted, the QDT provisions required that all trustees of a QDT be U.S. citizens or domestic corporations. This provision was retroactively amended twice and ultimately required that the trust must provide that no distributions can be made unless a U.S. trustee has the right to withhold the estate tax imposed on the distribution.

Proposal. Under the proposal, a QDT created prior to the enactment of the 1990 OBRA whose governing instrument requires that all trustees be U.S. citizens or domestic corporations would be treated as satisfying the withholding requirement of current law.

Administration position. The Administration supports this provision of the bill. The trustee requirements for a qualified domestic trust have been amended twice in an attempt to give taxpayers greater flexibility in the choice of trustees while also protecting the government's ability to collect the tax imposed on the trust. We believe that the government's interest is adequately protected if the trust instrument requires that all trustees must be U.S. citizens or domestic corporations. The bill will reduce the number of individuals who will have to redraft wills to comply with the changes that have been made to the trustee requirement for QDTs.

5. Election of Special Use Valuation of Farm Property for Estate Tax Purposes (Section 505)

Current law. Under certain circumstances, a decedent's estate may elect to value real property used in a farm or a trade or business according to its actual use rather than its highest and best use. The election requires, among other things, the filing of an agreement signed by all the qualified heirs consenting to a recapture tax if the special use terminates within 10 years of the decedent's death. An executor who makes the election and substantially complies with the requirements in the regulation for making the election may provide missing information and certain signatures missing from the agreement within 90 days of notification by the IRS.

Proposal. Under the proposal, if the executor makes the special use valuation election and files the agreement regarding the recapture tax, the executor would be permitted to provide any missing information and signatures within 90 days of notification by IRS. This relief would be available without regard to whether the executor substantially complied with the regulatory requirements for making the election.

Administration position. The Administration does not oppose this provision. The special use valuation election is frequently defective because the executor fails to file certain required information or signatures. By expanding the scope of the

provision that permits defective elections to be cured, the bill simplifies qualification for the special use valuation in those estates for which it was intended to be available.

TITLE VI. EXCISE TAX PROVISIONS

A. Motor Fuel Excise Tax Provisions

1. Use Tax on Diesel and Aviation Fuel (Section 601)

Current law. Section 4091 imposes a tax on the sale of diesel or aviation fuel by a producer. For this purpose, a wholesaler or a tax-free purchaser (e.g., a State government) is treated as a producer, and a nonexempt use of fuel by a producer is treated as a sale. A person that purchases fuel at a reduced tax rate (e.g., for use in a bus or train) is not treated as a producer. Thus, section 4091 does not impose a tax when a reduced-tax purchaser diverts fuel to a nonexempt use. Section 4041 imposes a back-up use tax on fuel diverted to nonexempt uses, but this tax is redundant in the case of fuel diverted by a tax-free purchaser and does not apply to fuel diverted by a reduced-tax purchaser.

Proposal. The bill would combine the diesel and aviation fuel tax provisions into a revised section 4091. Reduced-tax purchasers would be treated as producers for purposes of the tax imposed by the revised section 4091 and would be liable for the tax when they divert fuel to a nonexempt use. The bill would also reorganize section 4041.

Administration position. We support the proposal. The proposal improves the organizational structure of the diesel and aviation fuel excise tax statutes, making the rules easier to locate and understand. The imposition of tax on fuel diverted to nonexempt uses by reduced-tax producers ensures equivalent treatment of nonexempt uses of diesel and aviation fuel by tax-free and reduced-tax purchasers.

2. Refunds of Diesel and Aviation Fuel Taxes (Section 602(a))

Current law. Producers (including wholesalers) of diesel or aviation fuel can make tax-free sales to exempt purchasers (e.g., a State government). If, however, a retailer sells diesel or aviation fuel on which tax has been paid to an exempt purchaser, only the exempt purchaser can claim a refund of the tax.

Proposal. The bill would permit the person who paid the tax (generally the wholesaler) to claim the refund if the amount of the tax is repaid to the retailer. (Presumably, the wholesaler would reimburse the retailer only if the retailer sells the fuel to an exempt purchaser at a tax-free price.) This rule would apply only to fuel sold for use in one of the following exempt uses: (1) export, (2) use as supplies for aircraft or vessels, (3) exclusive use by a State or local government, or (4) exclusive use by a nonprofit educational organization. In addition, refunds would be permitted only if the person paying the tax meets such requirements as the Treasury Department may impose under the regulatory authority provided in the bill.

Administration position. We do not oppose the proposal. The proposal significantly simplifies refund procedures for diesel and aviation fuel sold to certain exempt users and conforms those procedures to those applicable to special motor

fuels and gasoline. Under the proposal, however, there is a possibility of refund claims by both the wholesaler and the exempt user, and we expect it will be necessary to prescribe regulatory safeguards under the authority provided in the bill. These safeguards, including appropriate certifications by the exempt user, would be designed to prevent an exempt user from claiming a refund if the tax is refunded to the wholesaler. They would also assume that a wholesaler claiming a refund does not pass the tax on in the price of the product by requiring the wholesaler to establish that the price does not include the tax.

3. Consolidation of Refund Provisions (Section 602(b))

Current law. The excise tax imposed on fuel is refunded if the fuel is used for an exempt purpose. Refunds of fuel taxes are currently authorized under three separate Code sections.

Refunds may be claimed annually as a credit on the taxpayer's income tax return. In most cases, taxpayers also have the option of claiming quarterly refunds for the first three quarters of a taxable year. This option is not available, however, with respect to taxes imposed on gasoline and special motor fuel used on a farm for farming purposes. In addition, quarterly refunds are permitted only if the amount of the refund meets a statutory threshold. Different thresholds are prescribed depending on the Code provision authorizing the refund, and claimants may not aggregate refunds authorized under different Code sections (e.g., gasoline refunds authorized under section 6421 and diesel fuel refunds authorized under section 6427) in determining whether the statutory threshold is met.

An expedited refund procedure is available for gasohol blenders.

Proposal. The bill would consolidate the Code provisions authorizing refunds into a single section. This section would prescribe only one refund threshold, and all gasoline and diesel fuel refunds would be aggregated in determining whether this threshold is met. A refund would be permitted for any quarter (including the fourth quarter) in which the cumulative overpayment exceeds $750. Refunds would be permitted under this rule with respect to taxes imposed on gasoline and special motor fuel used on a farm for farming purposes. The special expedited procedure for gasohol blenders would be retained.

Administration position. We do not oppose the proposal. The proposal significantly simplifies the refund procedures by consolidating the rules in a single section and providing uniform threshold and refund procedures. A single standardized refund claim for all fuel taxes reduces administrative burdens imposed on taxpayers that are eligible for refunds of several different types of excise tax.

4. Refunds to Cropdusters (Section 602(b))

Current law. The excise tax imposed on gasoline or aviation fuel is refunded if the fuel is used for cropdusting. The tax is generally refunded to the farmer; the cropduster is entitled to a refund only if the farmer waives the right to a refund.

Proposal. The bill would eliminate the waiver requirement and provide that only the cropduster is entitled to the refund.

Proposal. The bill would permit proprietors to maintain records and reports at locations other than the plant premises. As under current law, the records and reports would be required to be available for inspection by the Treasury Department during business hours.

Administration position. We do not oppose the proposal. The waiver requirement is cumbersome and prevents many cropdusters from claiming refunds.

5. Information Reporting on Certain Sales (Section 603)

Current law. When diesel or aviation fuel is sold free of tax or at a reduced tax rate, both the seller and the purchaser are required to file an information return with the IRS.

Proposal. The bill would permit the Treasury Department to issue regulations waiving the information reporting requirement.

Administration position. We support the proposal. The authority to waive the reporting requirement in appropriate cases will allow the IRS to administer the exemptions more efficiently and relieve taxpayers of unnecessary paperwork burdens.

B. Alcohol Excise Tax Provisions

Imported Distilled Spirits Returned to Plant (Section 611)

Current law. When tax-paid distilled spirits that have been withdrawn from bonded premises of a distilled spirits plant are returned for destruction or redistilling, the excise taxes are refunded or credited. Bottled imported distilled spirits are not eligible for this refund or credit because they are originally withdrawn from customs custody and not bonded premises. Additionally, distilled spirits brought into the United States from Puerto Rico are not eligible because they are not withdrawn from bonded premises.

Proposal. The bill would provide that refunds or credits of the tax would be available for all spirits that are returned to the bonded premises of a distilled spirits plant.

Cancellation of Export Bonds (Section 612)

Current law. An exporter that withdraws distilled spirits from bonded warehouses for export or transportation to a customs bonded warehouse without the payment of tax must furnish a bond to cover the withdrawal. The required bonds are canceled "on the submission of such evidence, records, and certification indicating exportation as the Secretary may by regulations prescribe."

Proposal. The bill would allow the bonds to be canceled "if there is such proof of exportation as the Secretary may require." Under this rule, the Treasury Department could permit exporters to satisfy the proof requirement by maintaining records of exportation. Thus, bonds could be canceled without submission of proof of exportation.

Location of Records of Distilled Spirits Plant (Section 613)

Current law. Proprietors of distilled spirits plants are required to maintain records and reports relating to their production, storage, denaturation, and processing activities on the premises where the operations covered by the records are carried on.

Transfers from Brewery to Distilled Spirits Plant (Section 614)

Current law. A distilled spirits plant may receive tax-free beer on its bonded premises for use in the production of distilled spirits. This rule applies only if the beer is produced on contiguous brewery premises.

Proposal. The bill would provide an exemption from excise tax, subject to Treasury regulations, for beer removed to a distilled spirits plant from any brewery for use in the production of distilled spirits. The bill would also authorize the receipt of such beer by a distilled spirits plant.

Sign Not Required for Wholesale Dealers (Section 615)

Current law. Wholesale liquor dealers are required to post a sign identifying the firm as such. Failure to do so is subject to a penalty.

Proposal. The bill would repeal the requirement that a sign be posted.

Refund on Returns of Merchantable Wine (Section 616)

Current law. Excise tax paid on domestic wine that is returned to bond as unmerchantable is refunded or credited, and the wine is once again treated as wine in bond on the premises of a bonded wine cellar.

Proposal. The bill would permit a refund or credit in the case of all domestic wine returned to bond, whether or not unmerchantable.

Increased Sugar Limits for Certain Wine (Section 617)

Current law. Natural wines may be sweetened to correct high acid content. If the amount of sugar used exceeds the applicable limitation, however, the wine must be labeled "Substandard." For most wines the limitation is exceeded if sugar constitutes more than 35 percent (by volume) of the combined sugar and juice used to produce the wine. Up to 60 percent sugar may be used in wine made from loganberries, currants, and gooseberries.

Proposal. The bill would provide that up to 60 percent sugar could be used in any wine made from juice, such as cranberry or plum juice, with an acid content of 20 or more parts per thousand.

Beer Withdrawn for Embassy Use (Section 618)

Current law. Imported beer, wine, and distilled spirits to be used for the family and official use of foreign governments, organizations and individuals may be withdrawn from customs bonded warehouses without payment of excise tax. A similar rule

applies to domestically produced wine and distilled spirits. There is no similar exemption for domestic beer withdrawn from a brewery or entered into a bonded customs warehouse for the same authorized use.

Proposal. The bill would provide an exemption for domestic beer similar to that available for domestically produced wine and spirits. The exemption would be subject to Treasury's regulatory authority.

Beer Withdrawn for Destruction (Section 619)

Current law. Beer removed from a brewery for destruction must be tax-paid rather than withdrawn without payment of excise tax.

Proposal. The bill would provide an exemption from tax for removals for destruction, subject to Treasury regulations.

Drawback on Exported Beer (Section 620)

Current law. A domestic producer that exports beer may recover the tax (receive a "drawback") found to have been paid on the exported beer upon the "submission of such evidence, records and certificates indicating exportation" required by regulations.

Proposal. The bill would allow a drawback of tax paid "if there is such proof of exportation as the Secretary may by regulations require." Under this rule, the Treasury Department could permit exporters to satisfy the proof requirement by maintaining records of exportation. Thus, tax could be refunded without submission of proof of exportation.

Imported Beer Transferred in Bulk to Brewery (Section 621)

Current law. Imported bulk and bottled beer is subject to tax when removed from customs custody.

Proposal. The bill would provide that, subject to Treasury regulations, beer imported in bulk containers could be withdrawn from customs custody and transferred in bulk to a brewery without payment of tax. Under this provision, the proprietor of the brewery to which the beer is transferred is liable for the tax imposed on the withdrawal from customs custody and the importer would be relieved of liability.

Administration Position on Alcohol Excise Tax Provisions. We support these proposals.

Until 1980, the method of collecting alcohol excise taxes required the regular presence of Treasury Department inspectors at alcohol production facilities. In 1980, the method of collecting tax was changed to a bonded premises system under which examinations and collection procedures are similar to those used in connection with other Federal taxes.

A number of proposals conform reporting and recordkeeping requirements to the current collection system. These changes will allow the Bureau of Alcohol, Tobacco, and Firearms to administer alcohol excise taxes more efficiently and relieve taxpayers of unnecessary paperwork burdens.

Other proposals expand the circumstances in which the Code permits tax-free removals of alcoholic beverages (or allows a credit or refund of tax on a return to bonded premises). These

changes are also consistent with the current collection system and will not jeopardize the collection of tax revenues. In a number of cases, the changes will eliminate inappropriate disparities in the treatment of different types of alcoholic beverages. In addition, several of these proposals will provide producers with additional options in complying with environmental and other laws that regulate the destruction and disposition of these products.

The remaining proposals (i.e., the repeal of the sign requirement and the increased sugar limits for certain wine) repeal or revise outmoded provisions. We do not believe the adoption of these proposals will have adverse consequences.

C. Other Excise Tax Provisions

1. Waiver of Registration Requirement (Section 631)

Current law. The Code exempts certain types of sales (e.g., sales for use in further manufacture, sales for export, and sales for exclusive use by a State or local government or a nonprofit educational organization) from excise taxes imposed on manufacturers and retailers. These exemptions generally apply only if the seller, the purchaser, and any person to whom the article is resold by the purchaser (the second purchaser) are registered with the IRS. The IRS can waive the registration requirement for the purchaser and second purchaser in some but not all cases.

Proposal. The bill would authorize the Treasury Department to specify the cases in which the registration requirement applies to purchasers and second purchasers. Exempt sales to unregistered purchasers and second purchasers would be permitted in all other cases.

Administration position. We support the proposal. The authority to waive the registration requirement in appropriate cases will allow the IRS to administer the exemptions more efficiently and relieve taxpayers of unnecessary paperwork burdens.

2. Deadwood--Piggyback Trailers and Deep Seabed Minerals (Section 632)

Current law. The Code includes a provision relating to a temporary reduction in the tax on piggyback trailers sold before July 18, 1985, and provisions relating to the tax on the removal of hard minerals from the deep seabed before June 28, 1990.

Proposal. The bill would repeal these provisions.

Administration position. We support the proposal. Continued retention of these deadwood provisions is unnecessary.

TITLE VII. ADMINISTRATIVE PROVISIONS

A. Administrative Provisions

1. Employment Tax Reporting for Household Employees (Section 701)

Current law. Household employers who pay cash wages of $50 or more per quarter must withhold social security taxes

(including Medicare taxes) from wages paid to the employee during the quarter. The withheld taxes, together with the portion of the tax paid by the employer, are paid with a quarterly FICA return on Form 942. Household employers who pay cash wages of $1,000 or more in any calendar quarter in the current year or the preceding year are subject to Federal unemployment taxes and must file an annual FUTA return on Form 940 or Form 940EZ. Quarterly deposits are required if certain FUTA liability thresholds are met. Although wages of household employees are not subject to mandatory income tax withholding, an employer and employee may enter into a voluntary withholding agreement. In that case, withheld income taxes are reported and paid on the quarterly return filed for FICA purposes. After the end of each calendar year, household employers must provide copies of Form W-2 (Wage and Tax Statement) to each employee and must transmit all Forms W-2 to the Social Security Administration with Form W-3 (Transmittal of Income and Tax Statements).

Household employers subject to FUTA are typically required to file quarterly state unemployment tax returns as well.

Proposal. Household employers would report all FICA and FUTA taxes and any withheld income taxes ("domestic service employment taxes") on a schedule to Form 1040. No quarterly payments or deposits would be required, but domestic service employment taxes would be counted in determining the employer's estimated tax penalty. Thus, a household employer would be required either to make payments of estimated taxes or to increase the rate of withholding on his own wages to cover his liability for domestic service employment taxes.

To make simplified annual reporting possible, the quarterly FICA threshold would be changed to an annual threshold of $300.

In addition, the Secretary would be granted the authority to enter into agreements with the states which would allow the IRS, acting as agent for the states, to collect state unemployment taxes in the same manner.

Administration position. The Administration supports the proposal. The proposal should provide substantial simplification and increased compliance.

Current law requires employers of household employees to file 5 Federal returns annually in addition to forms such as W-3 and W-2. State unemployment reports must be separately filed on a quarterly basis, often to remit quite small liabilities ($7-8 annually). Household employers are frequently unaware of and do not comply with such requirements. By incorporating Federal return requirements into Form 1040, the compliance burden should be eased and household employers will be reminded of their filing responsibilities. While State participation in the Form 1040 filing system would be voluntary, many states may find the system cost effective to collect the relatively small sums involved.

We recommend that the proposal be made effective for remuneration paid after December 31, 1992, in order to allow the IRS to prepare forms and inform taxpayers about the new filing system. In addition, we recommend that the return due date provision be clarified to make certain that the schedule is not due earlier than the date of the Form 1040 if the taxpayer utilizes an extension to file.

2. Uniform Penalty Provisions to Apply to Certain Pension Reporting Requirements (Section 702)

Current law. Any person who fails to file an information report with the IRS on or before the prescribed filing date is subject to penalties for each failure. The general penalty structure provides that the amount of the penalty is to vary with the length of time within which the taxpayer corrects the failure, and allows taxpayers to correct a de minimis number of errors and avoid penalties entirely. A different, flat-amount penalty applies for each failure to provide information reports to the IRS or statements to payees relating to pension payments.

Proposal. The bill would incorporate into the general penalty structure the penalties for failure to provide information reports relating to pension payments.

Administration position. We support this proposal because conforming the information-reporting penalties that apply with respect to pension payments to the general information-reporting penalty structure will simplify the overall penalty structure through uniformity and provide more appropriate information-reporting penalties with respect to pension payments.

3. Use of Reproductions of Returns Stored in Digital Image Format (Section 703)

Current law. Under section 6103(p)(2), the IRS is required to provide a reproduction of a return upon request from a person entitled to disclosure of the return, and may provide return information to such a person through a variety of media. Reproductions so provided have the same legal status as the original return and may be admitted into evidence in judicial or administrative proceedings.

Proposal. The Code would be amended to clarify that the IRS may discharge its obligations to persons seeking disclosure of returns by furnishing them with reproductions produced through digital image technology. Such technology will eventually enable the IRS to store returns in digital image form and realize significant costs savings. The cost of storing, retrieving and copying tax returns is today about $42 million annually. The bill also would require the Comptroller General to conduct a study of available digital image technology for the purpose of determining the extent to which reproductions of documents stored using that technology accurately reflect the data on the original document and the appropriate period for retaining the original document.

Administration position. We support this proposal. In addition to cost savings, the use of digital image technology will speed the retrieval of return information for use by the IRS in resolving taxpayer inquiries, conducting examinations and litigating tax issues. To ensure that accurate and legible document images are created, the IRS will institute strict quality control standards. As provided in section 6103 generally, taxpayer information will continue to be protected from unauthorized disclosure.

4. Repeal of Tax Shelter Registration Rules (Section 704)

Current law. The Code requires the registration of tax shelters with the IRS and imposes penalties for failure to comply with the registration requirements. The provisions were adopted in 1984 to enable the IRS to identify and audit more effectively tax shelter investments that had proliferated during the early

1980s. Due to changes in the tax laws since 1984, tax shelter activities have declined substantially. On the other hand, partnerships with over 500 investors have almost doubled. The tax shelter registration provisions are particularly cumbersome for such widely held partnerships. Organizers and sellers of potentially abusive tax shelters are required to keep lists of investors and to make them available to the IRS on request.

Proposal. The tax shelter registration rules would be repealed. Current law rules applicable to organizers and sellers of potentially abusive tax shelters would be retained.

Administration position. The Administration supports this provision. The steep decline in the number of tax shelters being marketed has greatly reduced the amount of information being provided under the tax shelter registration rules. The information is no longer sufficiently useful to justify the paperwork burdens it creates both for taxpayers (particularly widely held partnerships) and the IRS.

5. Repeal Authority to Disclose Whether Prospective Juror Has Been Audited (Section 705)

Current law. Section 6103(h)(5) provides that in connection with any civil or criminal tax case the Secretary (or his delegate) must disclose, upon written request from either party to the lawsuit, whether an individual who is a prospective juror has or has not been subject to any audit or other tax investigation by the IRS. In *United States v. Hashimoto*, 878 F. 2d 1126 (9th Cir. 1989), it was held that the defendant had an absolute right to information about prospective jurors under section 6103(h)(5), and that trial court rulings that had the effect of denying the defendant this right constituted reversible error. Following the *Hashimoto* decision, the IRS has received from defendants an escalating number of requests for information under section 6103(h)(5).

Proposal. The bill would repeal the authority to disclose whether prospective jurors have been audited.

Administration position. We support the repeal of section 6103(h)(5). Information regarding prior tax investigations can be elicited from prospective jurors in *voir dire* questioning, without resort to the cumbersome, time consuming and sometimes harmful mechanism of section 6103(h)(5) as interpreted in *Hashimoto*.

6. Repeal TEFRA Audit Rules For S Corporations (Section 706)

Current law. An S corporation generally is not subject to income tax on its taxable income. Instead, it files an information return and the shareholders report their pro rata share of the S corporation's income and deductions on the shareholders' tax return. The Subchapter S Revision Act of 1982 generally made the TEFRA partnership audit and litigation rules applicable to S corporations. These rules require the determination of all "Subchapter S items" at the corporate, rather than the shareholder, level. These rules also require a shareholder to report all Subchapter S items consistently with the corporation's information return or to notify the IRS of any inconsistency.

Proposal. The bill would repeal the unified audit procedures for S corporations, but retain the requirement that shareholders report items in a manner consistent with the corporation's return.

Administration position. We support repeal of the TEFRA audit rules for S corporations. The vast majority of both existing and newly formed S corporations are expected to qualify for the small S corporation exception from the unified audit and litigation provisions. Accordingly, a unified audit procedure, with the intendant necessity for the IRS and the courts to prescribe special rules and procedures, is unnecessary and often confusing for those S corporations subject to the provision.

It would be desirable before final enactment to clarify the effect of the provision on pending proceedings and years before the effective date as to which no proceeding is pending. The provision also should be effective for taxable years ending after a given date, rather than for taxable years starting after a given date. The precise date an S corporation's first taxable year commences may be unclear in certain cases.

7. Limitations on Assessment and Collection (Section 707)

Current law. Taxpayers who have invested or that have an interest in passthrough entities such as partnerships, S corporations and trusts currently are asserting that the IRS cannot make adjustments to their returns with open statutes of limitations when the adjustments asserted arise from distributions from passthrough entities for which the statutes of limitations have expired. Recent court cases have given support to taxpayers. See Kelley v. Commissioner, 977 F.2d 756 (9th Cir. 1989), in which the Ninth Circuit held that an extension of time for assessing tax for the 1980 year executed by a shareholder of an S corporation did not permit an S corporation adjustment to the shareholder's return if the statute of limitations with respect to the S corporation had expired, and Fendell v. Commissioner, 906 F.2d 362 (8th Cir. 1990), in which the Eighth Circuit held that the Commissioner cannot adjust individual income tax returns for 1975 and 1977 with open statutes of limitations, when the adjustments arise from the distributions to a beneficiary of income from a complex trust for which the statute of limitations has expired.

Proposal. The proposal would clarify that the running of the statute of limitations begins with the filing of the return of the taxpayer whose liability is in question, rather than the filing of the return of another person (such as a partnership, S corporation, or trust) from which the taxpayer received some item of income, gain, loss, deduction, or credit. The proposal would not affect the statute of limitations applicable to an entity subject to the TEFRA unified audit rules.

Administration position. We support this clarification, because it would avoid years of protracted and costly litigation over collateral matters.

B. Tax Court Provisions

1. Overpayment Determinations of the Tax Court (Section 711)

Current law. The Tax Court has jurisdiction to order the refund of an overpayment determined by the Court, plus interest, if the IRS fails to refund such overpayment and interest within 120 days after the Court's decision becomes final. Whether such an order is appealable is uncertain. In addition, whether the Tax Court has jurisdiction over the validity or merits of certain credits or offsets (e.g., student loans, child support, etc.) made by the IRS which serve to reduce or eliminate the refund to which the taxpayer was otherwise entitled is unclear.

Proposal. The bill would clarify that these orders are appealable in the same manner as a decision of the Tax Court. The bill would also clarify that the Tax Court does not have any jurisdiction over the validity or merits of any credit or offset made by the IRS which would serve to reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Administration position. We support the bill's clarification of current law.

2. Awarding of Administrative Costs (Section 712)

Current law. Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding. No time limit is specified for the taxpayer to apply to the IRS for an award of administrative costs. In addition, no time limit is specified for a taxpayer to appeal to the Tax Court an IRS decision denying an award of administrative costs. Finally, the procedural rules for adjudicating denial of administrative costs are unclear.

Proposal. The bill would provide that a party who seeks an award of administrative costs must apply for such costs within 90 days of the date on which the party was determined to be a prevailing party. The bill would also provide that a party who seeks to appeal a denial by the IRS of an administrative costs award must petition the Tax Court within 90 days after the date that the IRS mails the denial notice. The bill would clarify that dispositions of administrative cost petitions by the Tax Court are reviewed in the same manner as other decisions of the Tax Court.

Administration position. We support clarifying the procedures for applying for a cost award and appealing from a denial of such an award.

3. Redetermination of Interest Pursuant to Motion (Section 713)

Current law. Section 7481(c)(4) provides that a taxpayer may seek a redetermination of interest after certain decisions of the Tax Court by filing a petition with the Tax Court.

Proposal. The bill would substitute a motion for a petition for this purpose.

Administration position. We support this clarification because it serves both to eliminate possible confusion and conforms the terminology of section 7481(c)(4) to that of analogous sections, such as section 6512(b)(2), which directs the taxpayer to invoke the Tax Court's jurisdiction in other types of supplementary proceedings by motion.

4. Application of Net Worth Requirement for Awards of Litigation Costs (Section 714)

Current law. In the Federal courts, including the Tax Court and the Claims Court, a taxpayer who prevails may be awarded reasonable litigation costs, including attorneys' fees. The Code provides that the prevailing party must meet the net worth requirements of section 2412(d)(2)(B) of title 28, United States Code. The provision is silent as to whether the net worth requirement relates to trusts and estates.

Proposal. The bill would clarify that the net worth requirement applies to trusts (determined as of the last day of the taxable year involved in the proceeding) and estates (determined as of the date of the decedent's death). The bill also would provide that individuals who file a joint tax return are treated as one individual for purposes of computing the net worth limitations. An exception to this rule would be provided for innocent spouses.

Administration position. We support clarifying that the net worth requirement applies to trusts and estates and that individuals filing a joint return are treated as one individual for purposes of the net worth requirement.

C. Cooperative Agreements

Permit IRS to Enter Into Cooperative Agreements With State Tax Authorities (Section 721)

Current law. The IRS is generally not authorized to use funds appropriated for Federal tax administration to provide services to non-Federal agencies even if the cost is reimbursed.

Proposal. The IRS would be authorized to enter into reimbursable agreements with the states to enhance joint tax administration. Reimbursable costs would include such items as data processing, software development and hardware acquisition as well as personnel costs, travel, and visual items involved in providing a service.

Administration position. We support authorizing the IRS to enter into reimbursable agreements with the states for these purposes. The proposal could lead to joint Federal-state programs which would simplify and shorten return preparation time for taxpayers and reduce processing costs at both the Federal and state level.

☐ CORRECTED (if checked)

Partner's Share of Income (Loss) From a Large Partnership

PARTNERSHIP'S name, street address, city, state, and ZIP code		1 Taxable income (loss) from passive activities $	OMB No. 1545-XXXX	
		2 Taxable income (loss) from other activities $	1992	
PARTNERSHIP'S Employer I.D. number	PARTNER'S identifying number	3 Net capital gain from passive activities $	4 Net capital gain from other activities $	**Copy B For Partner** This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
PARTNER'S name		5 Net passive AMT adjustment $	6 Net other AMT adjustment $	
Street address (including apt. no.)		7 Other		
City, state, and ZIP code				

Form **1099K** Department of the Treasury - Internal Revenue Service

DRAFT

Instructions to Individual Partners Filing Form 1040

(Filers of Other Returns: Follow the instructions for your tax return instead of the instructions shown below.)

Box 1.--If income is reported in box 1, report the income on Schedule E, Part II, column (h). If a loss is reported in box 1, report the loss following the Form 8582 instructions, to determine how much of the loss can be reported on Schedule E, Part II, column (g). See the Schedule E instructions for other rules that limit losses.

Box 2.--Report the income or loss in box 2 on Schedule E, Part II, column (i) or (k). See the Schedule E instructions for special rules that limit losses.

Box 3.--Report the gain in box 3 on Schedule D, line 11, column (g).

Box 4.--Report the gain in box 4 on Schedule D, line 11, column (g).

Box 5.--If you are required to file Form 6251, Alternative Minimum Tax--Individuals, include this amount on Form 6251, line 4s.

Box 6.--If you are required to file Form 6251, include this amount on Form 6251, line 4q.

Box 7.--Follow the instructions shown below for the code(s) shown in this box.

Code A--General credits.--Report this amount on Form 3800, line 7.

Code B--Low-income housing credit for property placed in service after 1989.--Report this amount on Form 8586, line 5.

Code C--Rehabilitation credit (including low-income housing credit for property placed in service before 1990).--Report this amount on Form 3468, line 3c.

Code D1 through D6--Foreign tax credit information:

Code D1--Type of income.--Check the box for this category of income on Form 1116.
Code D2-- Name of foreign country.--Enter on Form 1116, Part I, column A, B, or C.
Code D3--Total gross income from sources outside the U.S.--Enter this amount on Form 1116, line 1. Enter "partnership income" on the dotted line to the left of the entry space for line 1.
Code D4--Total applicable deductions and losses.--Enter this amount on Form 1116, line 2.
Code D5--Total foreign taxes paid or accrued.--Enter this amount on Form 1116, line 8.
Code D6--Reduction in taxes available for the credit.--Enter this amount on Form 1116, line 12.

Code E--Tax-exempt interest.--Report this amount on Form 1040, line 8b.

Prepared Statement of Fred Goldberg

INTRODUCTION

Mr. Chairman, I want to commend you and your colleagues for taking on this difficult but all-important issue. I am convinced that the greatest challenge our tax system faces during the 1990's is to reduce the burden of complying with our tax laws. The administrative and transaction costs our system imposes on the American public are simply unacceptable. We are needlessly consuming billions of hours and dollars of our citizen's time and money in maintaining records, preparing forms, "structuring" their transactions and financial affairs, and dealing with government agencies—time and money that would be far better spent on family, friends, productive ventures and the pursuit of happiness.

I am equally convinced that the burden and complexity of our tax system is eroding voluntary compliance. I fear that the combination of laws, rules, and IRS procedures are frustrating taxpayers to the point where it may become too difficult, too expensive, and too time-consuming for taxpayers to comply. And when they stop complying, they stop paying their fair share.

There are many causes for the burden and complexity faced by taxpayers. I want to emphasize from the outset that many of these factors have nothing to do with the tax laws as such. We cannot hide behind a veil of "blame it on Title 26." The IRS must step forward and accept responsibility for making the system work better for the American public. We have endless opportunities to simplify tax administration and reduce the burden on taxpayers—opportunities that do not require substantive tax law changes. We can and should be held accountable for our efforts.

In this regard, I believe we are heading in the right direction. We are committed to transforming tax administration during the 1990's. With support and oversight from the Administration, Congress, and the public, I am confident we will succeed. Attachment 1 to my statement is an overview of our efforts to make the system more workable for the American public.

While we must shoulder a great deal of the responsibility, it is also clear that existing tax laws are a major cause of needless complexity and burden. In my view, a long-term legislative effort to simplify compliance with our tax laws is essential to preserving the health of our system. I am convinced that you and your colleagues are taking a meaningful first step down this road. I applaud your foresight and your leadership.

I. SOME GENERAL OBSERVATIONS

Before turning to pending legislation that is the subject of this hearing, I would like to offer a number of general observations on the subject of tax simplification. They are based on my experience as a private practitioner and as the IRS Chief Counsel, as well as my current role as Commissioner of Internal Revenue.

A. *Does Simplification Require "Hard Choices?."* The common wisdom is that simplification requires hard choices among competing policy agendas. While simplifying the tax law is a difficult task requiring great care and tough decisions, the alleged "hard choices" are often illusory.

1. *Simplification versus Revenue.* Some suggest that the price of simplification is a reduction in revenue; others fear that simplification will be used as a cover for tax increases. With all due respect, I believe these claims and concerns are groundless. It is absolutely clear that simplification can be achieved in ways that lose revenue; it is equally clear that simplification can be achieved in ways that raise revenue. But it is also clear that meaningful simplification can be achieved in ways that are revenue neutral.

2. *Simplification versus Certainty.* Some suggest that the price of simplification is more uncertainty. To the contrary, simplification is the one true prerequisite for certainty. The 1980's were devoted to a well-meaning effort to provide certainty through detailed laws and regulations. With the benefit of hindsight, I am convinced that the quest was doomed to failure. Each new rule spawns its own measure of uncertainty, unintended consequences, and the need for special exceptions. We have generated thousands of pages of laws, regulations and rulings—and a system that is rife with uncertainty.

3. *Simnlification versus Equity.* Some suggest that the price of simplification is greater inequity. The complexity imposed by current law is hardly fair or equitable. Providing "equity" for this particular taxpayer or that particular taxpayer through a special provision in the law may appear fair from the perspective of that taxpayer. But the net result is to impose "inequity" on all other taxpayers who must understand and deal with that provision. No matter how careful, well-intentioned, and

skillful we may be, our efforts to fine tune rules to deal with special circumstances are sure to visit unintended inequities, costs, and burdens on other taxpayers in the system.

B. *Is there a "Constituency" for Simplification?* It has been suggested that there is no true constituency for simplification; i.e., "It sounds nice in theory, but no one cares enough to demand concrete action." Again, Mr. Chairman, I think the common wisdom on this score is wrong. I am convinced there is overwhelming support for genuine and broad-based simplification.

It's easy to find the constituency—all we have to do is open up our ears beyond the beltway. It starts with 120,000 IRS employees who day in and day out see a system that is too difficult and too complicated to meet the needs of the American taxpayer. It moves on to tens of thousands of practitioners and millions of taxpayers who are frustrated beyond measure by a system that has lost touch with the real world. These "interest groups" are not represented by high priced lobbyists—but we ignore them at our peril. Their disenchantment threatens our tax system and public confidence in the institutions of government.

C. *Some Recommended Guidelines.* In approaching a legislative or regulatory simplification agenda, I believe there are four points to keep in mind.

1. *A Long-Term Endeavor.* Simplification is a long-term endeavor. There is no silver bullet, no magic solution that is going to simplify the tax law overnight. Simplification can only be achieved one step at a time—the same way we built the system we have today. We are not going to find a single proposal that affects 20, 30, or 50 million taxpayers, and we should not be disappointed or frustrated when we fail to make dramatic progress. We can find proposals that affect hundreds of thousands or millions of taxpayers in small but meaningful ways. If we are patient, and if we persevere, the overall impact will be profound.

2. *Embrace Rough Justice.* I urge the Committee, as well as those of us responsible for implementing regulations, to embrace rough justice and beware of the purists. By background and training, many of us tend to chase the theoretically complete answer. We seek to resolve every imaginable question, address every imagined loophole, deal fairly with every special circumstance. We are sure to fail—and leave the American public with an unworkable and unadministrable system.

We should remember that the tax system is a means, not an end in itself. We should be content with general rules and straightforward provisions that meet our overall objectives, and not worry about the edges. As the saying goes, the best approach is often to "Just Say No!" When we hear of the special case, the need for the special exception, the unanswered question, or the potential abuse—we should remember that our efforts to do something may not succeed, and that the rules we write are sure to be everyone else's burden and everyone else's transaction cost.

3. *The Need for Stability.* One of the primary causes for complexity and taxpayer burden is constant change. One of the most important keys to simplicity is stability. By now, I'm sure the statistics are well recognized: since 1977 there have been 124 public laws amending the Internal Revenue Code; thousands of sections have been added or amended and the Code has more than doubled in size.

The tax law should and will change over time. Indeed, as Assistant Secretary Gideon has testified, the Administration is supporting a number of initiatives now pending before this Committee. The point is not to resist all change; the point is to recognize that the very fact of a law change imposes a burden on taxpayers, and that the cumulative effect of incessant "micro-modifications" can make the burden unbearable. The benefits of any proposed changes should be measured against this very real and very troublesome downside.

4. *Simplification is Always on the Agenda.* While it is essential to pursue a free-standing simplification agenda in the years ahead, it is equally important to recognize that simplification is always an issue. Substantive tax legislation and fundamental tax policy changes must be administered in the real world. Whenever laws or regulations are adopted or revised, we should always pose questions such as: What are the costs of implementation and compliance? Are there less burdensome and more administrable ways to achieve our overall objectives? We must pursue these matters with as much intensity and concern as the more traditional "policy" issues relating to impact on economic incentives, competitiveness, and horizontal and vertical equity.

II. COMMENTS ON SPECIFIC PROPOSALS

I would now like to turn to a number of proposals under consideration by the Committee. Assistant Secretary Gideon's Statement sets forth the Administration's position on these measures, including a variety of technical and revenue concerns.

Numerous witnesses will also comment on particular technical aspects of the legislation as currently drafted.

Rather than focus on specific legislative language and technical issues, I would like to summarize the "problems" that a number of proposals are trying to address, and the benefits that will be realized if the legislation can be crafted to meet its intended objectives. Hopefully, this will help provide benchmarks to evaluate specific proposals, and make clear that your efforts—if enacted—will have a profoundly positive impact on the American public and tax administration.

In the interest of time, I am limiting my remarks to a number of proposals that have broad impact on numerous taxpayers or illustrate innovative approaches to tax simplification. The fact that any particular provision is not covered does not suggest that it is unimportant or ill-advised. Most notably, Assistant Secretary Gideon has set forth the Administration's proposal to simplify the Earned Income Tax Credit (EITC). From our perspective, we are convinced that the proposal would improve the administration of the EITC and be of great help to the intended beneficiaries.

III. ADMINISTRATIVE PROVISIONS

Pending legislation contains a number of measures that do not involve the substantive tax law, but hold great promise for reducing the burden on taxpayers.

A. *State Cooperative Agreements*. Section 721 of S. 1394 would permit us to enter into reimbursable agreements with the states to enhance joint tax administration. This may not sound like much, but its potential impact is far-reaching. It will permit a meaningful reduction in burden for most taxpayers throughout the country.

Forty-two states impose some form of income tax; all fifty states impose taxes of one sort or another. Whether it's a low-income individual or small business required to file with the Federal government and his or her state of residence, an individual or business with more complex affairs required to file with the Federal government and several state taxing authorities, or a large business required to file with the Federal government and numerous state taxing authorities, the measure of burden and complexity involves taxation by all levels of government.

Under present law, we cannot enter into cooperative agreements with our state colleagues to reduce the burden on taxpayers. An initial endeavor along these lines would be to permit combined Federal/state electronic filing of tax returns. We successfully tested such a program in South Carolina this year and plan to expand the test to several additional states for the 1992 filing season. Under this approach, the taxpayer simply files his or her return once, electronically, with the IRS—and the taxpayer's done. We then distribute the appropriate information to the state. Joint electronic filing of returns would expedite refunds, enhance quality, and reduce costs to the taxpayer, the IRS, and the participating state governments. To put this effort in context, more than 7 million taxpayers filed electronically with the IRS during 1991, and we expect this number to exceed 25 million by the mid-1990's.

A second area where we could use this authority involves the wage reporting system. This system affects every employer; it is the backbone of our entire tax collection system at the Federal level and provides the information necessary to administer a number of Federal and State programs.

Employers face a frustrating and costly array of filing and reporting requirements in their dealings with the IRS, the Social Security Administration, and state and local government agencies. We are actively pursuing a national wage reporting system with our colleagues at the Social Security Administration and in state tax administration (working through the Federation of Tax Administrators). If augmented by the proposed legislation, this effort could lead to a system where all of the more than 5 million employers throughout the United States could meet all of their payroll tax filing obligations through a single wage reporting system.

B. *Payment of Taxes by Credit Card*. Section 103 of S. 1394 would permit the Department to enter into arrangements that would allow for the payment of taxes by credit card. While some of us had reservations at the outset, the idea is strongly supported by taxpayer and practitioner groups. It is essential if we are to make electronic filing available to 25 million taxpayers who file balance-due returns each year. It will also permit us to deal with certain types of delinquent accounts and installment agreements much more effectively. The payment of obligations by credit card is an overwhelming realty of the late 20th century, and it's high time that the IRS caught up.

IV. REFORM OF PAYROLL TAX DEPOSIT RULES

The payroll tax deposit system is the key to collecting Federal and state income tax revenues, as well as contributions for social security and unemployment compensation. It also affects every employer throughout the United States. And it is in desperate need of reform.

The following data highlight the importance of the payroll tax deposit system, summarize current rules, and illustrate enormous problems created by those rules:

- Accounts for 80% of all revenues collected by the Federal government.
- Approximately 5.1 million employers deposited close to $850 billion during FY 1990.
- The current deposit rules are as follow:

  —Daily: accumulate $100,000 or more
  —Eighth-monthly (eight times each month): accumulate $3000 but less than $100,000
  —Monthly: accumulate $500 but less than $3,000
  —Quarterly: accumulate up to $500
  —5% safe harbor for under deposits, with make up any shortfall required within 15 to 45 days (depending upon when the shortfall occurs)

- Net results of the current rules:

  —More than 1.5 million employers are assessed penalties each year (21.3% of penalties and 61.6% of penalty dollars subsequently abated).
  —Payroll tax deposit cases account for more than $30 billion (30%) of our $100 billion accounts receivable inventory and more than $13 billion (40%) of our currently not collectible accounts.

There are many reasons for this unacceptable state of affairs. Taxpayers, practitioners, and the IRS certainly share some responsibility. But I am absolutely convinced that a primary cause is the uncertainty and complexity generated by the current deposit rules.

In the first place, the eighth-monthly system is inherently unworkable. Businesses operate on some variation of weekly or monthly cycles. In all our looking, we haven't found anyone who thinks or functions on an eighth-monthly schedule.

Second, the accumulation rules—which require deposits to be made according to the accumulation of funds—lead to uncertainty and traps for the unwary. For example, if an employer's routine quarterly deposit liability is $2,800, it becomes accustomed to the monthly deposit requirement. However, if at any time during the month that employer accumulates more than $3,000 of payroll tax liabilities, it immediately moves to the eighth-monthly system. It may not realize that its deposit requirement has changed until it totals up its liability at the end of the month. By that time, it's too late—the taxpayer's caught, the penalty is assessed (in many cases, only to be abated several frustrating and costly months later). As a practical matter, numerous taxpayers may be subject to several different deposit rules during a quarter—and those requirements can change without notice.

Your colleagues on the House Ways & Means Committee are to be congratulated for first addressing this issue and proposing legislation to remedy the situation (H.R. 2775). The pending Senate proposal (S. 1610) would also simplify the deposit rules by eliminating the eighth-monthly rule and streamlining the payment schedule. Besides the large daily depositors ($100,000 or more), there would be only two types of depositors (other than household employers, as described later in my testimony):

1. Monthly depositors—those with quarterly liabilities of $18,000 or less; and
2. Tuesday/Friday depositors—those with quarterly liabilities greater than $18,000 (in essence, deposits would be required on Tuesday for payroll periods ending on the preceding Wednesday, Thursday, or Friday; deposits would be required on Friday for payroll periods ending on the preceding Saturday, Sunday, Monday, or Tuesday).

Without question, this proposal greatly simplifies the deposit rules. It also moves hundreds of thousands of small employers from the old eighth-monthly rule to a monthly regime. This is particularly beneficial to those small businesses who reconcile their books on a monthly basis.

As with H.R. 2775, the Senate bill provides additional certainty by requiring that taxpayers switch to a new system on a prospective basis, with one quarter lead time, based on prior deposit experience. Most notably, if an employer who has been on the monthly system accrues a liability of more than $18,000 during a quarter, that employer will not be required to move to the Tuesday/Friday deposit system until the

second calendar quarter following the quarter for which more than $18,000 was deposited. This should provide ample lead time to employers, and substantially reduce penalties for inadvertent mistakes.

At the same time, the IRS is firmly committed to changing the way it approaches trust fund cases. Imagine a world where the IRS could notify taxpayers, in advance, of the need to change deposit cycles—rather than imposing a penalty after the fact. Imagine a world where the IRS contacted employers within days or weeks after they appeared to miss a deposit obligation and did so with an offer to help—rather than an assessment (and 100% penalty claims) months or years after the fact. If the payroll tax rules are simplified, and if the IRS changes, the way it does business (and we will), this world can become reality in the years ahead. The net result would be a substantial reduction in cost and burden to the private sector, and substantial improvements in voluntary compliance.

In concluding on this subject, Mr. Chairman, I want to make several points. First, reform is long overdue. H.R. 2775 and S. 1610 would each make dramatic improvements over current law. The IRS initially recommended the approach of H.R. 2775, which essentially moved monthly depositors to the Tuesday/Friday or quarterly system. However, based on further review and consultation with various practitioner groups, we now prefer the approach of S. 1610, which largely eliminates the quarterly system and moves a number of eighth-monthly depositors to the monthly system.

Second, a number of private sector groups have expressed concern over some of the dollar thresholds in H.R. 2775. At the same time, the Treasury Department has indicated that the current thresholds in S. 1610 will result in an unacceptable revenue loss. I want to emphasize that the most important step to take is changing the structure of the rules: replace the eighth-monthly system with the Tuesday/Friday system; replace the accumulation rules with a requirement that taxpayers switch prospectively based on their actual prior deposit obligations. If we are willing to make these fundamental changes, I am confident we can find thresholds that will cause no loss of revenue and will benefit a substantial number of small employers.

V. PENSION SIMPLIFICATION

Along with Social Security and retirement savings, pension plans are essential to providing income security for the elderly. Demographics and increased life expectancies make it essential that all three "legs of the stool" function properly. Unfortunately, the current maze of constantly changing and exceedingly complex rules undermine the viability of the private pension system.

A. *The Perspective of Plan Sponsors.* IRS and the Department of Labor estimate current use of pension plans by private sector employers:

	Number of employers (Millions)	Employers with pension plans (Percent)	Number of employees (Millions)	Employees covered by pension plans (Percent)
All employers	4.0	20	80	55
Employers with 100 or fewer employees	3.9	18	33	24
Employers with more than 100 employees	0.1	70	47	67

From an overall standpoint, current data indicate that less than 55% of all employees are covered by qualified pensions.

While there are many reasons why small employers are not sponsoring pension plans, and employee coverage is limited, the complexity of the current rules is certainly a major contributing factor. We therefore applaud efforts to design rules that would permit employers with 100 or fewer employees to adopt truly simplified plans that would eliminate most transaction and paperwork costs, while providing significant incentives for meaningful pension savings. I recognize that a number of technical issues have been raised, and various dollar amounts and thresholds have been questioned. But the goal of providing a workable regime for small employers is a most laudable and important objective—and one that is within your reach. It won't be a panacea, but it will make simplification an option for those who are so inclined.

B. *The Perspective of Plan Participants.* Nowhere is the need for simplification more acute than with respect to the Code provisions that govern the tax treatment of pens ion distributions. The rules impose terrible transaction costs, create traps for the unwary, and discourage savings. They are also extremely difficult to admin-

ister, and result in widespread over- or underpayment of tax liability. For example, under current law:

- Only lump sum distributions can be "rolled over" into another retirement savings plan—and in order to do so, the funds must be distributed to and transferred by the beneficiary. This results in traps for the unwary, increased cost and burden to the individual, and a practical disincentive to continued saving.
- Lump sum distributions are also eligible for special 5 or 10 year averaging if the distribution is taken into income rather that rolled over. This adds enormous complexity for the sake of limited tax benefits, discourages continued saving, and undermines compliance by precluding any system that would assure the proper reporting of taxable income.
- There is a $5,000 death benefit exclusion that is of limited practical value, but creates additional record-keeping burdens and also undermines compliance by precluding any system that would assure the proper reporting of taxable income.
- Certain pension distributions represent the partially tax free return of prior contributions by the beneficiary. Publication 939, which explains how to compute the taxable portion of pension and annuity income, contains 10 pages of text and examples, 65 pages of actuarial tables, and two worksheets (one with 28 entries and one with 40 entries).
- Because of the complications in determining the taxable portion of pension distributions, up to 15% of the 30 million Forms W-2P furnished annually provide no helpful information to taxpayers who must make this calculation on their tax returns.

A number of proposals advanced by the Administration and H.R. 2730 would repeal the 5- and 10-year averaging options, repeal the $5,000 death benefit, mandate simplified basis recovery rules, permit the rollover of periodic distributions, and permit direct plan-to-plan rollover of distributions. As such, they would:

- Eliminate traps for the unwary.
- Provide additional savings incentives and eliminate disincentives.
- Repeal illusory options and replace the maze of uncertain and complex rules with simple and administrable provisions.
- Improve voluntary compliance by permitting the straight-forward determination of taxable income.

Mr. Chairman, of all the many simplification proposals pending before Congress, these may be the most important. They will have a direct impact on tens of millions of senior citizens in the years ahead. Some will argue that certain of the proposals are unfair or inequitable. Don't believe it for a minute. The rules we have today—with all their complexity, traps for the unwary, savings disincentives, and unadministrable provisions—embody all that's unfair and inequitable in our current system. The need for change is urgent and compelling.

VI. SIMPLIFICATION OF HOUSEHOLD EMPLOYER REPORTING RULES

Another area ready for simplification are the rules for reporting and paying employment taxes for household employees. Under current law, taxpayers are required to file five Federal forms and make five separate deposits of employment taxes each year for their household employees. These deposit obligation dates do not coincide with any other tax payment dates for individuals. Most household employers face a similar array of state filing and payment requirements.

The current FICA filing threshold is $50 of wages per employee per quarter. We feel strongly that the quarterly filing of Forms 942 and the annual filing of Form 940 (Employer's Annual Federal Unemployment (FUTA) Tax Return) impose an unacceptable burden on a typical household employer who otherwise would have to file a tax return only once a year.

The proposal would result in a very simple filing and deposit system for household employees. It would replace the quarterly 942 and annual 940 with a single schedule to be attached to the employer's individual Form 1040. The employment tax liability would be paid through the employer's personal withholdings or estimated tax payments. We estimate that the proposal will result in an 80-percent reduction in the burden of filing those forms. Coupled with other legislation I've already mentioned, it will give us the potential to combine Federal-state filing requirements. Finally, we believe this will result in a significant improvement in voluntary compliance. (Approximately 500,000 individuals make the requisite filings; Census and other data suggest that there may be two million household employers subject to these requirements.)

VII. LARGE PARTNERSHIP RULES

S. 1394 contains provisions for the simplification of both the reporting and audit systems for large partnerships. Generally, a "large partnership" is defined as one having at least 250 partners. For 1989, about 3,000 of the almost 1.7 million total partnerships had at least 250 partners. However, over 50% of all partners held interests in these 3,000 large partnerships. Therefore, while S. 1394 would affect less than one percent of the total partnerships, it would benefit over 50% of all partners.

A. *Reporting System*. Under current law, certain partnership items are separately stated on partners' income tax returns. Each partner takes into account a distributive share of income, gain, loss, deduction or credit. Elections are made at the partner level, and limitations are applied at the partner level. As a result, the information document return that a partnership furnishes to partners (Schedule X-1) has become very complex with almost 90 line items. For many years taxpayers have complained of the complexity of the Schedule K-1 and have requested a simplified information document.

The proposal would drastically reduce the number of items a large partnership is required to state separately to each partner. Elections would be made at the partnership level, and limitations would be applied at the partnership level. This would permit most of the 9 million partners of large partnerships to receive a simplified Form 1099-K in place of the complicated and lengthy Schedule K-1. Furthermore, a partnership having at least 100 but less than 250 partners would be eligible to elect this simplified reporting method. This could benefit an additional 650,000 partners. We believe that this proposal would provide much desired simplicity for the majority of partners and, or the IRS, would facilitate the matching of partnership items to the information reported on the partners' income tax returns.

B. *Audit System*. The Internal Revenue Code requires that all examination adjustments made to a partnership return be passed from the partnership to each partner who held an interest during the tax year under examination. This results in adjustments to the partners' returns for the years to which the examination adjustments apply. Likewise, any resulting penalties interest are assessed to the partners. For the IRS and and taxpayers alike, such adjustments are very cumbersome and expensive, in terms of resources, because the prior year income tax returns of partners must be recalled so these adjustments can be made. Many times, the adjustments are made long after the partner has disposed of the partnership interest. Moreover, adjustments that are quite large in the aggregate may be quite small at the individual partner level.

Under the proposal, adjustments resulting from the examination of a large partnership return would be treated as income to the partnership for the tax year during which the examination is completed; therefore, as a component of income, such adjustments would flow to the partners who hold interests in the partnership for that year—rather than to the partners who held interests in the partnership for the year to which the examination relates. In addition, the partnership would remain responsible for the payment of penalty and interest.

This proposal would eliminate the need to secure prior year returns of partners for adjustments and would end the practice of requiring partners to waive closure of tax years for which a partnership examination remains open. This would result in both more certainty for partners and a more streamlined administration of partnership examination adjustments by the IRS. Likewise, this would greatly facilitate the assessment and collection of tax, penalty, and interest resulting from large partnership examinations.

C. *Due Date for Furnishing Information to Partners*. The Internal Revenue Code currently requires partnerships to furnish statements to partners on or before the date of the partnership return (for calendar year partnerships, April 15 of the following year), including extensions. However, in order to timely file their income tax returns, taxpayers need their partnership information statements well before April 15. Even worse, if the partnership obtains an extension of the time for filing its income tax return, the partnership statements will be timely if distributed on or before the extended due date.

The proposed legislation would require partnerships to furnish information returns by the 15th day of the third month following the close of the partnership's taxable year (March 15, for calendar year partnerships). We think this proposal is workable for large partnerships, and is important because it will mandate that taxpayers receive their partnership information at a date which will permit them to file their individual tax returns in a timely manner.

VIII. SIMPLIFICATION OF FOREIGN TAX CREDIT

As we move toward a global economy, it is clear that individuals are beginning to make more foreign investments. The data showing the growth between 1989 and 1990 is striking: an increase from $10 billion to $14 billion of investments in foreign investment funds and an increase from $3 billion to close to $15 billion in foreign bond funds.

Consistent with these statistics, the number of individuals claiming the foreign tax credit is growing significantly. However, under current law, an individual with a small investment in one of these foreign funds is subject to all of the same foreign tax credit rules as are our largest multinational companies; even an investor in a domestic fund with a small amount of foreign holdings is subject to these complex rules. To claim the foreign tax credit, an investor must file Form 1116 which consists of 32 lines on 2 pages. However, before they do this, they must work through four pages of instructions. To complicate matters even more, an investor must file a separate Form 1116 for each type of foreign income.

S. 1394 simplifies this procedure for the small investor. Those taxpayers with $200 or less of foreign tax credits, all from passive investments where the income and credits are reported by third-party payers, will be able to claim the credit without filing Form 1116. However, the credit will be limited to 25 percent of the foreign source income. The impact of this proposal is that it spares 175,000 taxpayers from the need to prepare these forms at all. They don't have to pay anyone to prepare these forms. The practitioners, particularly the small practitioners, don't have to prepare them merely because the client has paid a small amount of foreign taxes. This proposal is clean and simple It reflects a basic notion that if it is small enough, it is not worth bothering with.

Of the universe of 640,000 who currently file Form 1116, 377,000 individuals claim foreign tax credits of $200 or less. However, the proposal will benefit only 175,000 of these; the other 202,000 have foreign income from other than passive sources and/or income which is not reported by a third party payor. If, however, these requirements were dropped, all of the 377,000 taxpayer with credits of $200 or less would benefit.

IX. EXPANDED ACCESS TO SIMPLIFIED INCOME TAX RETURNS

An integral part of tax simplification is the simplification of the forms which we require taxpayers to prepare each year. The IRS agrees that we need to expand access to simplified individual income tax forms. This goal is consistent with our continuous efforts to streamline the filing process and to reduce the corresponding taxpayer burden.

Section 109 of S. 1394 would require that we take appropriate actions to expand access to simplified individual income tax forms and to simplify the individual income tax returns. It would also mandate a report to the Congress listing the actions taken to meet this requirement and providing recommendations.

Before commenting on this proposal, I would like to describe briefly a number of simplification efforts we have underway. In the latter part of 1988, IRS established a strategic initiative to review and improve all activities associated with the production and distribution of tax forms and publications. We addressed problems and recommended improvements in design, technology, and forms simplification. We also undertook a study to ascertain taxpayers' ability to cope with tax forms and publications. Our goal was to recommend improvements to both. As a part of this strategic initiative, selected groups of employees in our field offices reviewed several of our major forms and instructions for the purpose of simplifying them and eliminating information not needed by taxpayers or IRS.

Another important aspect of the on-going forms simplification effort is obtaining and reviewing input from the public. We try to get as much feedback from the public as possible about whether taxpayers can understand the forms and publications. IRS also publishes advance proof copies of the major forms and instructions in the summer so taxpayers and tax practitioners get an early look at the forms. As an extra step, IRS often surveys taxpayers, asking them about the forms, instructions, and publications. Other initiatives include focus testing of new and revised forms and instructions, during which taxpayer-participants are asked to complete draft forms.

Specific examples of improvements made to the main tax forms as a result of IRS simplification efforts include:

—*Form 1040A—Elderly filers:* Beginning with the 1991 filing season, elderly taxpayers were allowed to use the shorter Form 1040A to report pension and annuity income. This opened up the door to a simpler tax filing for approxi-

mately 4.5 million taxpayers who can now report pension or annuity income, IRA distributions, and taxable social security benefits on Form 1040A. Other changes to Form 1040A permit it to be used by taxpayers who made estimated tax payments or want to claim the credit for the elderly or disabled.

—*Separate booklet for Form 1040EZ filers:* In prior years Form 1040EZ was included in a combined Form 1040A/1040EZ booklet that contained instructions for both forms. We discovered that some taxpayers found this to be confusing. Therefore, for the 1991 filing season, more that 19 million Form 1040EZ filers received a booklet containing only the Form 1040EZ and its instructions.

In addition to these specific improvements, IRS continues to encourage the wider use of the simpler Forms 1040A and 1040EZ for qualifying taxpayers. During the 1991 filing season, over 15 million taxpayers filed Form 1040A and over 13 million taxpayers filed Form 1040EZ. However, we are still not satisfied with these results and are continuing to explore further simplification alternatives for individual income taxpayers. One project underway now would reduce to an absolute minimum the amount of information a Form 1040EZ filer would be required to enter on the return and leave it to the IRS to compute the amount of tax or refund due. We tested this approach in one state (Texas) last year and will be expanding the test to three states in next year's filing season. Other initiatives are aimed at the large number of taxpayers who must use Form 1040 and supporting schedules simply because they have relatively small amounts of non-wage income or claim a few common itemized deductions. The goal of these initiatives is to permit these taxpayers to file a one or two page return providing summary income and deduction information on the return rather than on separate schedules. We have already discussed with your staff the idea of a simple return permitting itemizers who have only limited categories of deductions (e. g., home mortgage interest, charitable contributions and state and local income taxes) to claim them in this way.

As you can see, IRS is seriously and actively concerned with the simplification of its tax forms and wants to reduce the time required of taxpayers to comply with the law. In light of the ongoing nature of form design and development, we believe that the laudable objectives of 5.1394 may be better achieved through continued Congressional oversight and the continued, close working relationship between the IRS and Committee staff. While we view the proposed legislation to be in accord with our long-standing efforts in this area, and while we encourage continued Congressional oversight and attention in this important area, we believe that a formal study would simply duplicate our continuing efforts.

X. EFFECTIVE DATES

The timing of tax law changes can be as important as the substance of the changes themselves. The simplification measures in the pending legislation provide important benefits in terms of easing the tax system burden on tax professionals, commercial preparers, and the taxpaying public, not to mention Federal, state and local tax administrators. However, it is also important that the IRS is given adequate time to revise its forms and publications, reprogram its computer system and train its employees in the new law. Others affected by the changes who need adequate lead time include computer software companies that develop tax computation programs for accountants and taxpayers, tax professionals who must learn the new rules, and state and local governments that key their tax systems to the Federal system and who must revise their forms and computer systems. If these provisions can be enacted before the end of this month, it will still be possible to implement certain of them (including the EITC changes proposed by Assistant Secretary Gideon) in time for the upcoming filing season. If enactment is delayed, it will be necessary to reconsider the effective date for each provision to ensure that it can be implemented timely and without causing such confusion and disruption that the benefit of the provision is lost.

XI. CONCLUSION

Mr. Chairman, I believe that you and your colleagues have taken a very real and very meaningful first step down the road. I am convinced that the simplification legislation, as modified and improved based on comments by the public, will indeed make the world of living with the tax laws a lot easier for literally millions of small businesses and millions of American taxpayers. Thank you very much. This concludes my opening statement.

ATTACHMENT 1—OVERVIEW: IRS EFFORTS TO MAKE THE SYSTEM WORK BETTER FOR THE CITIZENS WE SERVE

Our mission requires us to increase voluntary compliance and reduce noncompliance, while *minimizing the burden on taxpayers* and costs to the government.

Our strategic plan sets our overall objectives, defines strategies to achieve those objectives, and provides benchmarks to assess our progress.

- "Reducing taxpayer burden" is one of our six overriding objectives;
- "one stop service" and "reducing lapse time" are among the strategies to deliver on this objective;
- and each of those strategies is embodied in measures and goals designed to assess our progress.

The five "drivers of change" that we believe will transform tax administration are all focused primarily on how we deal with taxpayers, on making the system work better for the citizens we serve.

- **Tax systems modernization** holds the promise of freeing up more than a billion hours and six billion dollars of time and money that our citizens spend in dealing with the tax system.
- Our commitment to **quality** is all about "customers"— meeting and satisfying taxpayers demands and expectations.
- **Compliance 2000** is a fundamental rethinking our approach to tax administration. It requires us to measure our success by our impact on improving voluntary compliance. It explicitly concludes that a primary cause of what we call "noncompliance" is complexity and burden—laws, rules and procedures that are barriers preventing taxpayers from properly meeting their obligations. While enforcement is a vital part of what we do, Compliance 2000 requires us to develop strategies that improve compliance through education, outreach and simplification.

- **Ethics and integrity** are the foundation of tax administration. Our efforts in this area go beyond the clear need to comply with our rules, regulations and procedures. We have learned that ethics and integrity tie directly to the ways we work with taxpayers, and taxpayer perceptions of the IRS and the system itself. Fundamental values require us to be fair, courteous, respectful and honest in our dealings with taxpayers; a system that is unduly complex and burdensome is an unfair, and ultimately unethical system.
- The IRS workforce, at all levels and in all functions must reflect the **diversity** of the society at large. We must meet this obligation because we are the government, and because Lit's required by applicable laws and regulations. More important, however, it's essential if we are to make the system work better for the citizens we serve.

OUTLINE AND SUPPORTING DATA

Introduction

- Cost and burden to the private sector
- Impact on voluntary compliance

Some General Observations

A. Does Simplification Require "Hard Choices?"
  1. Simplification Versus Revenue
  2. Simplification Versus Certainty
  3. Simplification Versus Equity

B. Is There a Constituency for Simplification?

C. Some Recommended Guidelines.
  1. A Long-Term Endeavor
  2. Embrace Rough Justice
  3. The Need for Stability
  4. Simplification is Always on the Agenda

A. ADMINISTRATIVE PROVISIONS

- Cooperative Agreements—State Tax Authorities
  —Electronic Filing
  —Wage Reporting System
  —Other
- Tax Payments by Credit Card
  —Electronic Filing
  —Delinquent Accounts

—Installment Agreements

B. REFORM OF PAYROLL TAX DEPOSIT RULES

Background (FY 1990 Data)

- Accounts for 80% of all revenues collected
- Approximately 5.1 million employers deposited close to $850 billion during FY 1990
- Current rules
  —Daily: accumulate $100,000 or more
  —Eighth-monthly: accumulate $3,000 but less than $100,000
  —Monthly: accumulate $500 but less than $3,000 — Quarterly: accumulate up to $500
  —5% safe harbor for under deposits; make up of shortfall required within 15-45 days
- Net results of the current rules:
  —More than 1.5 million employers are assessed penalties each year (21. 3% of penalties and 61. 6% of dollars subsequently abated)
  —Payroll tax deposit cases account for more than $30 billion (30%) of our $100 billion accounts receivable inventory and more than $13 billion (40%) of the currently not collectible accounts
- Some causes: uncertainty and complexity
  —Eighth-monthly requirement
  —Accumulation rules
  —Movement among four systems

The Proposal (S. 1610)

- Daily: over $100,000 in deposit obligations
- Tuesday/Friday after payroll date: over $18,000 per quarter
- Monthly: up to $18,000 per quarter
- $250/2% safe harbor, with make up to be specified by regulations
- Three-month lead time before moving to more accelerated requirements
- One-year look-back rule in determining whether to move to less accelerated rules

Impact

- Greater certainty
- Fewer penalty assessments
- IRS ability to work with taxpayers
  —Notify taxpayers that they must change to a different deposit cycle
  —Monitor deposits and promptly contact delinquent taxpayers

C. PENSION SIMPLIFICATION

Background

	Number of employers (Millions)	Employers with pension plans (Percent)	Number of employees (Millions)	Employees covered by pension plans (Percent)
All employers	4.0	20	80	55
Employers with 100 or fewer employees	3.9	18	33	24
Employers with more than 100 employees	0.1	70	47	67

- Tax Treatment of Distributions
  —Only lump sum distributions can be rolled over; funds must be distributed to and transferred by beneficiary
  —Lump sum distributions eligible for 5-year and 10-year averaging
  —$5,000 death benefit exclusion
  —Computation of table portion of pension distributions requires 10 pages of text/examples, 65 pages of actuarial tables, and two worksheets
  —About 15% of the 30 million W-2P's sent to pension recipients provide no helpful information on computing taxable income
- Net result of current distribution rules: terrible transaction costs, traps for the unwary, savings disincentives, administrative difficulties, wide-spread over- or underpayment of tax liability

Proposal

• Repeal the 5-year and 10-year averaging options, repeal the $5,000 death benefit exclusion, mandate simplified basis recovery, permit the rollover of periodic distributions, and permit direct plan-to-plan rollover distributions

Impact on tens of millions of senior citizens

• Eliminate traps for the unwary
• Provide additional savings incentives
• Repeal illusory options
• Replace uncertain and complex rules with simple, administrable provisions
• Enable employers to provide another 4.5 million pension recipients with needed information
• Replace 65 pages of tables plus 12 pages of worksheets, text and examples with ⅓ pages of instructions

D. SIMPLIFICATION OF HOUSEHOLD EMPLOYER REPORTING RULES

Background

• 500,000 families file up to five Federal Forms 940/942 and up to five state tax forms each year covering their household employees
• Five separate payment dates that do not conform to estimated tax payment due dates
• Current FICA threshold: $50 per quarter per employee Based on Census and other data, up to 2 million families should be filing these forms each year

Proposal

• Consolidate filing requirements: single schedule attached to Form 1040
• Raise FICA threshold to $300 per year
• Expand withholding estimated tax to cover household employer's deposit obligations

Impact

• Replace five forms and five separate payment obligations with a single schedule attached to Form 1040
• 80% reduction in burden of meeting filing, reporting and payment obligations
• Potentially combine Federal/state filing requirements
• Improve voluntary compliance

E. LARGE PARTNERSHIP RULES

Background (1989 Data)

	Total number of partnerships	No of partners (Schedules K-1)
All partnerships	1.65 million	18.3 million
Large partnerships (250 or more partners)	3,000	9.4 million
Partnerships (100-249)	4,500	650,000

• Current law

—Large partnerships subject to same reporting and audit rules as all other partnerships

• Result

—Staggering complexity for taxpayer/investors
—IRS audit efforts are not cost effective and are burdensome on taxpayers

Proposal

• Partnership level computations of income, deductions, credits and elections, resulting in one page, 10 line form (current K-1 replaced by 1099-K). 1099-K's would have to be provided investors by March 15
• Partnership level audit adjustments, with collection of interest and penalties at partnership level and flow-through of any net adjustments to their current partners (unless partnership elects to pay liability at the partnership level)
• Partnerships of 100-249 partners can elect into the system
• Provisions do not apply to service partnerships

Impact

• Dramatic reduction in burden and cost for an estimated several million taxpayers
• Administrable system from IRS perspective

F. SIMPLIFICATION OF FOREIGN TAX CREDIT

Background

	1989 (Billions)	1990 (Billions)
Dollars invested in foreign investment funds	9.9	14.3
Dollars invested in foreign bond funds	3.1	14.6

	1980	1984	1989
Number of individuals claiming FTC	287,500	371,900	640,000

Current law

• All foreign tax credit rules apply to individual taxpayers

—Must file 2-page, 32 line Form 1116, working through four pages of instructions
—Must file separate Form 1116 for each category of foreign income (up to 8 possible categories)

Proposal

• Limitations do not apply to taxpayers with $200 or less of foreign tax credits, all from passive investments where the income and credits are reported by third party payors

Impact (1989 data)

• Spare 175,000 taxpayers the need to file Form 1116 Relief targeted at investors in mutual funds who have no other foreign source income

	Amt of FTC	No. of taxpayers
Total claiming foreign tax credit		640,000
Claiming FTC:		
	$500	438,000
	400	417,000
	300	401,000
	200	377,000
Eligible for relief under current proposal		175,000

G. EXPANDED ACCESS TO SIMPLIFIED INCOME TAX RETURNS

• IRS agrees with need to expand access.
• Recent IRS initiatives:

—1988 strategic initiative on production and distribution of tax forms and publications
—Obtaining public input (proof copies, surveys, focus groups)
—Form 1040A—Elderly filers
—Separate booklet for Form 1040EZ filers

• Results: 15 million 1040A's and 13 million 1040EZ's filed in 1991 filing season.
• Future initiatives:

—Reduced entry Form 1040EZ (Form 1040EZ-1)
—Form 1040A-type return for taxpayers with small amounts of non-wage income or who claim limited categories of deductions (e. g., mortgage interest, charitable contributions, and state and local income taxes)

PREPARED STATEMENT OF BENSON S. GOLDSTEIN

My name is Benson S. Goldstein, Manager of the Tax Policy Center of the U.S. Chamber of Commerce. The U. S. Chamber is pleased to provide testimony on S. 1394, the Tax Simplification Act of 1991.

The Chamber supports the Committee's efforts to rationalize and simplify the current tax law. This statement focuses on simplification proposals relating to foreign taxation, the interest rate on large corporate underpayments, S corporations, the alternative minimum tax and the payroll tax deposit system.

FOREIGN PROVISIONS

The business community views simplification of the foreign provisions of the Internal Revenue Code as a high priority. Therefore, the U.S. Chamber of Commerce is very interested in working closely with the Senate Finance Committee towards that objective. The Committee should be commended for its efforts to simplify the Tax Code.

In order to achieve meaningful simplification in the foreign area, a review of complex sourcing and allocation rules is necessary. Basic simplification also necessitates a review of the underlying complexities of the foreign tax credit baskets and limitation rules, as well as analysis of the complicated rules governing deferral. Although some of the foreign provisions of S. 1394 may indicate a modicum of simplification, the provisions do not appear to provide much simplification in practice and appear to be almost as complicated as current law.

At a time when Congress and the nation are concerned about the competitiveness of U.S. industry in world markets, there is a fear among the business community that the foreign provisions of the Simplification Act may actually worsen to a degree the competitive standing of American corporations doing business in international markets and increase the tax burden of U.S. multinational corporations.

Deferral of Tax on Income Earned Through Foreign Corporations and Exceptions to Deferral

The Tax Simplification Act consolidates the anti-deferral rules applicable to foreign corporations earning substantial amounts of passive income. A single integrated system is created which provides for three different methods of taxation, dependent on the degree of U.S. ownership of the foreign corporation and whether the firm's stock is publicly held.

We commend the Committee for including proposals to repeal unnecessary anti-deferral regimes on income earned through foreign corporations. However, we are concerned that these proposals appear to be a further erosion of deferral under the guise of simplification. The Chamber believes retention of deferral is important to ensure that U.S. based multinationals are able to compete successfully abroad. Erosion of deferral results in U.S. multinationals being subject to a higher tax rate on their undistributed profits than their foreign competitors.

The U.S. Chamber is concerned about three modifications made to the tax law in the area of the consolidation of the anti-deferral rules which we believe are substantive changes in the law. These changes include the effective reduction in the present passive foreign investment company (PFIC) gross income test from 75 to 60 percent, and the denial of high-tax and export trade exceptions.

Reduction In the PFIC Gross Income Test

The PFIC rules, added to the Tax Code by the Tax Reform Act of 1986, were originally intended to address perceived abuses with respect to minority investments by U.S. taxpayers in overseas mutual funds. Unfortunately, controlled foreign corporations (the overseas subsidiaries in which a U.S. corporation has significant investment) have not been excluded from the scope of the PFIC provisions. It is the Chamber's view that meaningful simplification could be accomplished if controlled foreign corporations (CFCs) were excluded from the scope of the PFIC rules. CFCs should not be subject to the PFIC rules, especially since the passive income of CFCs is already subject to subpart F of the Tax Code.

Instead of eliminating the overlap between the CFC and PFIC rules, S. 1394 exacerbates the problem through the creation of a single anti-deferral regime, which the bill calls passive foreign corporations (PFCs). The legislation retains the current PFIC 50 percent asset test for purposes of the new PFC rules, but reduces the current PFIC 75 percent gross income test to 60 percent under the new PFC regime. This has the effect of increasing the number of U.S. shareholders of controlled foreign corporations subject to the new PFC rules, a result which cannot be viewed as simplification or anything other than a further erosion of deferral.

Denial of the High Tax Exception

To the extent income of a CFC constitutes foreign base company income under subpart F, that income is not eligible for deferral. Code section 954(b)(4) provides for a "high tax exception" to the definition of foreign base company income. This high tax exception is a general relief measure which ensures that foreign base company income subject to high income tax rates overseas is not subject to taxation under subpart F.

The bill departs from the current treatment of passive income under subpart F. In its merger of the current treatment of passive income under subpart F into the proposed PFC regime, the legislation eliminates the high tax exception with respect to the treatment of passive income under the new rules. The high tax exception is further eliminated for U.S. persons holding 25 percent or more of the shares in a PFC that is not U.S. controlled. Specialized rules are applied to U.S. persons owning less than 25 percent of a PFC. These new rules must also be viewed as a further erosion of deferral.

Denial of an Export Trade Exception

The Tax Code provides a modest tax incentive for exports called a Foreign Sales Corporation (FSC). A FSC is generally a subsidiary of a U.S. corporation which is organized in a foreign country and maintains company books and records at an office overseas. The foreign trade income of a FSC is classified as either exempt income or other income. Exempt income of a FSC is considered under the tax law as not effectively connected with a U.S. trade or business, and therefore, is treated as exempt from U.S. tax. The passive income of a FSC is not treated as exempt income.

If a FSC invests its foreign trade income, its earnings on that income would be treated as passive income and conceivably may become subject to the PFC rules. This situation may occur because FSCs are not exempt from the 50 percent assets test of the new PFC regime. The Chamber is concerned this situation may result in double taxation with respect to these earnings, particularly since the FSC provisions of the Code already subject the FSC's passive income to U.S. tax. For this reason we strongly recommend that FSCs be provided with an export trade exception from the proposed PFC rules. Without such an exception, the Chamber views this as a further erosion of the general concept of deferral under the tax law.

Provisions Affecting Controlled Foreign Corporations

S. 1394 makes a number of modifications in the treatment of income derived from disposition of stock in a controlled foreign corporation. With respect to certain of these modifications, the Chamber supports extension of Code section 1248 to sales of stock in lower-tier CFCs.

Under section 1248, if a U.S. parent has gain on the sale of stock in a CFC, the gain is treated as ordinary dividend income to the extent of the U.S. parent's proportionate share of earnings and profits in the CFC. Gain in excess of such earnings and profits is treated as capital gain. By extending section 1248 to sales of stock in lower-tier controlled foreign corporations as the bill proposes, Congress would accomplish true simplification and elimination of an aspect of the Tax Code which serves no legitimate economic or tax policy rationale. This proposal could achieve further simplification benefits if deemed dividends were allowed to be included in the scope of the same-country exception available to actual dividends.

The Chamber is opposed to the repeal of sections 960(a)(3) and (b). We strongly disagree with the Treasury position that the simplification achieved by repeal outweighs the "modest" burdens imposed on the business community. Sections 960(a)(3) and (b) permit a U.S. corporation to adjust its foreign tax credit limitation to prevent the loss of a credit for foreign withholding taxes imposed on distributions (received from a controlled foreign corporation) which represent previously taxed income. Repeal of these Code provisions is likely to increase the incidence of double taxation for U.S. multinationals resulting in further harm to the overall competitive position of American industry.

Translation of Foreign Taxes Into U.S. Dollar Amounts

Section 986(a) requires foreign taxes, paid in a foreign currency, to be translated into U.S. dollars on the "date of payment" for purposes of claiming a foreign tax credit. This provision was added to the Tax Code by the Tax Reform Act of 1986. Since a U.S. multinational is likely to enter into an extremely large number of separate tax payments in differing currencies on differing dates, the date of payment rule imposes highly burdensome recordkeeping burdens on those taxpayers.

Under the bill, the Treasury is given the authority to permit the use of an average exchange rate for an appropriate period, determined by regulation, rather than the exchange rate on the specific payment date. Although the proposal represents a small measure of simplification, the proposal does not address the true administration burdens placed on the business community by the 1986 Tax Reform Act changes. The Chamber recommends a return to the Bon Ami rule which was available prior to 1987. This is a relatively simple rule for taxpayers and the IRS to follow. Another option would be to translate foreign taxes on a "year of accrual" basis as opposed to the "year of payment" rule.

The Chamber is disappointed with the failure of the legislation to address basic simplification issues. In this regard, Senator Max Baucus (D-MT) has introduced S. 936, the Foreign Tax Simplification Act of 1991. Representative Bill Gradison (R-OH) has similarly introduced H.R. 2948, the Foreign Income Tax Reform Act of 1991, legislation which includes both meaningful simplification provisions and measures which are designed to improve the competitive standing of U.S. corporations in world markets. For purposes of the simplification process, the Chamber recommends the Committee give careful consideration to S. 936 and the simplification provisions of H.R. 2948. While modest in scope, these simplification measures should contribute to a lessening of the tax compliance burdens placed on U.S. corporations doing business in global markets.

PAYROLL TAX DEPOSITS

Simplification of the payroll tax deposit system is very important to the small business community. The current system is unnecessarily complex and warrants overhaul. The payroll tax deposit proposal of H.R. 2775 replaces the current deposit system with three basic deposit timetables. Under the general rule of the proposal, employers are required to make payroll deposits twice a week, on Tuesdays and Fridays, a procedure which would replace the current eight-monthly system. Second, the current law "large depositor" requirements are retained. Large depositors, defined as having payroll tax accumulations of $100,000 or more, are currently required to make deposits the next day. The third component of this proposed system involves employers with payroll tax deposit amounts of $3,500 or less per quarter for a previous two year base period. If an employer meets this threshold test, he is called a "small depositor" for purposes of the legislation and is only required to make payroll deposits on a quarterly basis. The basing of the small depositor rule on "a previous two year base period" could be referred to as a "look-back rule."

Under current law, small depositors (those with between $500 and $3,000 in payroll tax accumulations in any calendar month) are required to deposit those taxes once a month. Employers with less than $500 in payroll tax accumulations at the end of a calendar quarter are required to deposit such amounts once a quarter. The proposed small depositor rules of H.R. 2775 are clearly an acceleration of tax payments for many small businesses, because they would have the effect of moving certain small employers (those with monthly withholding accumulations of between $1,166 and $3,000) from a once a month payment schedule to the new Tuesday/Friday schedule. Therefore, the Chamber opposes the small depositor rule of H.R. 2775 which is based on quarterly payroll tax accumulations of $3,500 or less.

Senator Baucus has introduced legislation S. 1610, which would adopt a Tuesday/Friday deposit rule and increase the current monthly small deposit threshold from $3,000 to $6,000. The legislation would allow taxpayers with average monthly payroll tax deposit amounts of $6,000 or less (based on a previous four calendar quarter base period) to make deposits on a monthly basis. The Chamber supports Senator Baucus' small depositor rule.

Current regulations provide a five percent safe harbor regarding deposit shortfalls of employers with monthly payroll tax accumulations of $3,000 or more. Both H.R. 2775 and S. 1610 reduce this safe harbor to two percent. The Chamber opposes any attempt to reduce the current five percent safe harbor. Businesses, particularly those with multiple payrolls and a changing work force, encounter significant problems in accurately determining their withholding liability on a next-day basis -- many find it impossible. The five percent safe harbor provides employers with a modicum of flexibility.

A large percentage of IRS and taxpayer disputes over payroll tax deposits are a result of the unnecessarily complex system for determining the due date of deposits. In this regard, the Chamber conceptually supports proposals to base the frequency of certain payroll deposits on a Tuesday/Friday rule. We believe the current monthly deposit system should be maintained for purposes of defining small depositors. The current system could also be simplified by increasing the current $3,000 monthly deposit threshold and the Chamber supports the increase to $6,000 contained in Senator Baucus' bill. Further simplification can be achieved by adopting the proposed look-back rule for determining who is a small depositor.

INTEREST RATE ON LARGE CORPORATE UNDERPAYMENTS

Under current law, large corporate underpayments (underpayments by subchapter C corporations of any tax imposed for any period which exceed $100,000 for the period) are assessed interest equal to the federal short-term rate plus five percentage points.

The large corporate underpayment rate generally applies to periods beginning 30 days after the earlier of the date on which the initial letter or notice of deficiency, proposed deficiency, assessment, or proposed assessment is sent even if the initial notice is for an amount less than $100,000. As a result, nondeficiency notices relating to minor mathematical errors by taxpayers may result in the application of the large corporate underpayment rate to a subsequently identified income tax deficiency.

The bill would provide that for purposes of determining the period to which the large corporate underpayment rate is applied, any letter or notice of deficiency will be disregarded if the amount of the deficiency, proposed deficiency, assessment or assessment proposed in the letter or notice is less than $100,000. The application of this provision would help to ensure that corporations are not subjected to the underpayment rate simply because of a relatively minor error. The Chamber supports this provision.

S CORPORATION PROVISIONS

The complexity of the Tax Code presents special problems for small businesses. The U.S. Chamber is pleased that S. 1394 attempts to address areas of specific concern to S corporations. In general, the bill represents a step forward in simplification for an important segment of the business community.

Under current law, a business is not eligible for S corporation status if it has more than one class of stock. Differences in voting rights are disregarded in determining whether a firm will be treated as having more than one class of stock. The bill provides that a corporation is treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. While supportive of this provision, the Chamber recommends the Committee include report language to provide a clearer definition of the term "one class of stock." This would ensure that every disproportionate distribution does not create a second class of stock, but rather would be treated as what they really are -- additional compensation or gifts. The making of such payments should have no effect upon the determination of whether an S corporation has more than one class of stock.

Present law prohibits an S corporation from being a member of an affiliated group of corporations. The bill repeals this rule by allowing an S corporation to own up to 100 percent of the stock of a C corporation. However, the S corporation would not be allowed to be included in a group filing a consolidated return. The Chamber supports this move, but would recommend that the rule be expanded to allow S corporations to own up to 100 percent of the stock of another S corporation.

The proposed legislation also contains other provisions which are helpful and simplify the task of S corporations' compliance with the tax laws. For example, specific authority would be given to the Internal Revenue Service to validate ineffective or late S elections. S corporations would be treated as corporate shareholders in C corporations for purposes of permitting tax-free liquidation of C corporations into S corporations. These provisions are steps in the right direction.

ALTERNATIVE MINIMUM TAX

Corporate taxpayers are often required to compute depreciation in as many as seven or more different ways, including for regular tax, alternative minimum tax (AMT), financial reporting, and state income tax purposes. This necessitates using a variety of different declining balance rates for various kinds of property. Under the corporate AMT, alternative minimum taxable income (AMTI) is increased by 75 percent of the amount by which adjusted current earnings (ACE) exceed AMTI, as calculated before

the ACE adjustment. Corporate taxpayers generally must make two depreciation calculations for AMT purposes -- one using the 150 percent declining balance method for AMTI purposes, and another using the straight line method for the ACE calculation.

The use of two separate depreciation systems introduces an additional complication into an already complex system. S. 1394 eliminates the depreciation calculation under ACE, but maintains the depreciation calculation for AMTI purposes. The proposal creates one AMT depreciation system by applying a 120 percent declining balance method to personal property for purposes of determining the AMTI of a corporation. This change would eliminate additional recordkeeping for many taxpayers.

While the Chamber believes this proposal is a good first step toward simplification, we continue to be concerned that the large depreciation preference overstates economic income and, therefore, results in overpayment of tax by low-profit, capital-intensive firms. As in the foreign area, we urge the Committee to review the underlying policy of the AMT in a broader context than simplification.

PREPARED STATEMENT OF GLENN GRAFF

Mr. Chairman, my name is Glenn Graff, Chief Financial Officer and Executive Vice President of the Linbeck Construction Corporation of Houston, Texas. I appear today on behalf of the Associated General Contractors of America.

The Associated General Contractors of America is pleased to participate in this hearing on the Tax Simplification Act of 1991. The need to simplify the tax code is compelling:

- compliance today is impossible without high administrative costs and a practically unmanageable paperwork burden;
- pervasive uncertainty about what rules mean and how to implement them undermines compliance;
- lack of regulatory guidance is compounded by the backlog of new regulations projects; and
- lack of stability in the tax statutes and regulations thwarts long-range business planning.

The Associated General Contractors of America is a national trade association of more than 33,000 firms, including 8,000 of America's leading general contracting firms. They are engaged in the construction of the nation's commercial buildings, factories and industrial facilities, shopping centers, warehouses, highways, bridges, tunnels, airports, water works facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multi-family housing projects and site preparation/utilities installation for housing development.

Eighty-five percent of AGC's membership has gross receipts of less than $10 million annually; ninety percent qualify under the Small Business Administration's definition of small business.

We wish to express our gratitude to Chairman Bentsen, to Ranking Member Bob Packwood, to Taxation Subcommittee Chairman Boren, and to the Committee Members for their unwavering commitment to tax simplification.

This bill is a major achievement because of the overwhelming odds arrayed against meaningful tax legislation this year: a deficit which the Office of Management and Budget now estimates to be $68 billion larger than it projected for the same time last year, a budget agreement that strictly limits new expenditures, and the ever-present temptation to "decorate" available tax legislation with non-germane spending items. It was no easy task to craft a tax simplification bill that lost little, if any, revenue and adhered to the Committee's requirement that the underlying tax policy of current law must be maintained.

In spite of these constraints, you have put forward a bill that moves us in the right direction, toward tax fairness and true tax simplicity. This bill advances the goal of "rough justice" in the tax code, and moves away from the damaging and ultimately unattainable goal of theoretical purity. Thousands of new provisions have been added to the tax code since 1980, perhaps on the principle that "more is better." This legislation establishes a new principle: "better is better."

Tax fairness, and the country, will gain with passage of this bill because tax compliance will improve. It is no secret that tax compliance for small business is historically low primarily because taxpayers simply can't understand how to apply the perplexing maze of Federal tax rules. As IRS Commissioner Goldberg told Congress recently, "Most noncompliance is unintentional. Much of it is due to the complexity of the tax laws."

Construction firms faced with bewildering or unnecessary rules will win much-needed relief. Because construction accounts for nearly ten percent of the gross national product, the economy will win because construction contractors can spend more time on the job, not with their lawyers and accountants. Unintended consequences of current law that threaten business stability and succession will be clarified or corrected. You may hear today about what some may believe this bill does not do. But the fact is that every construction firm will benefit if this forward-looking legislation becomes law.

AGC testimony will focus on four provisions of S. 1394:

- A proposed new ten percent look-back de minimis rule in Title IV B,
- A proposed new ten percent look-back de minimis rule in Title IV B,
- Clarification of the S corporation one-class-of-stock rules in Title IV A,
- Treatment of distributions by S corporations during a loss year in Title IV A, and
- Authority to validate certain invalid S elections in Title IV A.

A PROPOSED NEW TEN PERCENT LOOK-BACK DE MINIMIS RULE

The 1986 tax act added a new provision called the look-back rule in accounting for long-term contracts. The look-back rule essentially requires a construction firm to file a completely new tax return for every contract that is subject to look-back in the year the contract is completed and to refile it in subsequent years if income or costs in the contract change.

In the year a long-term construction contract is completed, the construction firm must go back and substitute for each year the contract was in progress, the actual costs and revenues for the estimated costs and revenues used in prior years' tax computations. Taxes for all prior years must then be recalculated for both regular and alternative minimum tax purposes. Next, the difference between the taxes actually paid each year and the taxes that would have been paid, had actual figures rather than estimates been used, must be calculated. Finally, daily compounded interest, subject to rate change on a quarterly basis, must be calculated on that difference. The construction firm then either pays interest to or receives interest from the government.

If any tax provision is a misdirected attempt to achieve technical purity in the code, it is the look-back rule in Section 460 of the Internal Revenue Code as it applies to the construction industry. The Internal Revenue Service estimates that it takes three hours and forty minutes just to read and comprehend form 8687, the look-back reporting form, and an additional seventeen and one-quarter hours just to complete it. Many construction firms spend more to comply with the look-back provision than they pay in interest to or receive in refunds from the government.

Because look-back compliance costs are deductible business expenses, the government actually incurs a net revenue loss that is not measured when the government calculates the revenue effect of the look-back rule. Much of the true cost of this burdensome rule is in effect "off-budget." If normal accounting principles, and the principles of sound public policy, were applied to the look-back rule, it would receive far greater scrutiny.

The underlying premise for the look-back rule is a mistaken assumption that construction contractors defer income from their long-term contracts. Unlike other taxpayers who are manufacturing contractors, such as those in the defense industry, construction firms must recognize, not defer, income to satisfy banking relationships and to obtain adequate bonding capacity.

A 1986 General Accounting Office study reported that construction firms deferred a mere six percent of the taxes that were deferred by manufacturing firms. Construction is a highly competitive business, with profit margins often of one to two percent. A construction firm cannot successfully bid on new work without adequate surety bonding. The bonding capacity of a construction firm is approximately twenty to twenty-five times the working capital available to the company.

Surety bonding is also highly competitive. Surety companies closely examine the financial statements of construction contractors to assess their financial health. Bonding companies frequently call for the contractor's tax returns, and any variance between book and tax income must be disclosed. Deferred taxes impair and

limit bonding capacity because they indicate future liability and decreased working capital. Construction contractors prefer to accelerate, not defer, recognition of income in order to build up working capital and maintain access to the maximum amount of surety bonding.

The look-back provision has also been justified as a deterrent against the underreporting of income. Unlike any other section of the tax code, Section 460 incorporates an enforcement mechanism into a basic income tax accounting provision and then applies that mechanism to a particular industry.

However, the Internal Revenue Code already has stiff penalties for negligence or disregard of rules or regulations and substantial understatement of income tax. The new accuracy-related penalty found in Code section 6662 imposes an addition to tax of twenty percent of the amount of an underpayment resulting from the taxpayer's inaccurate reporting. There is no exception for underpayments attributable to the underreporting of profit on a long-term contract. Section 6662 works. It mandates proper reporting. It provides effective penalties. It is a strong deterrent to any underreporting by construction firms, just as it is to other taxpayers.

The proposed ten percent look-back tolerance factor for the application and reapplication of look-back will benefit every construction contractor not currently exempt from application of the look-back rule. Even though a contractor would still be required to apply the first step of the look-back calculation under the election not to apply the look-back method for de minimis amounts, contractors with multiple look-back contracts will face a significantly lower administrative burden. A large percentage of AGC general contractor members who have long-term contracts also have multiple look-back contracts.

My own company recently completed an analysis of the post-completion costs for all of our contracts over the past ten years to which look-back would have applied had it been in effect. Of the one hundred sixteen contracts which had post-completion costs, seventy of the contracts had post-completion costs of less than ten percent of contract profit. During this same ten year period there were only three contracts with post-completion revenue.

The experience of my company and many others demonstrates that the look-back rules result in more interest refunds to taxpayers than in interest payments to the government. One AGC member recently filed for a look-back interest refund for $257,000. The IRS refused to pay. The Service asserted that even though the construction firm was owed the refund, it was not required to pay. Only after weeks of negotiation was the matter resolved and payment received.

Rather than preparing bids for new work or finding new ways to be competitive, the current rules force my firm to spend an enormous amount of time and company resources making calculations and filing forms with the IRS to claim interest which we never owed in the first place. In the intensely competitive construction industry, we have no margin for error. Every administrative burden imposed on us by Washington threatens our competitiveness. When you add them all up, the weight of these regulatory burdens can endanger a construction contractor's survival.

We estimate that for the current fiscal year, our firm will expend forty to fifty manhours in complying with the look-back regulations. We will incur additional cost in reviewing these computations with our independent accountants. Under the proposed simplification bill, we would expect a fifteen to twenty percent reduction in the cost of complying with look-back. In addition, because the bill would substitute an annual interest rate for the quarterly rate now in effect, construction firms would have to use only one interest rate in their look-back calculations, rather than the twenty-one interest rates now in effect. This simplification bill offers real relief that construction contractors will see on the bottom line—without any revenue loss to the government.

CLARIFICATION OF S CORPORATION ONE-CLASS-OF-STOCK RULES

The simplification bill also modifies current statutes and proposed regulations by clarifying that a corporation is treated as having only one class of stock if all the outstanding shares of the corporation confer identical rights to distribution and liquidation proceeds. According to IRS statistics, about one in four corporations in the United States, or about one million businesses, operate as S corporations. About two-thirds of AGC general contractor member firms are S corporations. The law requires that S corporations have only one class of stock. Congress ratified this requirement out of concern about the complexity that could result from allocating an S corporation's income and losses among the holders of different classes of stock.

This legislative clarification was introduced after the IRS issued proposed regulations on October 5, 1990, after nine years with no regulatory guidance, that would determine that an S corporation has a second class of stock if distributions to share-

holders differ in timing or amount. The penalty for finding a second class of stock is termination of the S election.

Consider, for example, two taxpayers who operate a family business. They probably organized their family business as an S corporation in order' to avoid the double tax on distributed earnings and to avoid the more complex rules that pertain to C corporations. Each owns 1,000 shares of stock and each receives a $50,000 distribution during the calendar year. Taxpayer A receives his money on March 1, and taxpayer B receives a distribution on July 1. Under the initial proposed regulations, the distributions are unequal, and the corporation has two classes of stock. In fact, any minor difference in the timing or amount of distributions to different shareholders would be considered as creating a second class of stock. Termination of an S election could result in an increased tax liability of as much as 88%, according to the Small Business Administration.

When the extent of the potential damage that might be imposed on many thousands of S corporations became apparent even to the IRS, the initial proposed IRS regulations of October 5, 1990 were replaced. The new proposed regulations resolve many problems, but they do not go far enough. S. 1394 provides that applicable State law, determined by taking into account legally enforceable rights under the corporate charter, articles or bylaws and any agreements, determines whether the outstanding shares confer equal rights to distribution or liquidation proceeds.

The new proposed IRS regulations provide that certain types of state laws and binding agreements are disregarded in determining whether all of a corporation's outstanding shares of stock confer identical rights.

State law should take precedence. The provision under section 401 of the Senate bill is preferable to the reissued proposed regulations because it is far easier to understand and implement without sophisticated tax planing. Moreover, the Senate bill specifically provides that where an S corporation in fact makes distributions which differ as to timing or amount, the Internal Revenue Service is not restricted in its ability to properly characterize the transaction for tax purposes.

Congress clearly stated, when it passed the Subchapter S Corporation Revision Act of 1982 that it intended to simplify the law, and to remove traps for the unwary.

The proposed legislative change in S. 1394 promotes simplification by reaffirming current law and Congressional intent.

Authority to Validate Certain Invalid S Elections

The simplification bill extends the authority of the Internal Revenue Service to waive the effect of an inadvertent termination to also waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents.

Under current law, a small business must elect S corporation status no later than the 15th day of the third month of the taxable year for which the election is effective. The IRS cannot validate a late election. But the consequences of an inadvertent late election can be enormous to the taxpayer.

This proposed change promotes tax simplification and fairness because it is in the spirit of Congress' intent as expressed in the Subchapter S Revision Act of 1982, which is to facilitate qualification of the S corporation. Disqualification should not be the automatic consequence of a mistake where other remedies are available.

TREATMENT OF DISTRIBUTIONS BY S CORPORATIONS DURING ASS YEARS

This proposed change provides that the adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year.

The S corporation rules regarding adjustments are now often interpreted to require application of adjustments to basis before adjustments for distributions. This can reduce or eliminate the ability to pay dividends.

Because an S corporation is a pass-through entity more like a partnership, the treatment afforded distributions under the partnership rules is the more appropriate treatment. This provision would conform the S corporation rules regarding distributions to the more favorable partnership rules.

CONCLUSION

AGC hopes that these comments assist the Committee in its review of tax simplification. AGC looks forward to working with the Committee to advance tax policy that promotes certainty, provides stability, and reduces the huge sums taxpayers

spend every year to comply with our swiftly changing laws. AGC is pleased to support the Tax Simplification Act of 1991.

PREPARED STATEMENT OF JAMES H. MACK

Thank you, Mr. Chairman, and good afternoon. My name is James Mack, and I am Vice President for Government Affairs of NMTBA-The Association for Manufacturing Technology. NMTBA is a member of the Invest To Compete Alliance (ITCA), a non-profit group of corporations and trade associations founded in 1985 to address the economic challenges facing the nation's capital-intensive industries and related service industries.

We appreciate this opportunity to present our views on the important issue of tax simplification, specifically as it relates to the corporate Alternative Minimum Tax or AMT. This is a matter of widespread concern because all corporate taxpayers must calculate the AMT to determine whether or not they must pay the AMT. These ANT calculations are an extremely complex burden for American industry.

As you know, the AMT was implemented as part of the 1986 Tax Reform Act in an effort to ensure that corporate taxpayers paid a minimum tax. At that time, the ANT was envisioned as applying to only a few companies. It made political sense and it appeared reasonable, but in fact, the actual structure of the AMT has resulted in a much greater number of taxpayers being in the ANT periodically than was originally expected.

The corporate ANT was targeted at large corporations that report high book profits to their shareholders while reporting low taxable income to the Internal Revenue Service. In practice, however, the ANT has primarily and unexpectedly struck at small and medium-sized companies that are only marginally profitable, as well as companies that make large equipment investments to improve their productivity and competitiveness.

The problem for American industry is two-edged. For taxpayers in the ANT position, it means an increased cost of capital for investment in the plant and equipment necessary to grow and be competitive. Without question, the ANT discourages investment. Beyond this problem, the ANT turned out to be complex almost to the point of being unworkable for both the taxpayer and those charged with auditing compliance.

Under current law, the most complicated part of the IT calculation is the need to make two separate depreciation calculations in computing the alternative minimum taxable income beginning in 1990. The corporation first determines its Alternative Minimum Taxable Income (ANTI) using 150 percent declining balance depreciation; this yields a smaller depreciation deduction than is allowed under the regular tax. Starting with 1990, all companies, whether they fall under ANT or not, now must also keep an additional separate set of books for Accelerated Current Earnings (ACE). That is because ANTI must be increased by 75 percent of the amount by which ACE exceeds ANTI as initially calculated. ACE requires capital-intensive companies to further decelerate depreciation all the way down to the straight-line rate, not only for newly acquired equipment but also for equipment acquired prior to 1990.

In 1989, legislation was introduced in the House that recognized that this double calculation would be an overwhelming burden in determining ANTI and enforcing compliance. The bill also redressed the unforeseen economic penalty that would occur for ANT taxpayers as they went through the transition from the ANT system used in 1987-89 to a new system beginning in 1990. This bill, introduced by Chairman Rostenkowski, would have integrated the double depreciation calculations into one calculation, and would have eliminated the transition economic penalty. The bill also eliminated the burdensome book income depreciation limitation.

However, revenue estimates associated with removing the economic penalty resulted in the Chairman's bill not being enacted in 1989, except for the one element of simplification that removed the book backstop.

Our coalition strongly supports the ANT simplification provision that is now proposed in 5.1394 and H.R. 2777. This is an important step forward, and we applaud Congressional efforts to simplify the ANT by integrating the double calculations into one.

While we strongly support and endorse this initiative to simplify the ANT calculations, that proposal alone will not achieve true simplification. Because the effective date of the simplification proposed in 5.1394 and H.R. 2777 is for tax years beginning after 1990, property placed in service in 1990 will still be subject to the compli-

cated double calculation that the proposed simplification amendment seeks to replace for years after 1990.

We recommend that the Committee modify the proposed ANT simplification provision to remove the requirement to treat property placed in service in one year, 1990, with the current law double calculation. Otherwise, property placed in service in 1990 when ACE went into effect must continue to be treated under one formula and all post-1990 property under another formula.

There are several alternatives that could be adopted to eliminate the need to deal with property placed in service in 1990 under a separate formula. The effective date of the simplification provision could be made January 1, 1990, requiring all taxpayers to recalculate their 1990 returns.

As a second option, the January 1, 1991, effective date could be kept but an election could be provided for taxpayers to go back and amend their 1990 returns to use the new simplified calculation for 1990 equipment. The taxpayer could then use the new simplified calculation for that 1990 equipment in subsequent years.

A third option would be to provide that taxpayers be allowed to use the new simplified calculation on 1990 property, using the remaining basis in 1991 as if the 120 percent declining balance method had been used in 1990. Under any of these three alternatives, true simplification would be achieved, the revenue impact would be negligible, if any, and compliance enforcement would be made much easier.

The ANT is a great handicap to the ability of American industry to invest in the plant and equipment which makes these entities more productive and competitive. Recent studies by the Center for Policy Research of the American Council for Capital Formation found that U.S. firms paying the ANT recover their investment costs for new equipment much more slowly than do companies in major competitive nations such as Japan, Germany and South Korea. Furthermore, the studies found that the AMT may cause a corporation to actually forgo additional investment in productive equipment to avoid ANT status.

The ANT selectively discourages firms from investing in the capital equipment necessary to compete in international markets. The ANT increases the cost of capital relative to our competitors' cost at a time when America should be aggressively engaging foreign firms in the global marketplace. The ANT drives merger and acquisition activity where certain corporations find that because of their ANT position, they must merge with or be acquired by non-capital intensive companies, or foreign companies, to continue to invest and survive. Finally, in these recessionary times, when we should be encouraging capital investment to bring about renewed economic growth, the ANT actually discourages these important investments in our nation's future. To understate, that is not a desirable result of tax policy.

Let me conclude by again urging the adoption of the AMT simplification provision in S. 1394 and H.R. 2777 but with an amendment to address the 1990 property depreciation issue I discussed. I thank the Committee members for your concern and in closing urge your continued study of the IT to fully understand its impact on American business and industry.

PREPARED STATEMENT OF ROBERT N. MATTSON

My name is Bob Mattson. I am Assistant Treasurer of the IBM Corporation responsible for the Company's worldwide tax operations. I appreciate the opportunity to be here today to present the National Association of Manufacturers' (NAM) views on the pending legislation for simplifying the United States tax code. I will particularly address those issues affecting the overseas operations of the U.S.-based global companies.

When in 1986 Congress and the Administration concluded the process of reform of the tax system, the underpinning elements of that agreement were lower statutory tax rates and a broadened tax base, both to serve the goals of equity and efficiency. At the same time, there was an expressed objective of simplification. The rates, the base and simplicity of the tax code are intertwined. But four years of experience has convinced NAM membership that the simplicity leg of the agreement is wobbly, to say the least. The provisions applying to a company's foreign operations are unnecessarily burdensome and complex.

NAM commends Senator Bentsen for his leadership in introducing a primary tax simplification bill. We also commend the staff who worked on the obviously enormous effort to produce S. 1394, the Tax Simplification Act of 1991, and the accompanying technical explanation. Additionally, NAM applauds the recent bill 5.936, the Foreign Tax Simplification Act of 1991, introduced by Senator Baucus. It would substantially simplify the rules governing international activity by U.S.-based compa-

nies without materially affecting their U.S. tax liabilities. NAM urges the Committee to include the provisions of S. 936 in the tax simplification bill.

TAX RATES

It should be the first goal of tax simplification to maintain the existing corporate tax rates, and work to reduce the distortions within the corporate alternative minimum tax.

The U.S. corporate tax rate has resulted in substantial benefits to U.S. global companies. This is not merely because the 1986 Tax Reform Act reduced corporate taxes. A major, and often overlooked, benefit from a reduced U.S. corporate tax rate is that it served to encourage other countries to significantly lower their tax rates. (See Attachment I for a list of some of these changes.) These reduced foreign taxes allow greater amounts of dividends to be repatriated for investment in the U.S. and enhance the amount of returns paid by U.S. parent companies to their shareholders with a positive economic benefit to the U.S. economy.

Corporate tax rate increases or surtaxes can make otherwise sound business transactions uneconomical, resulting in competitive losses for U.S.-owned business. In addition, high tax rates are the enemy of simplicity in that they eventually lead to further complexity as exceptions and special rules filter into the tax code to avoid these consequences. The 1986 tax rate reductions, unquestionably the most positive tax policy achievement of the last decade, should under no circumstances be reversed.

FOREIGN PROVISIONS

Another dramatic change in the 1986 Tax Reform Act was the layer upon layer of complex rules that were directed at U.S. corporations' activities outside the U.S. Many of these provisions did not raise revenue but were enacted because of the fear that in some way the lower U.S. rate operating in conjunction with the foreign tax credit had to be back-stopped by a set of complex protective rules. After examination of these rules, most experts agree that the level of complexity is unwarranted. It is important to note that similar costs and pressures involved in complying with these rules are not borne by companies based in other countries with which U.S. companies compete.

Attachment II provides an overview of the burdensome compliance work required to prepare the annual tax return information relating to foreign operations of U.S. companies.

What was imposed on America's global companies in the 1986 Tax Reform Act included:

- Nine multiple complex separate limitation "basket" calculations of the foreign tax credit. Furthermore, the "10-50" basket can result in hundreds, if not thousands, of separate limitation calculations depending on the form of joint venture operations abroad.
- Complex allocations of numerous categories of domestic expenses.
- Uncertainty in a new set of very complex source rules.
- Complex calculations of non-U.S. entity-by-entity "earnings and profits" pools.
- Burdensome translation of foreign taxes causing many companies thousands of hours of wasted effort with no revenue impact.

There is an urgent and compelling need to relieve the burden of complexity of these rules affecting the foreign operations of U.S. companies. The labyrinth of these foreign tax credit restrictions add needless complexity with little or no tax revenue involved. The member companies of NAM have experienced an increased burden for the cost of data collection, an increase in tax return preparation time, increased costs to deal with the dazzling maze of intricate compliance steps in meeting the rules, and increased compliance personnel requirements. Since 1986, taxpayers have uniformly observed the exhaustion of intellectual and other resources to comply with these foreign source rules.

For this reason, we urge the incorporation of S. 936 in the foreign provisions of S. 1394.

While S. 1394 intends to unify and replace the anti-deferral rules, much of today's complexity remains. The changes simplify very little and are more onerous than current law. The bill also modifies certain rules affecting controlled foreign corporations, but these are mainly technical changes, not simplification. The bill repeals Section 960 (a)(3) and (b) on the pretext that only a few taxpayers are affected, and NAM opposes this restrictive change as a most unfavorable one which may impact a number of its member companies.

Furthermore, S. 1394 lacks a realistic solution to the foreign tax translation rules and does not address the "10-50" basket problem related to non-controlled Section 902 corporations. These two provisions have had universal complaints. Also, the bill does not redress the application of the uniform capitalization rules to foreign corporations.

NAM enthusiastically supports S. 936, Senator Baucus's foreign tax simplification bill, both from a simplification and competitiveness point of view. Its five provisions cover some of the most egregious complexities affecting foreign activities of U.S.-based companies. It provides real compliance simplification for all corporations active in world markets. Other than the provision eliminating the separate foreign tax credit limitation for dividends paid by each "10-50" company, it could be scored as nearly revenue neutral.

A further provision to be considered with and complementary to S. 936 is a revision of Section 6046. The provision currently requires information reporting for minority investments as low as five percent by U.S. shareholders in foreign corporations. The five percent investment threshold is not otherwise relevant for U.S. tax purposes. NAM recommends that the threshold be increased to ten percent for such information reporting.

CONCLUSION

One of the most disturbing myths burdening American tax policy today is that simplification results in lost revenue. In many cases, simplification will actually increase revenue by reducing unnecessary costs of compliance. In addition, it is time to discard the idea that there is a tradeoff between simplification and fairness. Simplification of our tax laws is fair, it's the right thing to do and I am confident it will result in increased, not less revenue. NAM appreciates and supports the Finance Committee's recognition of the need to simplify the nation's tax structure and will work with your staff toward that goal in any way we can.

Attachment I—WORLDWIDE TAX REFORM STATUTORY RATE REDUCTION SINCE 1986

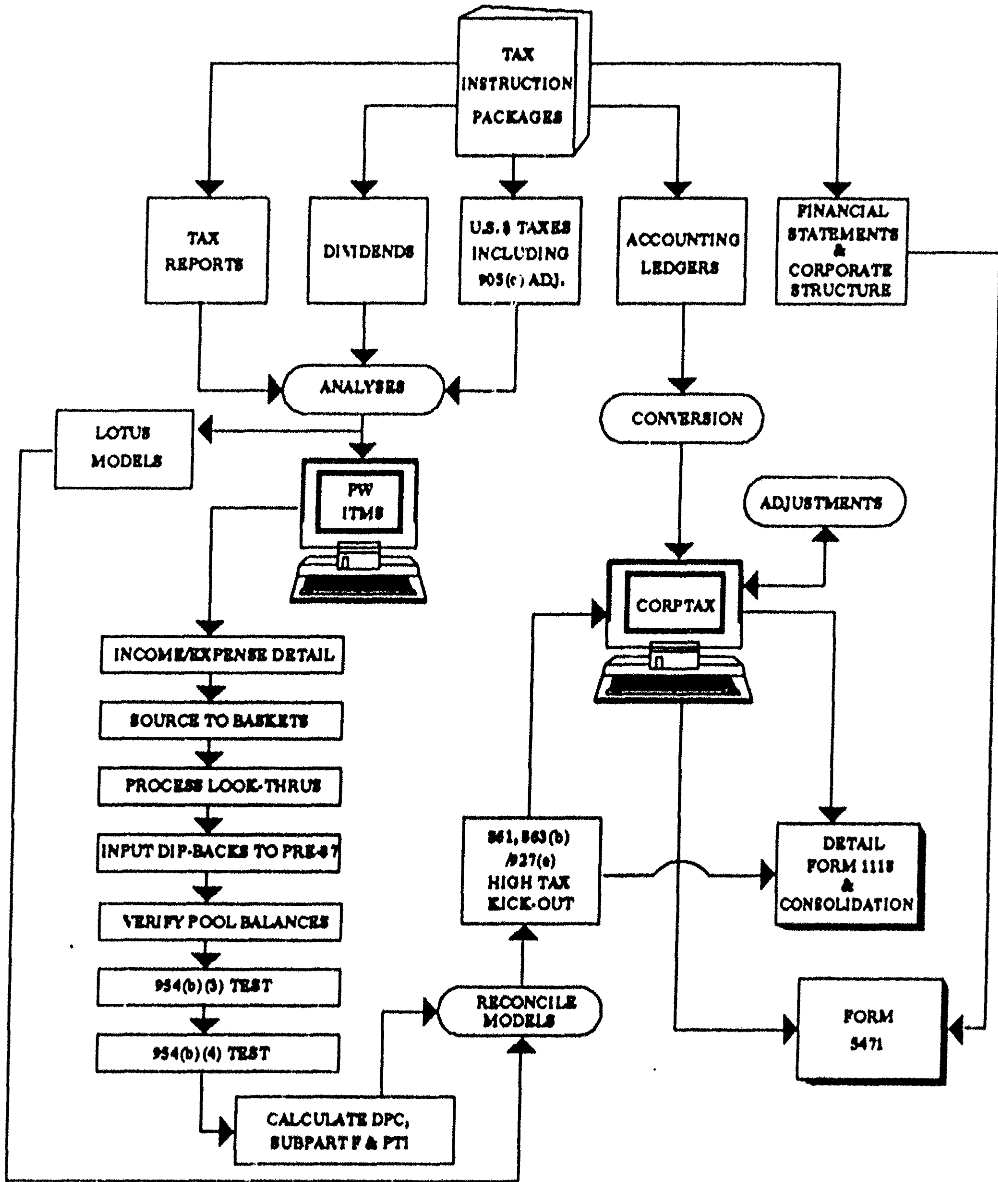
	Corp income tax rate		Combined Div. and Inc tax rate	
	1986	1992	1986	1992
USA (+ States)	50	38		
Argentina [2]	33	0	53	20
Australia	46	39	54	39
Austria	45	39	50	[1] 42
Belgium	45	39	53	[1] 42
Canada	52	42	57	48
Chile	10	15	37	36
Colombia	40	30	52	30
Denmark	50	38	53	41
France	50	34	53	[1] 45
Ireland	50	40	50	[1] 40
Korea	44	34	50	41
Mexico	42	35	61	35
Netherlands	43	35	46	[1] 38
Peru	55	30	69	37
Spain	35	35	48	[1] 42
Sweden	52	30	54	34
U.K. (Div. Tax Refund)	45	35	39	[1] 26
Venezuela [2]	50	30	60	30

[1] Favorable Tax Treaty with U S

[2] 1992 Proposed Rates

ATTACHMENT II

INTERNATIONAL TAX DATA FLOW



INTERNATIONAL TAX DATA FLOW—DISCUSSION OF ATTACHMENT II

"Tax Instruction Packages" are sent by the Company to over 120 non-U.S. countries (subsidiaries and branches). This generates over 3,000 separate "Tax Reports" prepared by the countries and sent to the U.S. parent company. There are 31 different reports that a country entity prepares.

"Dividends" analysis information is obtained from country entities with amounts remitted, dates of payment, exchange rates for currency translation, and withholding tax information. Each individual income tax payment by the foreign entity is converted into U.S. dollars as of the tax payment date. Extensive "Analyses" of adjustments under Section 905 (c) are prepared.

"Tax Reports" received from foreign entities must be examined and cross-checked to verify accuracy. Data inputs and calculation of earnings and profits adjustments are verified prior to input into the Price Waterhouse International Tax Management System ("PW ITMS"), an elaborate computer software program with numerous modules.

Company self-developed "Lotus Software Models" calculate deemed paid foreign tax credits related to dividends from each entity. Overall basket information is controlled by the Lotus Models, as back-up to the PW ITMS software. PW ITMS is used to perform numerous tax calculations by legal entity and for foreign tax credit baskets including subpart F and previously taxed income amounts.

"Income/Expense Detail" for each CFC is recorded by each individual income category for purposes of calculating subpart F and baskets. This work includes 24 individual income categories and nine columns of information to spread income, expense and taxes for each income category which then must be "Sourced to Baskets" prior to the look-thru calculations. Earnings and Profits adjustments must also be categorized by basket in order to accomplish proper look-thru analysis.

PW ITMS is then utilized to "Process Look-Thrus" for related interest and dividend calculations. Calculations on a 386-Chip Microprocessor require five hours for each look-thru payment revision using the PW ITMS. The look-thru payments require the characterization of any recipient of dividend or interest from a related party to reflect the underlying character of the payor's income. The look-thru calculations analyze all entities within the chain of ownership prior to final look-thru determination.

Various statutory "Tests" are made on the data. It is necessary to arduously "Verify Pool Balances" and where necessary, manual additions of deemed paid credit information for "Dip-Back to Pre-1987" layers are calculated.

The "Corptax" software is an additional program utilized to prepare the consolidated federal tax return. Corporate financial statement "Accounting Ledger" items are tax coded and converted to "Corptax" format. Schedule M "Adjustments" and reclassifications are entered.

Taxable income inputs to "Corptax" are not finalized until completing the "Calculated Deemed Paid Credit (DPC), subpart F and Previously Taxed Income (PTI)." To assure accuracy of taxable income, the PW ITMS and Lotus "Models are Reconciled." Then the "High Tax Kick-Out" work is performed to distribute taxable income to the final foreign tax credit baskets and into the Corptax program. Finally, this information is manually transferred onto "Detailed Form 1118's" (some 200 pages). Hundreds of separate "Form 5471's" are prepared for each foreign entity.

The Company employed about twenty-five tax professionals plus part-time college students working over an eight-month period (often requiring overtime work) to accomplish the above tasks in preparation of its 1990 U.S. federal corporate tax return. The Internal Revenue Service will probably expend two to three person years of work reviewing this information.

PREPARED STATEMENT OF WILLIAM MORRIS

On behalf of the IPA, I wish to commend the Chairman of the Committee on Finance, Senator Bentsen, and the ranking minority member, Senator Packwood, Senator Boren, Chairman of the Subcommittee and the other members of the Subcommittee for initiating tax simplification legislation and taking the time to consider these much needed changes and our suggestions for improvements in the proposed legislation.

My name is William Morris. I serve as General Counsel to the Investment Program Association and practice law with the firm of Rogers & Wells. The IPA has devoted considerable time, energy and resources to an effort to encourage the IRS, the Treasury Department and the congressional tax writing committees to seriously consider simplifying the tax reporting and compliance system for large, widely-held partnerships and for individual limited partners who own partnership interests.

We are delighted that IRS Commissioner Fred Goldberg, and his staff and Treasury Secretary Nicholas Brady, and Assistant Secretary for Tax Policy, Ken Gideon and his staff have recognized the mutual interest we all have in creating a simpler system under which large partnerships and limited partners can more successfully attempt to comply with the Federal income tax laws. We strongly support active consideration of Title II of S.1394 and its House counterpart, H.R. 2777, which provide for simplified reporting rules and audit procedures for large partnerships.

The proposed legislation would codify a series of changes to permit large partnerships to compute partnership income, loss, minimum tax liability, capital gains and losses and tax credits at the partnership level and to flow through these items to individual limited partners in far simpler fashion. These proposed changes make it possible to significantly alter the form on which this information is transmitted to limited partners.

We believe this approach represents a significant improvement over existing law for partners in large partnerships. We urge that this general approach be adopted with certain modifications I would like to describe in further detail for you:

1. Simplified Reporting for Individual Partners with De minimis Income or Loss -- To truly achieve a simplified reporting system for limited partners in widely-held partnerships, the IPA believes that one additional step must be taken by the Congress. This step requires special provision for individual partners with partnership income or loss of less than $1,000 per year. The IPA proposes that individual partners be permitted to report income from a partnership (both passive and portfolio) that totals less than $1,000 per year as a single item on Schedule "B" of the tax return. Capital gain or loss would be reported on Schedule "D." Passive losses of less than $1,000 could be suspended at the partnership level and would not be reported currently by electing partners. Instead, these losses would be offset against future passive income or reported as a loss in the year of disposition of the partner's partnership interest. Tax credits of $300 or less could be reported on Form 1040 without any separate schedules required.

This simplified procedure eliminates the need for individual investors who receive $1,000 or less of income or loss from widely-held partnerships to complete essentially unnecessary separate schedules or forms in preparing their annual Federal income tax returns. In particular, it eliminates the need for the preparation of Form 8582 wherein the deductibility of passive activity losses is determined and reported. In separately introduced legislation, H.R. 2775, Chairman Rostenkowski has proposed a $200 de minimis rule for the deduction of passive losses. As proposed, individuals with passive losses of less than $200 would be permitted to currently deduct up to $200 against ordinary income without further limitation. This proposed change is an important step in the right direction. We believe the de minimis rule we are proposing would provide even greater simplification for approximately 75% of the holders of partnership interests in widely-held partnerships, i.e., several million individual partners.

2. Definition of Large Partnerships -- New Section 776 would define a large partnership as a partnership of 250 or more partners. The IPA believes that the appropriate number of partners for this purpose should be set at 500 which is the number generally employed under the Securities laws to describe a large publicly-offered partnership. As provided under the bill, partnerships of over 100 partners should be provided with the election to be treated as a large partnership.

3. Exception for Certain Partnerships -- New Section 776 provides that the term "large partnership" does not include a partnership if 50% or more (by value) of the assets of such partnership consist of oil or gas properties. The IPA proposes that a like exception (similar to that provided under Section 7704(c) of the Code) be provided for partnerships, a principal activity of which is the buying and selling of commodities (not held as inventory), options, futures or forwards with respect to commodities.

4. Simplified Flow-Through of Net Capital Gain -- New Section 772 provides for the flow-through of net capital gain to individual partners. It does not provide for the flow-through of net capital loss. The IPA urges that a flow-through of net capital loss be provided in this legislation. As proposed, certain partnerships such as commodity pools would be particularly disadvantaged by a prohibition on the flow-through of net capital losses. These partnerships have no ability to elect to defer the recognition of capital gain or loss due to the annual mark to market rules of Section 1256. Without flow-through treatment for losses, commodity pools would be required to currently report all capital gain and defer all capital loss until offset by capital gain. Such a system is patently unfair. For other partnerships, deferral of net capital losses deprives limited partners of the ability to properly net aggregate gains and losses for each taxable year and further distorts the process of annually determining tax liability.

5. Loss of Character of Tax-Exempt Interest -- New Section 773(a)(5) provides that tax-exempt interest will only retain its character where more than 50% of the assets (by value) of the partnership consists of tax-exempt obligations held by the partnership. The IPA proposes that tax-exempt interest received by a partnership

during a taxable year retain its character as tax-exempt income, regardless of the percentage of assets held by the partnership receiving tax-exempt interest. A number of partnerships, for a variety of reasons connected with their business purpose, hold some portion of their assets in tax-exempt obligations. There is no logical reason to deny pass-through treatment for such income.

For example, some low income housing partnerships are required to maintain reserves and invest those reserves in tax-exempt obligations. Investors in such partnerships do not expect to receive taxable income in connection with these improvements and should not be required to report taxable income where none is received.

6. Change in Due Date for Furnishing Information to Partners of Large Partnerships -- Section 6031(b) would be amended to require such information be furnished to partners in large partnerships on or before the 15th day of the third month following the close of the taxable year. The IPA supports the objective of providing information to partners on a more timely basis. However, certain large partnerships own interest in other partnerships which may or may not be required to make information available on this same basis. In such instances, the IPA urges that large partnerships be provided with additional time to furnish information to its partners.

   In at least one instance we are aware of, one large partnership receives Form K-1s from more than 80 operating partnerships, not classified as large partnerships. Under such circumstances, without additional time, this large partnership cannot make a timely distribution of information to its partners.

7. Partnership Level Adjustments and Liability for Interest and Penalties -- New Section 6242 (b) provides for the payment of interest and penalties directly by a partnership where a partnership adjustment in tax liability is made. The IPA supports the concept of a flow-through of adjustment for the current year as an efficient method for the collection of additional taxes due where a partnership tax deficiency is determined. However, the IPA believes that the interest and any penalties associated with a deficiency should be similarly flowed through to partners. Only partners are taxpayers. Partnerships are merely conduits and are not appropriate entities to which liabilities for tax, interest and/or penalties should attach.

   Additionally, while the IPA is supportive of the flow-through adjustment method, we do have concerns that extraordinary circumstances could arise where a large tax liability is asserted and is significantly out of proportion to a partner's investment in a partnership. Under such circumstances, it is appropriate to provide a mechanism where the partner who obtained the prior tax benefit of a deduction, credit, etc., rather than the current partner, be obligated for any tax deficiency and related interest or penalty associated with that liability. The IPA suggests that a tax liability of $5,000 per partnership interest be the threshold for imposing and collecting the tax liability from prior year partners.

With the incorporation of the modifications enumerated above, the IPA supports the provisions of S.1394/H.R. 2777 regarding large partnerships and urges that the full Committee act as expeditiously as possible in making the benefits of tax simplification for partners in large partnerships as early as possible. Once again, the IPA thanks the members of this Subcommittee and the full Committee on Finance for devoting their time and attention to this important matter.

PREPARED STATEMENT OF SENATOR DANIEL PATRICK MOYNIHAN

The PFIC Tax Simplification Act of 1991, introduced by myself and Senator Packwood, the distinguished Ranking Member of the Finance Committee, is designed to simplify the tax code in its application to U.S. companies doing business abroad and, by removing unnecessary complexity in their tax compliance burden, make it easier for those companies to compete in international markets. The bill addresses what I believe most concede to be the overbreadth of the passive foreign investment company ("PFIC") rules.

The PFIC provisions, enacted in the Tax Reform Act of 1986, were intended to eliminate a loophole in the foreign tax rules that allowed individuals to invest in offshore mutual funds and avoid paying any current tax on the income building up in such funds. But as finally drafted, the PFIC rules reach much further, potentially applying to any foreign operating subsidiary of a U.S. company if the foreign subsidiary meets certain tests designed to detect the presence of excessive passive "investment-type" income (as distinguished from income derived from active business operations). If the foreign subsidiary meets the tests, it acquires "PFIC" status, and the results are draconian: the U.S. parent company loses the benefit of deferral of tax on the foreign subsidiary's profits. I should note that such deferral of tax on foreign profits, until repatriated, is a principal way that the U.S. tax system attempts to put U.S. companies operating abroad on an equal footing with international competitors.

One key problem with the PFIC provisions involves the tests for determining PFIC status. The experience of U.S. companies since passage of the 1986 Act has shown that the tests for PFIC status sweep far too broadly, bringing within the net of PFIC penalties companies which are predominantly engaged in active business operations. Such companies should not be within the scope of the PFIC rules, and it is time to modify them to insure that such is not the case.

A foreign subsidiary is classified as a PFIC if either one of two tests is met: an income test, which is met if 75 percent or more of a subsidiary's gross income for the year is passive income, and an asset test, which is met if 50 percent or more of the value of the subsidiary's assets held during the year consists of assets that produce passive income.

It is the asset test that has been the source of most difficulty, because a company can flunk it and be classed a PFIC for any number of "innocent" reasons, even though it is genuinely and predominantly engaged in the conduct of active business operations. For example, a sales subsidiary that collects cash deposits at the time orders are placed may inadvertently fail the asset test if cash on hand is high. Moreover, an asset test necessitates annual—in some cases quarterly—appraisals of property. The consequences of failing the asset test and becoming a PFIC are so adverse that companies must invest considerable time and effort insuring their compliance. In fact, the rules have come to encourage practices motivated by tax planning that distort sound business decisions—such as delaying the collection of accounts receivable to avoid failing the asset test. But most importantly, experience with the asset test has shown that it imposes the PFIC loss-of-deferral penalty in an arbitrary and overly broad way on companies that were not intended to be penalized.

There is a growing consensus that the asset test of the PFIC rules ought to be repealed. Many tax experts believe that the policy against deferral for passive income can be maintained without use of an asset test. Last year, at a hearing before the House Ways & Means Subcommittee on Select Revenue Measures, Assistant Secretary of the Treasury Ken Gideon testified:

"Since the PFIC regime was enacted, the Treasury Department has had doubts about the broad scope of the PFIC rules. In 1987, in connection with

Senate consideration of technical corrections to the 1986 Act, we testified as to our concern that the passive asset test operates to classify too broad a category of companies as PFICs. We concluded that the asset test warrants further study to determine whether it should be amended, or, given the addition of other safeguards, discarded, to prevent the PFIC provisions from applying too broadly."

The PFIC Tax Simplification Act eliminates the PFIC asset test for any U.S. -controlled foreign corporation, while making other modifications to the PFIC rules to insure that abuses do not occur. The bill makes the income test of the PFIC rules more stringent, by lowering the passive income threshold in the income test from 75 percent to 50 percent. In addition, the legislation provides a new anti-abuse rule to cover situations where there might be second-tier passive foreign subsidiaries in which a first-tier foreign subsidiary has a minority ownership interest. These additional safeguards should be sufficient to allow elimination of the asset test, which will both insure that the PFIC rules operate within their intended scope and constitute a very substantial and constructive step towards needed simplicity in our foreign tax rules.

I would like to clarify a technical point regarding S. 1654 as introduced. S. 1654 is not intended to change the current law treatment of a foreign corporation that is not a controlled foreign corporation. Accordingly, the bill will be modified so that Section 1296(c) would continue to provide that a non-controlled foreign corporation will be treated as owning its proportionate share of the assets of any 25 percent-owned corporation.

The revenue losses produced by this bill, I would add, are modest in comparison to its benefits. The legislation actually raises revenue in the first year, and over the first five years the net revenue loss from the bill should be approximately $26 million.

The more comprehensive Tax Simplification Act of 1991 (S. 1394), which is the primary focus of today's hearing, represents a very commendable effort to identify those areas where our tax rules can be streamlined and simplified without sacrificing important tax policy goals. The gains for economic efficiency, business competitiveness, and taxpayer compliance and goodwill of this simplification enterprise are manifest. The Tax Simplification Act contains significant simplification provisions in the foreign tax area, including modifications to the PFIC rules as part of a consolidation of the various anti-deferral regimes. Unfortunately, the Tax Simplification Act as introduced does not eliminate the PFIC asset test. However, I believe that elimination of the test as proposed in S. 1654 fits the goals of the simplification effort quite well, and it is my hope that the bill can be incorporated as an amendment to the Tax Simplification Act.

S. 1654 of course addresses only one area where the rules affecting taxation of U.S. companies doing business abroad can and should be simplified. But these changes have an important role to play in insuring that U.S. companies can compete effectively abroad, without unnecessarily complex and burdensome tax rules. I urge the Subcommittee to give careful consideration to this bill.

Prepared Statement of Ellen Nissenbaum

I appreciate the opportunity to testify here today. I am Ellen Nissenbaum, legislative director of the Center on Budget and Policy Priorities. The Center is a nonprofit organization that conducts research and analysis on a range of public policy issues, with an emphasis on issues affecting low and moderate income families.

Since 1984, the Center has issued a series of analyses and reports on tax policy issues affecting low-income households. We have devoted particular attention to the Earned Income Credit and ways to improve it. Following expansion of the credit in the Tax Reform Act of 1986, we have also designed and produced outreach materials and coordinated private sector public information efforts to increase awareness of the credit among low-income working families. In these efforts, we work closely with such organizations as the National Governors Association, the U.S. Conference of Mayors, the U.S. Catholic Conference, the United Way, and various unions and business associations.

My testimony today concerns the need to simplify the Earned Income Credit.

THE VALUE OF THE EARNED INCOME CREDIT

I probably need take little time before this Committee to stress the importance of the Earned Income Credit. Over the past decade, the Committee on Finance has played a central role in efforts to expand and improve the credit.

As you know, the credit is strongly pro-work. Only working families qualify for it. In addition, unlike welfare benefits, EIC payments rise rather than fall with earnings across that critical low-income range where we want to encourage work effort.

The credit is also pro-family. Only families that live with their children are eligible for it. An absent parent does not qualify.

The EIC helps offset the regressive effects of Social Security and Medicare payroll taxes among low-wage working families with children. It can also provide a wage supplement that lifts poor families closer to (or in some cases, above) the poverty line. If we wish to establish a basic goal that if a parent works full-time his or her family should not be poor, the EIC is a critical instrument to help attain the goal.

The importance of the EIC has grown in recent years as wages for low-paid work have eroded. Labor Department data show that average weekly wages for private, non-management jobs are lower now than in any year since 1969, after adjustment for inflation. In addition, the proportion of employed male high school graduates who earn low wages has climbed sharply over the past 18 years.

Furthermore, single mothers who work are likely not only to receive low wages but also to qualify for much less in public assistance benefits than in the past. Recently published data show that a mother with two children who works and earns wages equal to 75 percent of the poverty line—about what full-time minimum wage work now pays—had $3,100 less in disposable income in 1990 than in 1972, after adjustment for inflation. In 1972, such a family would have qualified in 49 states for some AFDC benefits to supplement its low earnings. Today, this family can qualify for AFDC in just six states.

As a result of trends such as these, Census data show that the poverty rate among families with children in which the family head works climbed one-fourth between 1979 and 1989.

These developments make the EIC even more important because the EIC can help to address these problems. It can make work a more viable alternative for poor families with children and can also help to ease their poverty.

Recognizing this, the Congress took landmark action last year to expand the Earned Income Credit, including the creation of a new health insurance credit and an EIC young child supplement. These EIC expansions also helped offset the regressive impact that the excise tax increases in the budget agreement would otherwise have had on low-income working families with children.

Unfortunately, the outstanding EIC work of the Congress—and particularly of the Finance and Ways and Means Committees—is now in jeopardy. Several rather detailed and technical aspects of last year's EIC provisions complicated the credit much more than was realized at the time. As a result, just when the support provided by the EIC is set to expand, the EIC threatens to turn into something of a nightmare for the 12 million low-income working families who benefit from it. The complexities loom so large that a substantial number of eligible families could fail to complete the proper paperwork and could lose the EIC benefits they have earned.

The good news is that this matter can be addressed—and at no cost.

THE NEW COMPLEXITIES FACING EIC FILERS

Until now, an eligible family needed only to file a 1040 or 1040A form to receive the EIC. No additional form was required.

Moreover, all the filer needed to do was to write "EIC" next to the appropriate line on the 1040 or 1040A form. The IRS would do the rest, calculating the family's credit for it.

In fact, if the family failed to write EIC in the designated space, the IRS would still compute the family's EIC for it, so long as other information on the tax form showed the family to be eligible. The IRS took such action for several hundred thousand families each year.

Now, this will change. Starting with tax returns for the 1991 tax year, eligible families will have to file a separate EIC schedule for the first time. Those who don't will lose their EIC benefits.

That a separate form would be required was known when last year's tax bill was being written. The hope was that the form would be short and simple. But the form has turned into a maze instead. Several of last year's legislative changes added substantially to the complexity:

• the establishment of a requirement that no family may get the supplemental EIC credit for a child under age one if the family claims the dependent care tax credit for that child; and
• the stipulation that a family may not claim health insurance costs in calculating the EIC health insurance credit if the costs are claimed as a medical deduction by a filer who itemizes or if the costs are claimed under the self-employed medical deduction.

The impact of the new complexities in the EIC law can be seen by examining the new EIC Schedule the IRS released for comment in June. (A copy of the schedule is attached.) As you can see, this is anything but a short, simple schedule. I'm not sure many of us here today could complete it without the help of a commercial preparer. Yet this is the new schedule more than 12 million low-income families—many with limited education—will have to file.

I cannot overstate our concern and that of many other organizations across the country that work with low-income families about the consequences the new schedule could have. Widespread confusion among low-income families is likely. We would not be surprised to see the number of families receiving EIC benefits drop by hundreds of thousands, perhaps by a million or more. Many eligible families are likely to be intimidated by the schedule.

The complexities created by the new schedule could not come at a worse time. Due to the recession, the principal wage-earner in many families will be unemployed for part of 1991. As a result, a substantial number of such families will have annual incomes below the EIC income limit and become eligible for the credit for the first time. Many of these families are already seeing their unemployment benefits run out. Now they will face difficulties in obtaining EIC benefits as well.

Furthermore, many low-income families who in past years completed their own returns are likely to be driven to commercial preparers by the new schedule. In essence, the new schedule may effectively dictate that to get the' EIC, an eligible low-income family must pay a commercial preparer. Is that the national policy we desire?

THE TAX SIMPLIFICATION BILL

It is hard to imagine there are many parts of the tax code for which the need for simplification is greater. Thus we were disappointed that the bipartisan simplification bill introduced in the House and Senate earlier this summer lacks provisions addressing these problems with the EIC.

More than 12 million working families with children received the EIC last year. Although they have the lowest incomes and probably the least education of any tax filers, they will suddenly confront one of IRS' more complex and intimidating forms. If 12 million middle-income taxpayers or businesses faced a problem of this magnitude, it is likely the outcry would have been loud. The families affected by the EIC complications, however, are not politically organized. They have no trade association through which to contact Members of Congress. Most of them will learn of the new complexities only when they sit down with their tax form next year. But they are hard-working families trying to raise their children on low wages. We believe they deserve priority consideration when tax simplification is taken up.

A POSSIBLE REMEDY

One remedy would be to remove two complex and unnecessary new provisions from the EIC sections of the tax code. The first such provision stipulates that a family may either claim the EIC young child supplement for a child under one, or the dependent care credit for that child (if the family incurs child care costs for the child), but not both. This entails that the family figure out whether the dependent care credit, which requires a separate form of its own, or the young child supplement would have greater value to it. That is an intricate task few families will be able to undertake themselves. The IRS itself does not intend to figure this out, either, and apparently will not do so if a family otherwise elects to have IRS compute its EIC for it.

Tax experts and practitioners generally urge that "either-or" elections like this be avoided. This is even more so the case when low-income taxpayers are involved.

The logical solution is to repeal this restriction and not condition receipt of one credit on failure to elect the other.

Indeed, there is no compelling reason for this restrictive rule. The EIC young child supplement and the dependent care credit serve different purposes.

Adding to the case for repealing this rule is the fact that few families will be eligible for both credits, anyway. Since the dependent care credit is not refundable, most

EIC families do not qualify for it. The Joint Tax Committee recently estimated the cost of repealing this restriction at just $41 million over 5 years. This is a fraction of one percent of the combined cost of the two credits. Thus, more than 12 million EIC families will be forced to deal with a more complicated EIC form and instructions because of an intricate interaction rule affecting a very small percentage of these families.

This small cost could easily be offset by changing the EIC phase-down rates by a small fraction of one percentage point.

Similarly, the restrictive rule stating that a tax filer must choose between the EIC health insurance credit and a medical deduction should also be dropped. The number of EIC families who both: (a) itemize their deductions and have medical expenses exceeding 7.5 percent of AGI, and (b) also would qualify for the EIC health insurance credit is minuscule. So is the number of EIC families who could qualify for both the self-employed medical deduction and the EIC health insurance credit. According to the Joint Tax Committee, repealing these restrictions affects such a tiny number of filers that the costs are only $38 million over 5 years. Yet all EIC families filing the 1040 form will be confronted with additional complexities as a result of this rule.

Repealing these two interaction rules would improve EIC administration and simplify the EIC filing process. There now appears to be growing bipartisan accord on the need to repeal these rules.

Finally, I would like to emphasize the urgency of addressing this matter in time for the 1991 tax filing season. If this is not done, 12 million low-income working families will face an extremely complex form next winter, with the likely result that many will fail to receive EIC payments they have earned while many others make errors on the new EIC schedule.

I hope you will make action to reduce the complexity of the EIC for 12 million American working families and their children one of your highest priorities for tax simplification.

SCHEDULE EIC (Form 1040)
Department of the Treasury
Internal Revenue Service

Earned Income Credit

▶ Attach to Form 1040. ▶ See Instructions for Schedule EIC (Form 1040).

OMB No 1545-XXXX
1991
Attachment Sequence No 43

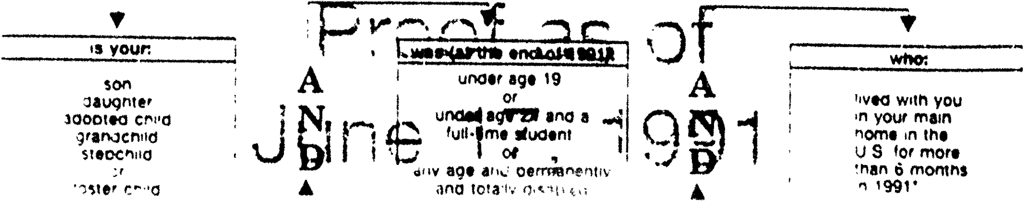
Name(s) shown on Form 1040 | Your social security number

Part I General Information

To take this credit—

- The amount on line 32 of your Form 1040 MUST be LESS than $21 250. AND
- Your filing status cannot be married filing a separate return. AND
- You MUST have a qualifying child

A **qualifying child** is
a child who:



IF YOU DON'T HAVE ANY QUALIFYING CHILDREN, STOP HERE. YOU CANNOT TAKE THE EARNED INCOME CREDIT.
IF YOU HAVE AT LEAST ONE QUALIFYING CHILD, GO TO PART II. (But if the child was married or is also a qualifying child of another person see page 45.)

Part II Information About Your Two Youngest Qualifying Children (List the younger child first.)

(a) Child's name (first initial and last name)	(b) Child's year of birth	For a child born before 1973, check if child was— (c) a student under age 24 in 1991 (see inst.)	(d) disabled (see inst.)	(e) If child was born before 1991, child's social security number	(f) Child's relationship to you	(g) No. of months child lived in your home in the U.S. in 1991
	19					
	19					

Caution: If you have a qualifying child who was born in 1991 but you chose to claim the child and dependent care credit for this child on Form 2441 instead of the credit for a child born in 1991 on this schedule, check here ▶ ☐

If You Want the IRS To Figure the Credit for You

In most cases, the IRS can figure the credit for you. If you meet the conditions explained on page 19 of the Form 1040 instructions and you want the IRS to figure the credit, fill in Part III below.

Figuring the Credit Yourself

If you want to figure the credit yourself, or if the IRS cannot figure it for you because you do not meet the conditions explained on page 19 of the Form 1040 instructions, skip Part III and go to Part IV on the back now.

Part III Other Information

2 If you received any **nontaxable earned income** (such as military housing and subsistence allowances) enter the total of that income on line 2. Also list type and amount here ▶ **2**

3 If you had health insurance that covered at least one of your qualifying children:
a First, enter the name of your insurance company here ▶ ....
b Then, enter the total amount you paid in 1991 for that health insurance. (See the instructions.) **3b**

IF YOU WANT THE IRS TO FIGURE THE CREDIT FOR YOU, STOP HERE!

ATTACH THIS SCHEDULE TO YOUR RETURN AND PRINT "EIC" ON THE DOTTED LINE NEXT TO LINE 56 ON FORM 1040.

Part IV Figure Your Earned Income Credit

4 Enter the amount from Form 1040, line 7. If you received a taxable scholarship or fellowship grant, see page 46 for the amount to enter . . . . | 4

5 If you received any **nontaxable earned income** (such as military housing and subsistence allowances), enter the total of that income on line 5. Also list type and amount here ▶ .... | 5

6 If you were self-employed or reported income and expenses on Schedule C as a statutory employee, enter the amount from the worksheet on page 46 . . . | 6

7 Add lines 4, 5, and 6. Enter the total here . . . ▶ | 7

Caution: *If the amount on line 7 is **$21,250 or more,*** **STOP** *HERE. You cannot take the earned income credit. But if you received any nontaxable earned income, enter "NO" on Form 1040, line 56.*

8 Enter the amount from Form 1040, line 32 . . . ▶ | 8

Proof as of June 17, 1991 (subject to change)

FIGURE YOUR BASIC CREDIT

9 Use the amount on **line 7** to look up your credit in **TABLE A** that begins on page 47. Then, enter the credit here . . . | 9

Next, look at the amount on line 8. If it is **less than $11,250**, enter on line 11 the amount from line 9.

10 **If line 8 is $11,250 or more,** use the amount on **line 8** to look up your credit in **TABLE A.** Then, enter the credit here . . . | 10

11 Compare the amounts on lines 9 and 10. Enter the smaller of the two amounts here. This is your **basic credit**. If you are not taking health insurance credit or the credit for a child born in 1991, go to line 20 now . . . ▶ | 11

FIGURE YOUR HEALTH INSURANCE CREDIT

12a Enter the name of your insurance company here ▶ ....

b Enter the total amount you paid in 1991 for health insurance that covered at least one of your qualifying children. (See the instructions for line 3b.) . . . | 12b

13 Use the amount on **line 7** to look up your credit in **TABLE B** that begins on page 50. Then, enter the credit here . . . | 13

14 Compare the amounts on lines 12b and 13. Enter the **smaller** of the two amounts here . . . | 14

Next, look at the amount on line 8. If it is **less than $11,250,** enter on line 16 the amount from line 14.

15 **If line 8 is $11,250 or more,** use the amount on **line 8** to look up your credit in **TABLE B.** Then, enter the credit here . . . | 15

16 Compare the amounts on lines 14 and 15. Enter the **smaller** of the two amounts here. This is your **health insurance credit** . . . ▶ | 16

Caution: *If you chose to take the child and dependent care credit on **Form 2441** for your only qualifying child born in 1991, you cannot take the next credit. Go to line 20.*

FIGURE YOUR CREDIT FOR CHILD BORN IN 1991

17 Use the amount on **line 7** to look up your credit in **TABLE C** that begins on page 52. Then, enter the credit here . . . | 17

Next, look at the amount on line 8. If it is **less than $11,250,** enter on line 19 the amount from line 17.

18 **If line 8 is $11,250 or more,** use the amount on **line 8** to look up your credit in **TABLE C.** Then, enter the credit here . . . | 18

19 Compare the amounts on lines 17 and 18. Enter the **smaller** of the two amounts here. This is your **credit for a child born in 1991** . . . ▶ | 19

FIGURE YOUR TOTAL EARNED INCOME CREDIT

20 Add lines 11, 16, and 19. Enter the total here and on Form 1040, line 56. This is your **total earned income credit** . . . ▶ | 20

PREPARED STATEMENT OF ALBERT C. O'NEILL, JR.

Mr. Chairman and members of the Committee:

My name is Albert C. O'Neill, Jr. I am Chair-elect of the American Bar Association's Section of Taxation. I am testifying today on behalf of the American Bar Association at the request of Talbot D'Alemberte, President of the Association, to discuss proposals to simplify the tax laws.

The Association strongly applauds the Committee for taking up the matter of simplification in this focused and careful way.

We unqualifiedly support simplification of the tax laws, which is the goal of these bills and the spirit behind them, and we support most of the specific provisions contained in the bills. As you know, the Tax Section has over 24,000 members across the country. The desirability of simplifying the tax law may be the only thing on which there is near unanimity in that huge group. The Section has long believed that the provisions of the Internal Revenue Code are unnecessarily and undesirably complicated and that that fact:

- is destructive of respect for the tax system;
- imposes unnecessary costs on taxpayers, the Internal Revenue Service, and the public at large;
- significantly reduces compliance by taxpayers; and
- produces uneven application of the laws, which in turn reduces fairness.

Most of the potential for simplification lies in making a multitude of modest, incremental changes. That is what these bills do. It is undramatic work. The Committee and the Committee staffs are to be commended for rolling up their sleeves and "having at it." It will be a major advance if there can be simplification bills in the future in the same way there are technical corrections bills today -- as a recurrent corrective device, carefully staffed in advance and processed by the taxwriting committees in a manner that is sufficiently deliberative that the bugs can be worked out and with an opportunity for public participation. We are gratified that the approach taken here is the approach recommended by the joint conference on simplification sponsored in 1989 by the American Bar Association and the American Institute of Certified Public Accountants.

We recognize that the two simplification bills before you represent a trailblazing experiment. If the experiment is to succeed, now and for the future, it will be important that the bills be kept clean and free of barnacles in the form of extraneous provisions.

We also recognize that there will be a temptation for some commentators to criticize the bills on the ground that anything as lengthy and technical as they are cannot conceivably be "simplification," but members of this Committee know, and professionals who work with the Internal Revenue Code know, that there are many situations, particularly in the areas of business taxation, where complicated language produces major simplification in practice.

We pledge to do what we can to educate the public on these two aspects.

Turning to the specific provisions in the bills, we note that the great bulk of them involve the taxation of businesses and not of ordinary individuals. We assume that disproportion to be a result of the budget constraints under which the bills were prepared. Simplifications, standing alone, frequently involve revenue losses and it may be thought easier to find acceptable offsetting gains in the business arena than it is from individual taxpayers. We, like you, need to hear from taxpayers as to how the revenue pick-up provisions affect individual cases in order to make a judgment as to whether the revenue trade-offs reflected in the bills are the optimal trade-offs and whether and to what extent they create new problems or complications.

We are particularly pleased with Subtitle A of Title IV of S. 1394, which makes important simplifications in the rules relating to S corporations. These provisions are particularly welcome, not only because S corporations are so widely used by smaller business enterprises but also because some of the particularly vexing complications that they would eliminate do not seem to rest firmly on any policy at all. The proposals would reduce transactional complexity by removing traps for the unwary (e.g., in the single class of stock area) and by eliminating loopholes that encourage over-aggressive tax planning (e.g., the use of S corporations to avoid gain on installment sales). The proposals are a bit cautious in some respects and we intend to submit some additional technical suggestions soon that would help produce a "cleaner sweep" without, we submit, changing "underlying policies."

Similarly, section 441 of S. 1394 would move in the right direction by conforming the treatment of revocable trusts more closely to the treatment of decedents' estates. We think that the provisions could go even further in this direction.

Based on our understanding that the Committee's goal in the foreign area was to simplify existing law without making any policy changes, we believe the draft provisions are generally quite well crafted. The attempt to unify the anti-deferral rules reflects a substantial degree of technical expertise and, subject to one or two technical points, we fully support this effort. The change in the section 1248 rules is also a major improvement.

The Tax Section believes, however, that there are a number of other good ideas for simplification in the foreign area which should be considered. The Committee should be aware that a considerable amount of effort has been spent by groups like the American Law Institute and the Tax Section to simplify and rationalize this difficult area of the law. We do not, of course, expect the Committee to adopt any particular proposal just because it is suggested, but we were sorry not to see more of these simplification initiatives addressed in the bills. Presumably it was concluded that these areas involved significant policy changes that were not to be undertaken, at least not at this point. If that is necessary to keep this legislation moving, so be it. In the long run, however, we will not make much of a dent in the complexity problem unless items such as these can be taken up.

We recognize that the bills were developed under a guideline that "underlying policy objectives of current law" were not to be "sacrificed." As a result, most of the changes

in policy in the bills are "minor" and can hardly be viewed as fundamental changes. That conservative approach seems appropriate for the initial version of bills like these.

Our suggestions that the Committee go further with particular provisions of the bills are intended as constructive comment and not as criticism. They do, however, illustrate a problem of legislative procedure that the Committee may wish to consider while its simplification efforts are evolving.

On the one hand, the staff, in drafting the bills, is under instructions not to change "underlying policy" and in the absence of active member involvement must be conservative in changes that it proposes. On the other hand, once a bill is drafted it is unfair to expect that each Committee member should attempt to master the details of all of the highly technical provisions involved. That leaves a substantial "no-man's land", where the staff dares not tread and to which the members have no map. This is especially a problem in super-complex areas like the foreign income provisions and the pension provisions, where members need to know the nature of the complications and where they are located in the context of the overall terrain. Many complicated problems arise in those areas. They can be explained easily and discussed in understandable, oral English, but it is very difficult for members to get a feel for them if they must be filtered through a parade of advocates for taxpayers with particular axes to grind or through formal testimony of this kind.

We respectfully suggest that the Committee might wish to consider whether there could be some informal procedure that would permit members to become more fully apprised of the substantive aspects of potential simplifications, to have a balanced dialogue with knowledgeable taxpayers and staff, and then to tentatively endorse policy changes that the staff might not otherwise feel free to make but that would permit significant simplification.

The problem of achieving important simplification without making policy changes is obviously compounded by budget procedures, as they essentially require that any revenue loss resulting from a simplifying change must be offset by revenue gain from some other change. Thus, it is necessary to avoid policy changes not only in a given simplifying amendment but also in the offsetting provision enacted to pay for it.

The pending bills do in fact reflect some potentially controversial policy changes. An obvious example is the deletion from the earned income credit of the so-called "wee tot" provision. I am not criticizing the deletion, for it is clearly simplifying, but I suggest that it illustrates the point that real progress in the simplification area will almost certainly require making such changes, and will involve political choices that the Committee members must ultimately make and not just technical changes of the kind that the Committee staff can prepare on its own.

The bills are, as I noted, heavily weighted towards business changes. We suspect that the leading candidates for simplification in the individual area would require policy decisions that might be controversial. In this regard, the Tax Section over the last two years has forwarded three sets of detailed suggestions that would have a major simplifying impact on a large number of ordinary individual taxpayers. (They appear in WMCP 101-27 beginning at page 105.)

One of the areas covered by those suggestions, relating to the deductibility of non-business interest, has not been dealt with. The other two -- one dealing with the so-called "kiddie tax" and the other with a series of proposals for low income individuals -- have been dealt with in only minor ways.

The existing non-business interest deduction provisions are among the most byzantine provisions of the Code. These provisions affect multitudes of ordinary individual taxpayers and create major complications in all kinds of every-day garden variety situations. Simplifying the area would require revising some earlier policy judgments, and this issue was presumably omitted at this stage for that reason. We strongly urge, however, that the Committee step up to this issue and deal with it soon. We believe that the proposal advanced by the Tax Section involved no major change in policy so far as the simplifying changes themselves were concerned.

The "kiddie tax" proposals forwarded by the Tax Section would affect individual taxpayers with children under the age of 14 who have investment income. That is obviously a smaller group of taxpayers, but many people are affected by these rules. The bills propose indexing of certain "floors," which would produce very modest simplification (offset by some additional complexity caused by the indexing itself), but the proposal does not go to the heart of the problem.

Finally, our prior suggestions had included a series of proposed changes affecting low income taxpayers in important ways. They dealt with six different items: the definition of abandoned spouse, the surviving spouse filing status, a uniform definition of the term "child," dependent exemptions, and the earned income credit. Of these six items, only the earned income credit has been dealt with in the bills. As to the other five items, we respectfully submit that they should be dealt with and that they can be dealt with fairly. Nowhere is simplification needed more urgently. The people affected by these provisions cannot afford to hire tax advisors to help them through the maze. If they are to get help, it will have to be right here in this room.

The sixth item, the earned income credit, was designed to help lower income taxpayers and its basic approach was ingenious and has been widely praised. The credit has become much too complicated, however, particularly for the class of taxpayers involved. The 1990 legislation deleted one complicating aspect of the credit, but it added new complications many times greater than the one removed. The current tax return forms contain a two-page schedule for claiming the earned income credit and <u>nine pages</u> of tables. The present bill would eliminate one of the complications added in 1990, but would still leave the credit inordinately complicated. The basic problem is that prior law has loaded too much freight on the credit. It has become essentially a mini-welfare system all by itself.

If there is any one provision where overwhelming complication exists for a class of people who are least able to deal with it, it is the earned income credit provision. Here again, simplifying will require making significant policy changes, some of which will doubtless be politically sensitive. But here again we strongly urge, not necessarily that the Committee adopt our particular suggestions, but that it do more to make the credit manageable for the low income persons to whom it is important.

As you now, the Tax Section operates through committees composed of expert tax lawyers from all over the country, in large towns and small and in big firms and small, who volunteer their time and efforts to improve the tax system. Our committees are preparing detailed analyses of parts of the proposed legislation and these will be submitted to you soon. Our members are available to Committee staff to share their detailed technical analyses and suggestions with you. We are prepared to volunteer whatever time it takes to provide assistance to you in this important effort. We wholeheartedly endorse simplification of the tax laws and the Committee's significant steps toward that end.

PREPARED STATEMENT OF ROBERT H. PERLMAN

Tax Executives Institute (TEI) is the principal association of corporate tax executives in North America, whose approximately 4,700 members represent more than 2,000 of the leading corporations in the United States and Canada. TEI represents a cross-section of the business community, and is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. As a professional association, TEI is firmly committed to maintaining a tax system that works — one that is consistent with sound tax policy, one that taxpayers can comply with, and one in which the Internal Revenue Service can effectively perform its audit function. TEI is pleased to submit the following comments on S. 1394, the Tax Simplification Act of 1991 (introduced by Senators Bentsen and Packwood); S. 936, the Foreign Tax Simplification Act of 1991 (introduced by Senator Baucus); S. 1654, the Passive Foreign Investment Company Simplification Act of 1991 (introduced by Senator Moynihan), and other tax simplification measures.

I. OVERVIEW

Tax Executives Institute commends the Senate Finance Committee for recognizing that the tax laws are in desperate need of simplification. The Institute shares the Committee's commitment to developing and maintaining an administrable tax system. For far too long, a sincere but sometimes misguided desire to close "loopholes" or even "pinholes" in the Internal Revenue Code has led to the enactment of mind-numbingly complex "band-aids" on an already too complex tax law. For far too long, concerns about the substantive, transactional, and transitional complexity spawned by tax law changes have been given short shrift — even where the concerns are voiced by taxpayers and IRS alike. For far too long, administrability and simplicity have been little more than an afterthought.

The Committee's focus on simplification, together with the IRS's related initiatives, is testimony to a desire to build a "new tax order." The Committee is to be commended for acknowledging Congress's role in creating complexity and in recognizing its obligation to reduce the heavy compliance burden imposed by unduly complex tax laws. These hearings clearly represent a step in the right direction.

Several provisions of S. 1394 will significantly reduce mechanical complexity, recordkeeping requirements, and compliance and administrative costs. For example, the provisions relating to the treatment of built-in losses for purposes of the corporate alternative minimum tax (AMT), the modification to the look-back method for long-term contracts, and the treatment of gain on certain stock sales by controlled foreign corporations (CFCs) under section 1248 of the Code would all further the goal of simplification.

There are, however, some notable omissions from S. 1394. For example, we urge inclusion of the proposal for creation of a single foreign tax credit (FTC) limitation "basket" for section 902 noncontrolled companies (so-called 10-to-50 companies). Even the Treasury Department has singled out the treatment of dividends from such companies as an area in need of simplification. Absent such relief, large multinational corporations will be forced to continue grappling with hundreds of separate FTC calculations. We thus commend the provisions in S. 936 which would provide a single FTC basket for companies that do not elect look-through treatment. S. 1394 also neglects the tremendous (and unnecessary) complexity spawned by the application of the uniform capitalization rules to foreign corporations — complexity that, again, S. 936 would end and at nominal cost to the fisc.

Certain proposals in S. 1394 would make substantive changes in the tax law and might actually increase the taxpayer's burden. For example, in the international tax area, S. 1394 would consolidate several anti-deferral regimes, which would at first blush provide some small measure of simplification. Upon analysis, however, the promise of simplification evaporates, for S. 1394 would supplant the existing rules with an expansive hybrid of the existing CFC, foreign personal holding company, and passive foreign investment company rules, as well as add a new "mark-to-market" provision. In other words, the good intentions of the drafters notwithstanding, the proposed passive foreign corporation (PFC) scheme is anything *but* simple. As discussed below, we believe a better, more targeted measure of simplification is available in S. 936.

On the domestic side, S. 1394 endeavors to mitigate the appalling complexity of the AMT and adjusted current earnings (ACE) provisions. Rather than recognizing that the mere existence of two separate and independent taxing schemes breeds inordinate complexity, however, S. 1394 provides only limited relief in calculating depreciation under the AMT/ACE rules *for newly acquired assets*. It thus completely ignores the requirement that taxpayers comply with the ACE requirements beginning in 1990 and that, even under the bill, they must continue to "track" the various depreciation regimes for assets acquired before the effective date of the proposed simplified method. This complexity can be meaningfully tempered by according taxpayers an election to apply the new rules to *all* years to which the ACE rules are relevant.

Moreover, in several instances S. 1394 eschews Congress's responsibility to effect meaningful simplification by simply delegating authority to the Department of the Treasury. For example, S. 1394 would grant the Secretary authority to issue regulations under section 986 that would allow foreign tax payments made by a foreign corporation to be translated into U.S. dollar amounts using an average exchange rate for a specified period. Although we commend the drafters for recognizing that something must be done to ease the burdens engendered by the Tax Reform Act of 1986, the approach taken in S. 1394 does not make sense. Rather than ceding the authority to correct the problem, Congress should forthrightly acknowledge that section 986 was misguided and amend the statute to provide a statutory rule that taxpayers can comply with and that the IRS can audit. S. 936 would provide a substantial statutory simplification by requiring foreign taxes to be translated at the same exchange rate as the income to which the tax relates. Another approach would be to adopt a year-of-accrual rule which translates the taxes at an average rate for the year in which the liability for foreign tax first arises. TEI would support either approach over the current year-of-payment rule.

A similar flaw underlies the provision in S. 1394 establishing a "simplified method" for applying the uniform capitalization rules. The proposal acknowledges the need for a simplified method for determining the cost of each administrative, service, or support function or department that is allocable to production or resale activities. Rather than establishing such a method, S.1394 would simply delegate authority to the Treasury Department to issue regulations allowing the use of a simplified method — the details of which would be "fleshed out" later. The simplified method, moreover, could not be used until such regulations were promulgated. Simplification deferred, however, is simplification denied: even if coupled with the injunction that the Treasury act with "all deliberate speed," S. 1394 not only denies taxpayers an opportunity to comment on the specifics of a proposed statutory change (because there are no specifics), but would also effectively sentence taxpayers to regulatory limbo, requiring them to wait months (or possibly years) to avail themselves of any such method. What's more, there is no guarantee that any regulations issued by the Treasury Department would truly promote the goal of simplification.[1]

* * *

TEI believes that the most effective safeguard against complexity is the allotment of ample time in which to analyze the administrability of specific proposals. To this end, we commend the Committee for providing taxpayers with a meaningful opportunity to review S. 1394, and we trust that the public will be given ample time to consider proposed revisions throughout the legislative process. In this way, Congress and the public can evaluate not only the policy underlying the proposals, but also whether that policy would be served by the legislative language. They will also be able to gauge whether the proffered scheme is not only wise but administrable.[2]

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[1] Indeed, in a statement filed with the House Committee on Ways and Means in connection with a hearing on H.R. 2777 (which is identical to S. 1394), the Treasury intimated that it would not issue any regulations under this provision.

[2] S. 1394 contains provisions that will benefit from taxpayer scrutiny. For example, section 302 sets forth new Code section 1292(a), the last sentence of which would read, "Except as provided in regulations, stock in the preceding sentence shall also apply for purposes of section 904(d)." We are uncertain about the reference to "stock" in this sentence. Is it intended to provide a look-through rule for purposes of section 904? The sentence could even be read to classify PFC income as entirely passive for purposes of section 904. The Technical Explanation of the bill provides no guidance on the meaning or purpose of the garbled provision. *See Technical Explanation of S. 1394 and H.R. 2777*, at 56 (June 26, 1991) (hereinafter referred to as "Technical Explanation").

II. INTERNATIONAL PROVISIONS

A. *The Passive Foreign Corporation (PFC) Regime.* The passive foreign investment company (PFIC) provisions of the Code were enacted as part of the Tax Reform Act of 1986. Almost from the date of enactment, TEI and others have pointed to the PFIC provisions as a prime example of legislative overkill. The goals of the PFIC provisions — to remove the economic benefit of tax deferral in certain perceived abuse situations and to prevent conversion of ordinary passive income into capital gain — were compromised by their excessive breadth. The definition of a PFIC is so broad that it has resulted in the classification of many corporations with active businesses (but substantial passive income or assets) as PFICs, even in situations where the foreign corporation is subject to high rates of foreign tax. Thus, whereas the target of the PFIC provisions was traditional investment companies, many other companies have become ensnared in the PFIC trap — one replete with tremendous administrative burdens.

TEI's proposed solution to this problem is simplicity embodied: exclude controlled foreign corporations (CFCs) from the reach of the PFIC provisions. A U.S. shareholder owning 10 percent or more of a CFC (*i.e.*, a foreign corporation that is more than 50-percent owned by U.S. shareholders) is already subject to immediate tax on passive income under Subpart F of the Code.[3] Within the context of the Committee's simplification initiative, TEI does not quarrel with the basic concept of Subpart F. We do, however, dispute the need to overlay another regime on top of Subpart F. The beauty of the Institute's proposal to exempt CFCs from the PFIC rules lies in its operational clarity: taxpayers could deal with an established set of rules, and need not undertake to unravel and comply with another regime that, in terms of tax policy, is wholly redundant and, indeed, never intended to apply to CFCs.

Regrettably, sections 301 to 304 of S. 1394 reflect a different approach to the Code's overlapping anti-deferral regimes. Under the proposed "unified" anti-deferral scheme, a passive foreign corporation (PFC) will still include a U.S. controlled corporation. In fact, the PFC regime is broader in scope — and more complicated — than the PFIC provisions it would supplant.

Under S. 1394, the PFIC 50-percent assets test would be retained for PFC purposes and the threshold 75-percent gross income test would be reduced to 60 percent. The high-tax exception to current inclusion of passive income under Subpart F would not carry over to the PFC rules because, according to the Technical Explanation (at page 50), that exception does not apply to PFICs and, hence, the bill's "modification to the application of a controlled foreign corporation rule [*i.e.*, elimination of the high-tax exception of section 954(b)(4) to passive income] preserves present law."[4] S. 1394 would subject a U.S. person holding 25 percent or more of the shares in a PFC that is not U.S. controlled to the same mandatory inclusion rule. In addition, U.S. persons with less than 25-percent ownership in PFCs could elect current, full inclusion; in the absence of such an election, the less than 25-percent shareholders are subject to tax under either a new "mark-to-market" regime or an interest-charge method adapted from the present PFIC rules.[5]

TEI objects to changes in the law that subject a greater proportion of non-"tainted," active business income to current taxation. The Technical Explanation is silent on why the PFC rules ought to apply to CFCs governed by current Subpart F rules. The 60-percent passive gross income threshold is proposed for PFCs apparently because such a threshold is contained in the foreign personal holding company (FPHC) rules, which are targeted at ending tax deferral by individuals. Such a gross *income* test, however, will in some circumstances cause CFCs with active operating businesses to be subject to the PFC rules. (The same is true under the 75-percent PFIC gross income test.) Assuming the absence of an explicit CFC exemption, TEI believes that the better, more targeted way of removing the effective penalty on active subsidiaries without vitiating the

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[3] Continued deferral of U.S. tax on passive income under Subpart F is limited to either *de minimis* amounts or income highly taxed in the foreign country (such that residual U.S. tax after the foreign tax credit is negligible).

[4] Unfortunately, the Technical Explanation glosses over the fact that, under present law, a shareholder in a PFIC (that is also a CFC) making the Qualified Electing Fund (QEF) election is provided a high-tax exception. Thus, making the QEF election prevents the full inclusion of highly taxed passive income.

[5] S. 1394 would eliminate the option of CFC shareholders subject to the current PFIC scheme to continue deferral under the current law interest-charge method for excess distributions. Such a modification would constitute a substantive, adverse change for those taxpayers that rely on the alternative excess distribution method to cope with the complexity of the PFIC and CFC overlap. In addition, those taxpayers would have to deal with the transitional complexity engendered by the change.

policy goals of the FPHC rules is to adopt a gross *receipts* test. We note that S. 936 adopts this approach. Although the need for such a test would not be as pronounced upon enactment of S. 1394 as under current law given the concomitant proposal in S. 1394 to repeal the generally applicable "once a PFIC, always a PFIC" rule, we nonetheless urge the Committee's careful consideration of a provision such as that in section 3 of S. 936 adopting a gross receipts test.

The current Subpart F rules require full inclusion of a CFC's income by U.S. shareholders where Subpart F income comprises 70 percent or more of gross income. FPHC income is one category of Subpart F income and, with modifications, serves as the definition of passive income for the PFC provisions. Under S. 1394, however, the threshold for full inclusion of CFC income would be reduced to 60 percent when a single category of Subpart F income — passive income — is involved. Reducing the threshold would not only increase the number of U.S. shareholders of CFCs subject to full inclusion of both tainted and non-tainted income, but would also create a dichotomy between the groups of tainted Subpart F income triggering a mandatory full inclusion. Thus, by reducing the PFIC gross income test from 75 percent — a figure greater than Subpart F's 70-percent full inclusion rule — to a 60-percent gross income threshold with mandatory full inclusion, the PFC provisions would broaden the tax base of U.S. corporations with CFCs. Such a result cannot be justified as "simplification."

Finally, S. 1394 would retain the 50-percent average passive assets test contained in the PFIC provisions. Such a test could unfairly trap foreign sales or distribution subsidiaries with high ratios of working capital to total assets. We believe this result would be improper where virtually all of the CFC's gross income arises from active business activities. Thus, absent a CFC exemption, the PFC assets test should be eliminated or the threshold percentage substantially increased. In this regard, we note that S. 1654 would eliminate the assets test for CFCs.

By retaining the assets test, lowering the gross-income test's threshold, eliminating the high-tax exception for passive income, and reducing the percentage of "tainted" income to total gross income triggering full inclusion, the PFC provisions in S. 1394 would increase the number of U.S. corporate shareholders operating active business CFCs subject to current taxation. Subjecting active operating earnings (or an even greater percentage of such earnings) to potential current taxation is at odds with longstanding tax policy to defer current taxation of active foreign-earned income. Doing so under the guise of simplification is inconsistent with, and undermines the credibility of, a simplification initiative.

One positive aspect of the new PFC provisions is the elimination of the permanent stain of PFIC status for CFCs (or PFCs deemed to be CFCs under proposed section 1292).[6] Under S. 1394, the "once a PFIC, always a PFIC" rule would be replaced by an annually applied test. Thus, even if a CFC became a PFC in one year (thereby subjecting both active and passive income to full inclusion by the U.S. shareholder), the subsequent year's *active* income would not necessarily be taxed under the PFC regime (though the passive income would be currently taxed under the Subpart F rules). Another positive feature, though too limited to provide relief to a substantial number of taxpayers, is the provision that would allow leased facilities to be included in the base for determining the existence of 50-percent average passive assets.

Although the PFC regime arguably better integrates the Code's anti-deferral provisions than current law, the simplifying nature of the proposal should not be exaggerated, especially in light of the substantive (on balance, taxpayer-adverse) changes the proposals would work, as well as the complexity inherent in the proposed new mark-to-market rules. True simplification could be accomplished by adding a single sentence to the Code that eliminates the overlap of PFIC and Subpart F rules.[7]

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[6] The "once a PFIC, always a PFIC" rule would remain in effect for a limited category of U.S. shareholders of PFCs.

[7] See, for example, section 13 of H.R. 2948, which was introduced in the House by Representative Gradison.

B. *Treatment of Foreign Sales Corporations.* It is unclear whether the current PFIC rules apply to foreign sales corporations (FSCs) whose passive income is already subject to current U.S. taxation. Section 302 of S. 1394 clarifies that the passive income of a PFC does not include a FSC's foreign trade income. Although the IRS has informally suggested that the PFIC rules do not apply to FSCs, the proposed change would bring certainty to this area.

S. 1394 fails, however, to provide FSCs with an exemption from the 50-percent assets test for purposes of the PFC provisions. Thus, FSCs that invest their foreign trade income might become subject to the PFC rules because the earnings on that income would be treated as passive income. Because the FSC provisions already subject a FSC's passive income to current U.S. taxation, this oversight could result in double taxation. Therefore, we recommend that a specific exemption from the PFC rules be provided for FSCs. At a minimum, an exemption from the assets test (if it is retained) should be included in S. 1394.

C. *Repeal of Sections 960(a)(3) and (b).* Section 312 of S. 1394 would repeal sections 960(a)(3) and (b) of the Code, which permit an indirect foreign tax credit (FTC) and an increased FTC limitation upon certain distributions by a CFC of previously taxed income (PTI). Under the bill, foreign taxes paid by a foreign corporation on a distribution of PTI would be added to the pool of indirect FTCs.

When the Joint Committee staff first advanced this proposal in its simplification recommendations, it averred that no real substantive change would be effected by its enactment because most taxpayers are in an excess credit position and could not use the credits that would be lost by the repeal of the statute. Staff of Committee on Ways and Means, 101st Cong., 2d Sess., *Written Proposals on Tax Simplification*, WMCP 101-27, at 33 (May 25, 1990) (recommendations of staff of the Joint Committee on Taxation). We suggest, however, that the Joint Committee staff misapprehended the effect of its proposal, since many taxpayers continue to rely on the mitigating provisions of section 960 to avoid double taxation of earnings. Distributions of PTI are frequently subject to foreign withholding taxes when they are remitted to the U.S. shareholder and, without sections 960(a)(3) and (b), there would be no specific mechanism to credit the additional taxes.

TEI believes that the tax policy against double taxation far outweighs any nominal simplification that may be achieved through the repeal of the statute. Thus, sections 960(a)(3) and (b) should be retained.

D. *Translation of the Deemed-Paid Foreign Tax Credit.* Section 321 of S. 1394 would grant the Secretary of the Treasury authority to issue regulations permitting foreign tax payments to be translated into U.S. dollar amounts using an average U.S. dollar exchange rate for a specified period. The bill thus adheres to section 986's requirement that foreign taxes be translated at a rate in effect during the year the taxes were paid.

Although the approach taken in S. 1394 represents a minor simplification of the translation of foreign tax payments, the proposal still fails to address directly the tremendous administrative burdens engendered by the Tax Reform Act of 1986's year-of-payment rule; the proposal would still require taxpayers to "track" the year in which myriad tax payments are made. TEI submits that the compliance burdens associated with section 986 are totally disproportionate to any practical or policy purpose that may be served by the provision.

Stated simply, the Code's foreign tax translation rules are in desperate need of simplification. Fortunately, administrable alternatives are clearly available. One is to return to pre-1987 law, which was relatively simple for both taxpayers and the IRS to administer. This approach is effectively embodied in section 5 of S. 936. Another alternative is to translate foreign taxes at a rate in effect in the year in which the taxes are accrued, perhaps averaging the rates in effect on the first and last days of the corporation's taxable year. Such a rule would substantially reduce the administrative burdens on taxpayers without sacrificing any sound tax policy or revenue goal.

E. *Simplified Method for FTC/AMT Calculation.* In computing its FTC limitation, a taxpayer is required to allocate and apportion deductions between U.S. and foreign sources. This limitation must be separately computed for both regular tax and alternative minimum tax (AMT) purposes. In essence, taxpayers that have allocated and apportioned deductions for regular tax purposes must re-allocate and re-apportion those same deductions for AMT-FTC purposes, using assets and income that reflect the AMT adjustments made in computing alternative minimum taxable income.

Section 322 of S. 1394 would accord taxpayers an election to use as their AMT-FTC limitation the ratio of foreign-source *regular* taxable income (rather than foreign-source *AMT* income) to their entire AMT income. The proposed election, however, would clearly operate to the taxpayer's detriment because foreign-source regular taxable income will invariably be less than foreign-source AMT income.

TEI questions the rationale set forth in the Technical Explanation (at page 69) that "the differences between regular taxable income and alternative minimum taxable income are often relevant primarily to U.S. source income." Indeed, any section 56 or 57 expense (such as depreciation) that is apportionable under Treas. Reg. § 1.861-8 will reduce foreign-source income. We believe that an alternative exists that is not skewed toward benefiting either the government or the taxpayer. Specifically, we recommend that taxpayers be permitted to elect to use their regular section 904(a) limitation fraction, *i.e.*, the ratio of foreign-source regular taxable income to their entire regular taxable income. This is the approach adopted by Congress in former section 59(a)(1)(C), regarding the allocation and apportionment of the book income preference.

F. *Treatment of Gain on Certain Stock Sales.* Section 311 of S. 1394 would provide that gain from the sale of stock of a foreign corporation by a CFC will be treated as a dividend to the same extent it would be under section 1248(a) of the Code if the CFC were a U.S. person. The modification clearly satisfies the simplification criteria, and TEI endorses it. We question, however, the rationale underlying the proposal to exclude such deemed dividends from the scope of the same-country exception that the Code provides for actual dividends.

III. DOMESTIC PROVISIONS

A. *Simplified Method for Applying Uniform Cost Capitalization Rules.* Section 412 of S. 1394 would grant the Treasury Department the authority to issue regulations that allow taxpayers to use a base-period percentage in determining the costs of any administrative, service, or support function or department that are allocable to production or resale activities.

The Institute finds it difficult to comment on this proposal because the particulars of the simplified method are for the most part left for Treasury to determine. The Technical Explanation (at page 86) does state that the base period would begin no earlier than four years prior to the taxable year, but it leaves many questions unanswered. For example, the explanation does not address the length of the base period. Will it be a four-year rolling period? A one-year period that would be used for the four succeeding years? If the base period is a four-year rolling period, simplification will be achieved only in the first year. Moreover, the proposed statutory requirement that the costs be capitalized on a department-by-department, function-by-function basis is far from simple. A better method would be to permit taxpayers an election to use a specific percentage based on an average capitalization rate determined from a four-year base period.

In addition, we note that the Technical Explanation (at page 85) states that S. 1394 "authorizes (but does not require)" the Treasury Department to issue regulations providing for the simplified allocation method. The proposed statutory language, however, would clearly require the Treasury to issue such regulations. The obligatory nature of the grant of authority should be confirmed in the committee report, especially in light of the Treasury's testimony before the Ways and Means Committee intimating that such regulations might never be promulgated.

B. *Depreciation for AMT/ACE Purposes.* Section 421 of S. 1394 would apply a 120-percent declining balance method (switching to straight-line at a point maximizing depreciation deductions) for personal property (other than transition property to which the ACRS system in effect before the Tax Reform Act of 1986 applies) for determining the alternative minimum taxable income of a corporation. No further adjustment for this property would be required for purposes of the adjusted current earnings (ACE) provision.

The proposal would provide a simpler method of determining depreciation for newly acquired property. It would not, however, permit taxpayers to use the same method with respect to assets acquired prior to 1991. Thus, the provision may actually increase a taxpayer's compliance burden by forcing it to maintain one more depreciation system (for property placed in service after December 31, 1990). TEI recommends that taxpayers be accorded an election to apply the simplified method retroactively for all years to which ACE applies.

C. *Built-In Losses for Purposes of the Corporate Alternative Minimum Tax.* Section 422 of S. 1394 would repeal the ACE rule relating to the treatment of built-in losses after a change in ownership (current section 56(g)(4)(G) of the Code). Thus, under the bill, the treatment of built-in losses would be the same for ACE, AMT, and regular tax purposes — a significant simplification of current law. TEI endorses enactment of this provision.

IV. OTHER SIMPLIFICATION MEASURES

A. *Exempt Controlled Foreign Corporations from Uniform Capitalization Rules.* One area that significantly increases the compliance burdens of all U.S. corporations is the uniform capitalization rules under section 263A of the Code, which require the capitalization of costs incurred in manufacturing or constructing tangible property. These accounting rules, which were enacted in 1986, are the most comprehensive costing provisions ever approved by Congress, and the price taxpayers have had to pay — not in additional tax but in compliance costs — has been staggering. The uniform capitalization rules — especially those relating to interest expense — create tremendous administrative and compliance burdens for U.S. companies operating abroad, principally in the computation of indirect foreign tax credits under section 902 of the Code. In addition, because all post-1986 earnings are pooled for purposes of this section — and capitalization only postpones the deduction — the section 263A amount becomes increasingly insignificant over time. The existence of excess foreign tax credits (FTCs) has a further averaging effect. Thus, the application of the rules to foreign operations produces relatively little revenue, certainly not enough to justify the astounding cost of compliance on taxpayers.[8]

TEI believes that the extension of section 263A to foreign subsidiaries is unwarranted. For these reasons, we recommend that the statute be amended to specifically exempt controlled foreign corporations from its reach. Section 2 of S. 936 will achieve this result.

B. *Use of U.S. GAAP for Computing Earnings and Profits.* The concept of "earnings and profits" (E&P) has relevance in the foreign tax area for several reasons. For example, E&P is used in measuring the amount of subpart F inclusions, the portion of a distribution from a foreign corporation that is taxable as a dividend, the amount of foreign taxes deemed paid for purposes of the deemed paid foreign tax credit under section 902, and the amount of section 1248 gain taxable as a dividend.

Under section 964, the E&P of a foreign corporation is to be computed in accordance with rules substantially similar to those applicable to domestic corporations. As a practical matter, however, a foreign corporation is frequently unable to compute E&P in the same manner as a domestic corporation. Although a domestic corporation generally calculates E&P by making adjustments to U.S. taxable income, a foreign corporation necessarily uses foreign book income as its base. The ensuing adjustments become especially difficult in the case of noncontrolled foreign corporations since the U.S. shareholder of such companies may encounter difficulty in obtaining all the information required to compute E&P.

Although foreign corporations do not compute U.S. taxable income, they frequently do adjust foreign book income to conform with U.S. generally accepted accounting principles (GAAP) for financial reporting purposes. There are numerous differences between GAAP and E&P, but most relate to timing differences and have at most a nominal effect on a company's U.S. tax liability, especially in light of the requirement of the Tax Reform Act of 1986 that taxpayers compute their section 902 FTC credit on the basis of a pool of post-1986 undistributed earnings.

Under current regulations, taxpayers need only make "material" adjustments between GAAP and E&P. Because the definition of materiality is a fluid one (with which IRS examining agents can take issue), taxpayers may feel compelled to make complicated and time-consuming — but essentially inconsequential — adjustments. If, however, taxpayers were permitted to use U.S. GAAP as a measure of E&P, the heavy compliance burden could be tempered, especially for depreciation, inventory capitalization, and foreign currency translation adjustments.

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[8] Indeed, for some corporations the application of the uniform capitalization rules in the foreign context may actually *reduce* their tax liability, even without regard to the deductibility of the cost of compliance.

Accordingly, TEI recommends that taxpayers be generally permitted to use U.S. GAAP in computing the E&P of foreign corporations. Although the Institute believes section 964(a) provides the Treasury Department and IRS with adequate authority to prescribe such rules, we suggest that Congress clarify such authority and, indeed, expressly direct the Treasury Department and IRS to promulgate regulations implementing this change.

C. *Interest Rate under Section 6621(c).* Section 321 of H.R. 2775 (introduced by Representative Rostenkowski) would provide that, for purposes of determining the period to which the large corporate underpayment rate applies under section 6621(c) of the Code, any letter or notice will be disregarded if the amount of the deficiency, proposed deficiency, assessment, or proposed assessment set forth in the letter or notice is not greater than $100,000 (without regard to any interest, penalty, or addition to tax). The proposal would thus clarify that a notice relating to a minor mathematical error by the taxpayer will not be sufficient to trigger the higher interest rate imposed by section 6621(c).

Although TEI continues to disagree with the policy underlying the so-called hot interest provision, we recommend that S. 1394 be revised to incorporate section 321 of H.R. 2775. Indeed, the bill should go even further to make the "hot interest" provision more administrable and fair. Specifically, Congress should provide for the mandatory abatement of "hot interest" during the period attributable to a delay by the IRS in considering a taxpayer's administrative appeal of proposed adjustments. In addition, the bill should provide for Tax Court review of adjustments paid by taxpayers to stop the running of interest. Finally, Congress should reaffirm its unequivocal instruction to the Treasury Department to implement a comprehensive netting procedure to ameliorate the unfair effects of section 6621(c). No such procedure has been forthcoming from the Treasury or IRS even though the congressional mandate dates back to 1986.

V. CONCLUSION

Tax Executives Institute appreciates this opportunity to present its views on S. 1394, S. 936, and other tax simplification measures and would be pleased to answer any questions you may have about its positions. In this regard, please do not hesitate to call either Robert H. Perlman, the Institute's Senior Vice President, who will testify on the Institute's behalf at the Committee's September 10 hearing, at (408) 765-1202 or Timothy J. McCormally of the Institute's professional tax staff at (202) 638-5601.

Prepared Statement of Lloyd Leva Plaine

Mr. Chairman and Members of the Committee:

As a practicing estate and gift tax attorney, I appreciate the opportunity to appear before the Committee today with respect to tax simplification and, in particular with respect to S. 1394 and H.R. 2777, The Tax Simplification Act of 1991 and H.R. 2775. Although a large part of the following comments have been prepared in coordination with various individuals (principally Carol Rhees, Frederick R. Keydel and Dave L. Cornfeld) who are members of the Estate and Gift Tax Committee (of which I am the Chair) of the Section of Taxation and of the Real Property, Probate and Trust Law Section (of which I am the Secretary) of the American Bar Association, the following is submitted only on behalf of myself as an individual.

I. COMMENTS REGARDING SECTIONS 441 and 502 - REVOCABLE TRUST

Section 441 of the Tax Simplification Act of 1991 provides that certain revocable trusts will be treated as estates for various tax purposes. Section 502 of that same proposed Act substantially rewrites section 2035 of the Code. As a part of that rewriting, section 502 partially eliminates the application of the three-year rule to gifts from certain revocable trusts, to that extent providing similar tax treatment for those who use funded revocable trusts as will substitutes.

A proposal for achieving equal tax treatment for individuals who use revocable trusts (the "revocable trust proposal," copy attached) was included in a series of proposals prepared by individual members of the Committee on Estate and Gift Taxes of the Tax Section and the Real Property, Probate and Trust Law Section of the American Bar Association. These proposals were submitted on March 26, 1991 (the "March 26 proposals"). At the request of Melvin C. Thomas, Senior Legislation Counsel of the Joint Committee on Taxation, further comments regarding the revocable trust proposal were prepared and sent to Mr. Thomas on June 5, 1991, including draft statutory language (the "draft statutory language," copy attached). I believe that proposal and draft statutory language would result in equal tax treatment for individuals who use revocable trusts.

People create revocable trusts for a number of legitimate reasons. Perhaps the most prominent reasons are to provide for the management of property, to provide for the disability of the grantor, and to avoid probate. Such trusts are never created for tax reasons because, under sections 671-677 and 2036-2038, they are ignored for basic income and estate tax purposes. Nevertheless, there are certain minor differences in the tax treatment of people who create such trusts and people who do not, with the result that the use of trusts is artificially discouraged. There does not appear to be any policy reason for this disparity in treatment.

Although section 441 (together with section 502) of the bills would achieve tax parity for certain revocable trusts and estates under some circumstances, it does not achieve equal tax treatment for individuals who use revocable trusts in many significant respects. I see no revenue or policy reason why the goal of this remedial legislation should not be complete tax parity for individuals who use revocable trusts, the common practice in many states, with those who use wills. Such equal tax treatment should apply for all transfer tax as well as income tax purposes, not only during the estate or equivalent administration period after death but also during lifetime. Comments addressing some of the specific shortcomings of sections 441 and section 502 are set forth below.

1. Definition of Revocable Trust

Section 441 defines a revocable trust which will be treated like an estate as any trust:

(1) all of which was treated under section 676 as owned by the decedent and

(2) to which the residue of the decedent's estate will pass under his will (or, if no will is admitted to probate, which is the trust primarily responsible for paying debts, taxes and expenses of administration).

A number of problems exist under the section 441 definition.

With respect to the first prong of the section 441 definition (i.e., the revocability requirement), the proposed legislation does not address the situation of a revocable trust which ceases to be revocable as a result of the incapacity of the grantor. A trust would probably be treated under section 676 as owned by the decedent under such circumstances, but this is not entirely clear. Many revocable trusts provide that, in the event of the grantor's incapacity, the trust will become irrevocable, with the grantor ceasing to have any right of withdrawal. The proposed legislation should therefore include language similar to that included in Part XIX of the draft statutory language making it clear that a trust will not be disqualified by the grantor's incapacity.

Also with respect to the first prong of the definition, it is similarly unclear whether a trust initially created by a third party would be treated under section 676 as owned by an individual where the trust property had been subject to his general power of appointment which lapsed. This sometimes occurs, for example, with section 2503(c) trusts where the beneficiary has a right of withdrawal at age 21. The proposed legislation should include language similar to that included in Part XIX of the draft statutory language treating such individual as the creator of the trust after the lapse of a general power of appointment. Thus, such a grantor trust (under section 678(a)(2) if not under section 676), the property of which the individual or a non-adverse party, or both, have the power to vest in the individual, will not be excluded from the new rule.

The first prong of the definition further requires that all of the trust be treated as owned by the decedent. In community property jurisdictions, it is not uncommon for a husband and wife to establish a joint revocable trust. Joint revocable trusts are also used in common law states, with one-half of the trust becoming irrevocable on the first spouse's death. Joint trusts such as these may not be treated under section 676 as owned in their entirety by either grantor. Thus, a special rule, similar to that included in the last two paragraphs of Part XIX of the draft statutory language, should be added to cover such joint trusts.

Perhaps even more importantly, the second prong of the test (the "pour-over" requirement) is unduly restrictive. With funded revocable trusts, it is not uncommon for the residue of a decedent's estate not to pour over to the trust under all circumstances. Indeed, to require a pour-over under all circumstances may serve only to complicate the administration of the estate and trust. Moreover, the alternative provided in the parenthetical covering the situation where there is no will admitted to probate does not provide adequate relief from the pour-over requirement; even with a funded revocable trust, there is often a will admitted to probate.

A serious question exists as to whether the second prong of the test is necessary at all. The language in the second prong appears to have been copied from section 6654(l) of the Code. There it was considered necessary in order to limit the relief from making estimated tax payments to one trust, in addition to an estate. There is no reason for a similar limitation here, particularly since proposed section 7701(a)(47)(C) provides that the "treatment like an estate" rule will not apply for the following purposes: determining the trust's taxable year, subtitle B (relating to estate, gift, and generation-skipping tax), section 642(b) (relating to the deduction

for personal exemption), and "such other provisions as the Secretary may by regulations prescribe."[1] I therefore strongly urge that the second prong of the definitional test be deleted, and that perhaps section 6654(l) should be amended, as well. If, however, the second prong must be included, I recommend that the alternative language in the parenthetical be reworded to delete the words "if no will is admitted to probate."

As a protection for the unwary, it may be helpful to add a cross-reference to section 7701(a)(47) and its treatment of a post-death revocable trust like an estate at the end of each of the more important code sections affected by that provision - - section 267(b) (losses between related parties) 642(c) (the permanently set-aside charitable deduction), 665 (the throwback rule), 1239(b) (gain on the sale of depreciable property between related parties), and 1361 (c)(2)(A) (subchapter S stockholders).

I believe a more comprehensive definition of a revocable trust would be desirable. Specifically, I suggest defining it, as was done in Part XIX of the draft statutory language, as

> (1) any trust the property of which may be withdrawn by a person and also
>
> (2) any trust created by a person, either directly or by the lapse of a general power of appointment, while such person (A) is the only permissible distributee of such trust's property and (B) holds any power of appointment with respect to such property.

The draft statutory language definition goes on to provide that, in either case, a trust will not fail such definitional requirements (i) because such person is unable because of incapacity to withdraw trust property or exercise a power of appointment or (ii) because such person is permitted to withdraw trust property or exercise a power of appointment only with the consent of a non-adverse party (within the meaning of section 672).

2. <u>Time Period for Treatment of Trust as an Estate</u>

The proposed legislation limits the period of treatment of a revocable trust like an estate to "taxable years which end after the date of the decedent's death and which begin before the date which is 3 years and 9 months after the date of such death." Although the administration of the vast majority of revocable trusts, like the vast majority of estates, will have terminated by that point, there are legitimate situations where the administration is further prolonged (<u>e.g.</u>, estate litigation or litigation with the Internal Revenue Service). I believe it would be better to simply apply the rules relating to the timing of the termination of an estate for income tax purposes to the timing of the termination of treatment like an estate for a trust (<u>see</u> Part V and also Parts I and VII of the draft statutory language).

I therefore recommend that further consideration be given to allowing a revocable trust to be treated like an estate so long as the trust, if it were an estate, would not be deemed terminated for income tax purposes. Alternatively, I suggest that a provision be added giving the Commissioner authority to extend the 3 year 9 month period for reasonable cause.

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[1] In addition, the section 469(i)(4) passive loss estate adjustment (involving the $25,000 offset for rental real estate activities) is easily addressed where there is more than one revocable trust treated like an estate. <u>See</u> Part III of the draft statutory language.

3. <u>Treatment of Revocable Trust During Grantor's Lifetime</u>

In addition to treating a revocable trust like an estate after the grantor's death, it would be desirable, in my opinion, to treat a revocable trust like an individual during the grantor's lifetime. Examples of the disparity in tax treatment accorded individuals using revocable trusts include (1) the prohibition against revocable trust ownership of section 1244 stock; (2) the possible disqualification of a QSST under section 1361(d)(3) if the QSST makes distributions to the income beneficiary's revocable trust; (3) the "gifts within three years of death" problem under section 2035; and (4) the possible unavailability of the marital deduction for gifts and bequests to a spouse's revocable trust. Although the proposed legislation does amend sections 2035 and 2038, it does not address the problems noted with respect to section 1244 stock, QSST's or the marital deduction. The draft statutory language included amendments with respect to these issues (*see* Parts II, VI, VIII, X-XIII, XV and XVI), as well as the post-death issues.

4. <u>Gifts Made From Revocable Trusts - Section 502</u>

Section 502 of the proposed legislation makes the three-year rule in sections 2035 and 2038 inapplicable to the relinquishment of any power "merely by reason of a transfer from a trust with respect to which the decedent had reserved the right to revoke." This wording does not define the term "right to revoke" (as does section 676). It is also unclear whether section 502 would apply in the situation of a revocable trust (i) which had ceased to be revocable as a result of the incapacity of the grantor or (ii) where the power to revoke was exercisable only with the consent of another. Furthermore, the proposed legislation appears to be inapplicable to transfers from a trust that was created by a third party that is treated as owned by the decedent by reason of the lapse of a general power of appointment previously held by the decedent. These uncertainties could be eliminated if wording similar to that of Parts XIII and XIV (together with Part XIX) of the draft statutory language were adopted in section 502.

The three-year rule of section 2035, as rewritten by section 502 of the proposed legislation, applies not only to the "relinquishment of a power" but also to "a transfer...of an interest in property" where the value of the property would have been included under section 2036 if the transferred interest had been retained by the decedent. Since a gift from a revocable trust could be viewed as either a "relinquishment of a power" or a "transfer of an interest in property" as to which the donor has an income interest, unless the proposed wording of Part XIII of the draft statutory language is used, the last sentence of proposed section 2035(a) (in section 502) should be revised to add the words "as having transferred any interest or" before the word "relinquished" and the words "the right to income or" before the phrase "the right to revoke." The proposal should also be changed to make it clear that a "transfer from a trust" includes the relinquishment of a power to revoke a revocable trust, the transfer of an interest in the trust, the assignment of such power to another or the assignment of a power over a portion of the trust.

The changes made by Section 502 should be made retroactive to the original effective date of prior changes to Section 2035 (January 1, 1982) which, in most cases, eliminated the three-year inclusion rule.

5. <u>Generation-Skipping Transfer Tax Uncertainties</u>

In addition to recommending equal income tax treatment for individuals who use revocable trusts as will substitutes, I would encourage equal generation-skipping tax treatment. Section 441 of the proposed legislation (i) does not deal with this aspect of revocable trusts during the grantor's lifetime and (ii) expressly makes proposed section 7701(a)(47) treating a post-death revocable trust like an estate inapplicable for purposes of generation-skipping taxes. At present, it is unclear how Chapter 13 will be applied to revocable trusts, particularly as to the post-death disposition of revocable trust property as compared with the post-death disposition of a

decedent's estate property. A revocable trust that is a will substitute should be treated the same as an estate for these purposes. Adoption of Part XVII (in conjunction with Part XIX) of the draft statutory language would accomplish this result and eliminate uncertainty.

6. The "65-Day" Rule

I also believe it would be desirable to extend to estates the elective deduction for distributions in the first 65 days of the taxable year under section 663(b). The 65-day rule, which is currently available to revocable trusts after the settlor's death, has simplified the administration of such trusts and made possible more equitable treatment of beneficiaries.

The 65-day rule should not be taken away from revocable trusts, especially since such trusts will still be required to use the calendar year as their taxable period. Furthermore, there appears to be no reason why such trusts should not be permitted to elect a fiscal year with a mandatory change to the calendar year when the estate treatment period ends.

7. Optional Election of "Separate Share" Rule

The letter transmitting the draft statutory language included a recommendation that both revocable trusts and estates be permitted to elect the separate share rule under section 663(c). Persons who have drafted revocable trusts as the testamentary vehicle expect the availability of the separate share rule. The rule also has the simplification effect of negating the necessity for the fiduciary to determine whether the timing of distributions will cause inequitable tax consequences, whether an equitable adjustment is proper and whether fiduciary liability will be incurred to beneficiaries who may be forced to pay taxes on income they will not receive.

8. Technical Correction to Proposed Section 7701(a)(47)(C)(iii)

Proposed section 7701(a)(47)(C)(iii) provides that the rule providing treatment like an estate shall not apply for purposes of "section 642 (relating to deduction for personal exemption)." I recommend that this limitation refer specifically to section 642(b), so as to eliminate possible confusion with respect to the availability of the charitable set-aside deduction provided by section 642(c).

II. COMMENTS REGARDING SECTION 501 - TAX RIGHT OF RECOVERY

Section 501 of the Tax Simplification Act of 1991 (S. 1394, H.R. 2777) provides that the right of recovery with respect to estate tax on qualified terminable interest property ("QTIP") provided by section 2207A may only be waived "if the decedent otherwise directs in a provision of his will (or a revocable trust) specifically referring to this section." The amendment will apply to estates of decedents dying after the date of enactment of the Act.

The existing language in section 2207A (which provides simply that the right of recovery is waived "if the decedent otherwise directs by will") presents a trap for the unwary, since standard testamentary language in the surviving spouse's will often directs that all taxes be paid from his or her residuary estate. I therefore support an amendment to section 2207A to prevent inadvertent waivers of the right of recovery. I am concerned, however, that the requirement in section 501 that the decedent's will specifically refer to section 2207A may necessitate the wholesale rewriting of many existing wills and may create yet another trap for clients and lawyers alike.

Many practitioners currently draft wills which make it clear that the right of recovery afforded by section 2207A is intended to be waived, even though the wills do not specifically reference that section. For example, such a waiver may instead refer to the marital trust under the predeceased spouse's Will, to the QTIP tax, or to the tax due under section 2044 of the Code. Rather than causing such

waivers to be ineffective, I suggest that the language of section 501 be broadened to encompass provisions such as these where the testator's intent is clear.

Alternatively, I recommend that the effective date of section 501 be revised so that the amendment will apply only to wills (or revocable trusts) executed more than 6 months after the date of enactment of the Act. Like the transitional rule provided by section 504 of the Act for qualified domestic trusts, such an effective date provision would eliminate the need to attempt to identify and revise all existing wills and trusts which intentionally waive the right of recovery but do not refer specifically to section 2207A.

III. SECTION 504 - GRANDFATHERING FOR CERTAIN QUALIFIED DOMESTIC TRUSTS ("QDOT")

I support the grandfathering of the QDOT, but believe some of the other simplification proposals in the March 26 submission and in other submissions by the Bar relative to these provisions should also be adopted.

IV. TITLE IV OF HR 2775: OVERRULING NORTHWESTERN PENNSYLVANIA NATIONAL BANK & TRUST CO. V. UNITED STATES AND ALEXANDER V. COMMISSIONER

I support the provisions in Title IV overruling these cases to the extent that the goal is to prevent a "specific portion" as that term is used in Sections 2056(b)(5), (b)(6) and (b)(7) to include a fixed dollar amount. The proposal provides that "the term 'specific portion' only includes a portion determined on a fractional or percentage basis." It is not completely clear how this provision would affect pecuniary formula marital deduction bequests which are used routinely in estate planning documents and have been sanctioned by the Service if the requirements of Rev. Proc. 64-19, 1964-1 C.B. 682, are met. The suggested language of Title IV should be revised to assure that it does not interfere with such pecuniary formula marital deduction bequests.

V. OTHER TAX SIMPLIFICATION SUGGESTIONS

The March 26 proposals included many other worthwhile simplification suggestions. Like many other practitioners, I believe there should be more stability in the transfer tax system. The ABA passed a resolution calling for greater stability in 1988. That resolution expressed the view, with which I wholeheartedly agree, that no change should be made in the law unless it can meet a heavy burden of persuasion that the inequity or inefficiency of the current system is so great that further changes and the resultant disruption are justified. The following proposals from that submission are ones which I believe can meet that burden of persuasion and would be valuable to have made at this time:

1. Repeal the Throwback Rule for Domestic Trusts

Section 644, which addresses sales of property within two years of its transfer to a trust, and the throwback rules of sections 665-668 were enacted to prevent abusive tax planning when the tax rates applicable to individuals were higher than those applicable to trusts. Since this is no longer the case due to the compressed tax brackets, these sections create unnecessary complexity in the tax code and should be repealed. The repeal of the throwback rules should be solely with respect to domestic trusts.

2. Portability of Unified Credit and GST Exemption

Under current law, unless the ownership of property is properly structured and tax-motivated estate planning is undertaken, the unified credit and GST exemption available to the first spouse who dies may be wasted. This involves complex drafting and administration. Sections 2010 and 2631 should be amended to provide that the

unused unified credit and GST exemption of a deceased spouse should be passed to and be usable by the surviving spouse.

3. Overrule Result of Rev. Rul. 79-353

In Revenue Ruling 79-353, 1979-2 C.B. 325, the Service took the position that a settlor's mere retention of the power to remove a corporate trustee and substitute a new corporate trustee causes the trustee's powers to be imputed to the settlor for purposes of sections 2036 and 2038. The Service has recently expanded the position announced in Revenue Ruling 79-353 (1) by holding that a beneficiary's power to remove and replace a trustee may be viewed as a general power of appointment under section 2041 (PLR 8916032 (Jan. 19, 1989)), and (2) by stating that a decedent's power to remove and replace a trustee is sufficient cause to attribute to the decedent the incidents of ownership the trustee had in a life insurance policy on the decedent's life under section 2042 (TAM 8922003 (Feb. 24, 1989)).[2] In light of this expansion and the continuing belief that the Service's position is unfounded, I urge that the issue addressed in the revenue ruling be addressed legislatively. The Internal Revenue Code should be amended to overrule the result of Revenue Ruling 79-353 with respect to sections 2036 and 2038, and to prevent its application to sections 2037, 2041, 2042 and Chapter 13).

4. Allow Correction of Defective Qualified Terminable Interest Property ("QTIP") Elections

Since the introduction of the QTIP election in 1982, there have been numerous instances of defective or incomplete QTIP elections. For many taxpayers, the unintended loss of this deduction is a serious tragedy, since it may substantially reduce the funds available to support the surviving spouse. A procedure should be adopted for permitting executors (and donors) to correct a defective QTIP election in situations where it is clear that the election was intended and the trust otherwise qualifies for the marital deduction. Limitations would have to be placed on the time for such a correction so as to prevent executors from making a defective election and then adopting a "wait and see" approach. Alternatively, a QTIP election could be conclusively deemed made with respect to any property claimed (or described by reference) as a marital deduction on an estate (or gift) tax return which could not otherwise qualify for the marital deduction.

5. Allow Severance of Trusts With a Generation-Skipping Transfer Tax ("GSTT") Inclusion Ratio Greater Than Zero

Chapter 13 should be amended to allow expressly the severing of trusts with an inclusion ratio greater than zero into two trusts, one with an inclusion ratio of zero and a second with an inclusion ratio of one, as long as the severance is based on the fair market value of property at the time of the severance.

6. Allow Beneficiary's Election to Include Trust in Gross Estate for Federal Estate Tax Purposes, Rather Than Subject Trust to Generation-Skipping Transfer Tax

Under current law, in order to avoid subjecting a trust (or portion thereof) to GSTT at the death of the beneficiary, the beneficiary must be given a general power of appointment. There may be non-tax reasons, however, why this is not desirable. Further, drafting for this, as well as administering such a provision, is very complex.

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[2] As recently as August 7, 1989, the United States Tax Court reached a result contrary to any extension of Revenue Ruling 79-353. *See* Estate of Headrick v. Commissioner, 93 T.C. 171 (1989), aff'd CA-6 (1990).

I believe it would be very desirable to amend Chapter 13 to allow the executor of an individual's estate to elect to include a trust or a portion of a trust in the gross estate of the individual who is a beneficiary of the trust and who dies at the same time that a taxable termination would otherwise take place. Such an amendment would be consistent with the policy behind Chapter 13 -- that it is a backstop for the estate and gift tax so that as long as estate tax is to be paid, it is appropriate to avoid GSTT (other than on direct skips). This should be accompanied by a provision, similar to section 2207A, granting a right to recover the estate tax which could be rebutted only by specific reference to this specific section of the Code or the tax resulting therefrom.

March 26, 1991

INDIVIDUAL MEMBERS OF THE
ESTATE AND GIFT TAXES COMMITTEE
OF THE SECTION OF TAXATION
AND
OF THE SECTION OF REAL PROPERTY,
PROBATE AND TRUST LAW

AMERICAN BAR ASSOCIATION

TAX SIMPLIFICATION PROPOSAL NO. 1

Internal Revenue Code References: § § 642(c), 645(a), 663(b) and (c), 469(i)(4), 267, 1239, 1244, 1361, 1361(d)(3), 2035, 2038(a)(1), 2056(b)(5), 2523(e), and 2652(b)(1)

Subject Area: Equal tax treatment for individuals who utilize revocable trusts.

Summary of Problem: Under current law, individuals who take advantage of a funded revocable trust are taxed differently in a number of circumstances from those who do not. These differences in tax treatment have no justifiable basis, other than an historical one.

Discussion: In recent years, there has been an increasing estate planning use of revocable trusts holding assets during the settlor's lifetime. Use of a funded revocable trust offers significant non-tax advantages over a traditional estate plan, in that it provides (1) a convenient vehicle for managing the property of the settlor, particularly in the event of illness or incapacity, and (2) a means of reducing or eliminating the delay, expense and potential lack of privacy associated with probate at death. Revocable trusts avoid no taxes; the income continues to be taxable to the settlor during life, and the trust property is includible in the settlor's estate for estate tax purposes at death. Under current law, however, individuals who take advantage of a funded revocable trust are taxed differently in a number of circumstances than those who do not. We recommend that those differences, which fall into the following six categories, be eliminated.

1. Tax Treatment of Estates and Revocable Trusts Following Death of Decedent/Settlor

The tax treatment accorded estates and revocable trusts following the death of the decedent/settlor differs in a number of respects. A suggested correction for each of those differences is set forth below.

2. Revocable Trust Ownership of Section 1244 Stock

Small business stock that is owned by a revocable trust is not entitled to ordinary loss treatment under section 1244. Such treatment is available only in the case of an "individual."[1] Section 1244 stock appears to be the only kind of property, the ownership of which by a revocable trust will disqualify the settlor from a tax benefit to which he or she would be entitled if he or she owned that property individually. We recommend that section 1244 be broadened to permit stock owned by a revocable trust to be taxed as though it were owned by the trust's settlor.

3. QSST Income Distributions to Beneficiary's Revocable Trust

In PLR 9014008 (Dec. 27, 1989), the Service concluded that if the income of a "qualified subchapter S trust" ("QSST") is distributed to the income beneficiary's revocable trust, rather than to the individual beneficiary himself, the trust will no longer be a QSST. This conclusion was apparently based on a literal reading of section 1361(d)(3) which states that the term "qualified subchapter S trust" means a trust --

> "(A) the terms of which require that -
>
> > (i) during the life of the current income beneficiary, there shall be only 1 income beneficiary of the trust,...and
>
> (B) all of the income...of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States."

This recent ruling appears to require that the income beneficiary of a QSST who has a revocable trust as a will substitute first receive the income and then subsequently transfer it to the revocable living trust to prevent termination of the corporation's S status. This may be difficult or impossible if the beneficiary becomes incapacitated during his or her lifetime. Furthermore, to avoid guardianship/conservatorship problems should a trust beneficiary become incapacitated, many trusts (including QSSTs) include boiler plate "facility of payment" clauses permitting the trustee to make distributions other than only to the beneficiary individually -- for instance, by direct payment of the beneficiary's expenses or by payment to "the trustee or trustees of any trust all the assets of which are then fully and unqualifiedly withdrawable by" the beneficiary (i.e., the beneficiary's revocable trust). The holding in this recent ruling

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[1] Section 1244(d)(4) provides that:

> "For purposes of this section, the term 'individual' does not include a trust or estate."

makes such a facility of payment clause a trap for the unwary -- a trap that is contrary to the income tax laws' almost universal treatment of transactions involving a revocable trust during the settlor's lifetime as though the trust did not exist and the transactions involved only the settlor individually (e.g., Rev. Rul. 74-613, 1974-2 C.B. 153).

We therefore recommend that section 1361(d)(3) be amended to make it possible for a QSST to make distributions to the income beneficiary's revocable trust without jeopardizing the trust's QSST status.

4. Gifts Made Within Three Years of Death From Revocable Trusts

Except in certain narrowly defined circumstances,[1] the Internal Revenue Service has taken the position that gifts made directly from a donor's revocable trust within three years of death, including gifts of $10,000 or less which are covered by the annual exclusion, are included in the donor's gross estate for federal estate tax purposes. In order to avoid this trap, individuals with revocable trusts are often put to the inconvenience of first transferring the property to be gifted out of their trusts and into their individual names before making the transfer to the donee (e.g., by writing the trust owned bank account check to the settlor who then endorses the check on the back to the donee). In the case of an individual who wishes his trustee to continue his gift program in the event he becomes incapacitated, the problem becomes more acute. In order to avoid this trap for the unwary, section 2035 should be amended so that the transfer tax consequences of making a gift from a revocable trust are no different than if such gift were made directly by the donor.

5. Marital Deduction Qualification for Gifts and Bequests to a Spouse's Revocable Trust

With the advent of the unlimited marital deduction, interspousal gifts, whether intended or inadvertent, will occur more frequently than in the past and with less attention given to the tax niceties. Where the spouses have revocable trusts, transfers between them are likely to be, in fact, transfers between their revocable trusts. However, the marital deduction, which would seem to most to be so obviously applicable, may turn out to be technically not available.

Often a typical revocable trust may neither contain a general power of appointment exercisable by the settlor in all events nor require distribution of all income to the settlor at least annually. See Treas. Reg. § 20.2056(b)-5(f)(6). In addition, it will probably not contain typical marital deduction savings clauses (e.g., with respect to unproductive property) and it may not prohibit the trustee from making distributions to persons other than the settlor (e.g., gifts in the event of the settlor's incapacity).

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[1] See, e.g., (i) Rev. Rul. 75-553, 1975-2 C.B. 477 and TAM 8940003 (June 30, 1989) (where the trust instrument directs that the trust property be distributed to the settlor's estate on the settlor's death) and (ii) TAMs 9010004 (Nov. 17, 1989), 9010005 (Nov. 17, 1989), 9017002 (Jan. 5, 1990), and 9018004 (Jan. 24, 1990) (where the trust instrument treats the settlor as the only permissible distributee and does not confer on anyone, even the settlor himself, the power to direct distributions to individuals other than the settlor) -- but note the recent holding in Perkins Estate v. U.S., 90-2 USTC ¶ 60,042 (N.D. Ohio 1990) that the three-year rule applies notwithstanding such trust instrument provisions.

We therefore recommend that language be added to section 2056 to allow transfers directly between typical revocable trusts without requiring the draftsman of a revocable trust to insert a detailed savings provision qualifying for the marital deduction additions to the trust made by the settlor's spouse during the settlor's lifetime.

6. Equal Generation Skipping Tax Treatment of Estates and Revocable Trusts Following Death of Settlor [Section 2652(b)(1)]

For Chapter 13 purposes, a revocable trust that is a will substitute should be treated the same as an estate.

Suggested Corrections: The following proposals are intended to provide equal and fair treatment for taxpayers who should not logically be taxed differently. They will affect an increasing number of taxpayers as the use of revocable trusts continues to grow. No taxpayers will be adversely affected, and there should not be significant revenue consequences.

1. Equal Income Tax Treatment of Estates and Revocable Trusts Following Death of Settlor [Sections 642(c), 663(b) and (c), 469(i)(4), 267, 1239, 1361, and 645(a)]

For a limited period following the death of the settlor, revocable trusts and probate estates should be treated as nearly as practicable in the same manner for tax purposes. We suggest that the period for such similar treatment be taxable years commencing within two years of the year of death if no federal estate tax return is filed. If a federal estate tax return is filed, then the period should be extended to include taxable years commencing no later than six months after the final determination of the federal estate tax. The treatment should be applicable to only one such revocable trust. The suggested wording of such a provision [patterned after section 6654(l)(2)(B)] is set forth in paragraph 6 below. The following are provisions which should be adopted to accomplish such simplification:

a. Section 642(c): Section 642(c) should be revised to allow revocable trusts a charitable deduction for amounts permanently set aside for charitable purposes as in the case of an estate. This proposal has been adopted in a resolution by the House of Delegates of the American Bar Association in 1989, a copy of which is attached as Exhibit A.

b. Section 663(b) and (c): The deduction for distributions in the first 65 days of the taxable year under section 663(b) should be allowed to estates as well as trusts. Likewise, the separate share rule under section 663(c) should apply to estates in the same manner as it now applies to decedents' revocable trusts.

c. Section 469(i)(4): Section 469(i)(4) [and section 502(d)(2) of the Tax Reform Act of 1986] should be amended to allow a decedent's revocable trust, during the extended period for similar tax treatment described above, the same passive loss exemptions as are available to a decedent's estate under those sections.

d. Sections 267 and 1239: Section 267 (and section 1239) should be amended to provide that, during the extended period for similar tax treatment described above, a beneficiary of a decedent's revocable trust will be treated as

unrelated to the trust in the same manner as the beneficiary of an estate is treated as unrelated to the estate. Such a provision would eliminate income tax differences in the funding of bequests, which presently exist, depending on whether the beneficiary received the distribution from an estate or from a revocable trust.

e. Section 1361: Section 1361 should be amended to provide that a decedent's revocable trust, during the extended period for similar tax treatment described above, can qualify to be a shareholder of an "S" corporation in the same manner as an estate can during such extended period.

f. Section 645(a): Section 645(a) should be amended to exempt a decedent's revocable trust, during the extended period for similar tax treatment described above, from the requirement that its taxable year be the calendar year, thereby permitting the decedent's revocable trust, like an estate, to initially choose any fiscal year as its taxable year. If the decedent has an estate that is required to file an income tax return, the taxable years of the estate and the revocable trust should be required to close at the end of the same month. Upon close of the extended period, the trust would be required to convert to the calendar year.

2. Revocable Trust Ownership of Section 1244 Small Business Stock [Section 1244]

We recommend that section 1244(d)(4) be amended to read as follows:

"(4) Individual defined. For purposes of this section, the term 'individual' does not include a trust or estate (other than a revocable trust which is treated as owned by its grantor under subpart E of part I of subchapter J of this chapter)."

3. QSST Income Distributions to Beneficiary's Revocable Trust [Section 1361(d)(3)]

We recommend that the following sentence be added at the end of section 1361(d)(3):

"Distributions to a revocable trust described in (c)(2)(A)(i) [a grantor trust] shall be treated as distributions to the grantor individually."

4. Gifts Made Within Three Years of Death From Revocable Trust [Sections 2035 and 2038(a)(1)]

As suggested by Janice A. Mays, Chief Tax Counsel of the Committee on Ways and Means,[1] (i) section 2035 should be amended so that the transfer tax consequences of making a gift from a revocable trust are no different than if such gift were made directly by the donor and (ii) section 2035 should be redrafted to make the current rules more comprehensible. See also Proposal No. 5 below, and proposed revision at Exhibit B.

5. Marital Deduction Qualification for Gifts and Bequests to a Spouse's Revocable Trust [Sections 2056(b)(5) and 2523(e)]

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[1] Committee on Ways and Means, U.S. House of Representatives, "Written Proposals on Tax Simplification," May 25, 1990, (hereinafter "Ways and Means Committee Print") at 69.

We recommend that section 2056(b)(5) [and section 2523(e)] should be amended so that the last part of that section would read as follows:

> "This paragraph shall apply only if such power in the surviving spouse to appoint the entire interest, or such specific portion thereof, whether exercisable by will or during life, is exercisable by such spouse alone and in all events. Where such power in the surviving spouse is exercisable with respect to any interest in property and the income therefrom in favor of the surviving spouse during the remainder of his or her lifetime, this paragraph shall apply to such interest notwithstanding that:
>
> (i) The surviving spouse is not otherwise entitled to the income therefrom,
>
> (ii) The property produces no income,
>
> (iii) There are restrictions on the exercise of such power in the event of the surviving spouse's alleged mental incapacity, and
>
> (iv) There is a power in any other person acting on behalf of the surviving spouse to appoint any part of such interest to persons other than the surviving spouse,
>
> and, for the purposes of sections 2041 and 2514, notwithstanding the existence of the circumstances described in clauses (iii) and (iv) above, such power shall be treated as though it were exercisable by such spouse alone and in all events."

6. Equal Generation Skipping Tax Treatment of Estates and Revocable Trusts Following Death of Settlor [Section 2652(b)(1)]

We suggest that, at the end of section 2652(b)(1), the following sentence [patterned after section 6654(l)(2)(B)] be added:

> "Any trust -
>
> (A) all of which was treated (under subpart E of part I of subchapter J of chapter 1) as owned by the settlor and
>
> (B) to which the residue of the settlor's estate will pass under his will (or, if no will is admitted to probate, which is the trust primarily responsible for paying debts, taxes and expenses of administration)
>
> shall be treated as an estate during taxable years of the trust commencing (i) within 2 years of the settlor's death or (ii) if a federal estate tax return is required and filed within that 2 year period, within 6 months of the final determination of the settlor's federal estate tax liability."

Contact Person: Lloyd Leva Plaine (202-383-0155) or Carol A. Rhees (202-429-6220).

June 5, 1991

BY MESSENGER

Melvin C. Thomas, Esquire
Senior Legislation Counsel
Joint Committee on Taxation
1012 Longworth Building
Washington, D.C. 20515

Re: Tax Simplification Proposal No. 1 - Equal Tax Treatment for Individuals Who Utilize Revocable Trusts

Dear Mel:

Enclosed for your consideration is draft statutory language intended to implement the March 26, 1991 proposal (made by individuals who are members of the Estate and Gift Tax Committee of the Section of Taxation and individuals who are members of the Real Property, Probate and Trust Law Section of the American Bar Association) regarding equal tax treatment for individuals who utilize revocable trusts.

At our meeting on March 28, you raised the possibility of including in section 7701 of the Code a generic definition of revocable trusts. The enclosed draft includes such a definition (proposed section 7701(l)). After considerable discussion, however, we have concluded that it is not advisable to use section 7701 to state a general rule regarding the treatment to be accorded revocable trusts. Rather, we have drafted statutory language amending the various Code sections where disparate treatment is a problem. (Although not included in our proposal, a similar change should also be made in section 1396a(k)(2) of the Social Security Act, 42 U.S. Code section 1396a(k).) The proposed section 7701 definition is still helpful, however, since it obviates the need to include a separate revocable trust definition in each of the substantive Code provisions that should be amended.

As you will note, our proposed section 7701(l) adopts a broad definition of revocable trusts. The definition reflects our considered opinion that --

(1) The definition should center on a person's unqualified right to withdraw the property of the trust. It, therefore, does include a trust the assets of which are withdrawable by a person other than the creator of the trust (e.g., withdrawable marital trusts, the portion of children's trusts that become withdrawable after attainment of a certain age, etc).

(2) The definition also includes a trust while its creator is its sole permissible distributee and holds any power of appointment over its property.

(3) The definition should not extend to all trusts treated as owned by the grantor under subpart E of part I of subchapter J.

(4) The definitional rule should not be limited to one revocable trust per grantor.

(5) Likewise, the definitional rule should not be limited to revocable trusts created by one grantor.

(6) The definition should treat revocable trusts created by persons other than individuals the same as revocable trusts created by individuals.

It is contemplated that the rules relating to the timing of the termination of an estate would also apply to the termination of treatment of a trust as an estate.

In addition to the revisions dealing with equal treatment for revocable trusts, we have included draft statutory language extending the "65-day rule" of section 663(b) to estates. The "65-day rule" which was applicable in the past to revocable trusts after the settlor's death has simplified their administration and made possible more equitable treatment of beneficiaries (without resort to complicated "equitable adjustments"). Rather than deny revocable trusts the use of this helpful rule, it should be extended to estates. This extension would not, in our view, create any potential for abuse or reduced taxes. In addition, we recommend that consideration be given to extending the time period under section 663(b) from 65 days until the date when the relevant fiduciary income tax return is due. Frequently the decision whether to make distributions cannot be made within 65 days because not all of the relevant information is available.

The simplification proposals submitted by individuals who are members of the American Bar Association also included a suggestion that the separate share rule of section 663(c) currently available to revocable trusts be extended to estates. Although we have not drafted proposed statutory language, we recommend that both revocable trusts and estates be given the right to elect to utilize the separate share rule. Absent an amendment, the enclosed draft amendments would cause revocable trusts to lose their eligibility for the separate share rule.

Finally, with respect to the proposed changes to sections 2035 and 2038, we strongly urge that a retroactive effective date be adopted.

The views expressed in this letter and the attached proposals are made by the individuals signing below. Although the undersigned are members of the Estate and Gift Tax Committee of the Section of Taxation and/or the Real Property, Probate and Trust Law Section of the American Bar Association, they are submitting their views and proposals in their individual capacities only. This letter and the proposals are not submitted on behalf of either Section or the American Bar Association.

The statutory language also reflects the joint efforts of the following persons in their individual capacities only: Richard B. Covey, who is counsel to the Trust Tax Committee of the American Bankers Association; Patrick A. Naughton, who is a member of the American Bankers Association; David E. LaJoie and Byrle M. Abbin, who are members of the American Institute of Certified Public Accountants; Thomas P. Sweeney, who is a fellow of the American College of Trust and Estate Counsel; and John A. Clark, who is a member of the Income of Estates and Trusts Committee of the Section of Taxation of the American Bar Association.

Please feel free to call on any of us if we can be of further assistance.

Sincerely,

Lloyd Leva Plaine
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June 5, 1991

EQUAL TAX TREATMENT

FOR INDIVIDUALS WHO UTILIZE REVOCABLE TRUSTS

PART I

Proposed sentence to be added at the end of
IRC section 267(b)

In applying this subsection, a trust shall be treated as an estate during the period such trust is treated as an estate pursuant to section 646.

PART II

Proposed revision of IRC section 469(i)(1)
(added words are underlined)

(1) In general. In the case of any natural person (including such person's revocable trust as described in section 7701(l)), subsection (a) shall not apply to that portion of the passive activity loss or the deduction equivalent (within the meaning of subsection (j)(5)) of the passive activity credit for any taxable year which is attributable to all rental real estate activities with respect to which such individual actively participated in such taxable year (and if any portion of such loss or credit arose in another taxable year, in such other taxable year).

PART III

Proposed revision of IRC section 469(i)(4)
(deleted words are bracketed - added words are underlined)

(4) Special rule for estates and trusts treated as estates.

(A) In general. In the case of [taxable years of] an estate or a trust that was revocable (as described in section 7701(l)) by a decedent immediately prior to his death, for taxable years commencing with the decedent's death and ending less than 2 years after the date of the death of the decedent, this subsection shall apply to all rental real estate activities with respect to which such decedent actively participated before his death. The $25,000 amount under paragraph (2) shall be allocated between such estate and trust or trusts in proportion to the otherwise qualifying passive activity losses and deduction equivalents (described in paragraph 1) of each for each such taxable year.

(B) Reduction for surviving spouse's exemption. For purposes of subparagraph (A), the $25,000 amount under paragraph (2) shall be reduced by the amount of the exemption under paragraph (1) (without regard to paragraph (3)) allowable to the surviving spouse of the decedent for the taxable year ending with or within the taxable year of the estate or trust.

PART IV

Proposed revisions of section 502(e)(2) of P.L. 99-514
[added words are underlined]

(2) Treatment of estates and trusts treated as estates. The estate of a decedent and any trust that was revocable (as described in section 7701(l)) by a decedent immediately prior to his death shall succeed to the treatment under this section of the decedent but only with respect to the first 2 taxable years of such estate or trust ending after the date of the decedent's death.

PART V

Proposed new IRC section 646

Sec. 646. Certain revocable trusts treated as estates.

Any trust that was revocable (as described in section 7701(l)) by a decedent immediately prior to his death shall, commencing with such decedent's death, be treated as an estate.

PART VI

Proposed new IRC section 672(g)

(g) Treatment of revocable trusts.

A trust that is revocable (as described in section 7701(l)) by any person shall be treated, while such trust is revocable, as owned by such person.

PART VII

Proposed sentence to be added at the end of
IRC section 1239(b)

In applying this subsection, a trust shall be treated as an estate during the period such trust is treated as an estate pursuant to section 646.

PART VIII

Proposed revision of IRC section 1244(d)(4)
[deleted words are bracketed - added words are underlined]

(4) Individual defined. For purposes of this section, the term "individual" does not include [a trust or estate] an estate or trust other than any trust which is revocable (as described in section 7701(l)) by an individual.

PART IX

Proposed revision of IRC section 1361(c)(2)(A)(ii) and (iii)
[added words are underlined]

(ii) Except as otherwise provided in clause (vi), a trust which was described in clause (i) immediately before the death of the deemed owner and which continues in existence after such death, but only for the 60-day period beginning on the day of the deemed owner's death. If a trust is described in the preceding sentence and if the entire corpus of the trust is includible in the gross estate of the deemed owner, the preceding sentence shall be applied by substituting "2-year period" for "60-day period."

(iii) A trust with respect to stock transferred to it pursuant to the terms of a will or a trust that is treated as an estate pursuant to section 646, but only for the 60-day period beginning on the day on which such stock is transferred to it.

PART X

Proposed new clauses to be added at the end of
IRC section 1361(c)(2)(A)

(v) A trust that is revocable (as described in section 7701(l)) by an individual who is a citizen or resident of the United States.

(vi) A trust described in clause (v) during the period such trust is treated as an estate pursuant to section 646.

PART XI

Proposed new clauses to be added at the end of
IRC section 1361(c)(2)(B)

(v) In the case of a trust described in clause (v) of subparagraph (A), such individual shall be treated as the shareholder.

(vi) In the case of a trust described in clause (vi) of subparagraph (A), such trust shall be treated as the shareholder.

PART XII

Proposed sentence to be added at the end of
IRC section 1361(d)(3)

For purposes of subparagraph (B), distributions to a trust which is revocable (as described in section 7701(l)) by an individual shall be treated as distributions to that individual.

PART XIII

Proposed revision of IRC section 2035
[entirely rewritten, principally as
to organization - revocable trust
words (only) are underlined]

Sec. 2035. Adjustments for gifts made during 3 years before decedent's death.

(a) Inclusion of certain transfers in gross estate. 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 made a transfer, by trust or otherwise, during the three year period ending on the date of the decedent's death, if such transferred interest would have been included in the decedent's gross estate under sections 2036, 2037, 2038, or 2042, had such transferred interest been retained by the decedent on the date of his death. The provisions of this subsection (a) shall not apply to any transfer from a trust which was revocable (as described in section 7701(l)) by the decedent unless such transfer, if made directly by the decedent, would be a transfer to which this subsection (a) would apply.

(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 three year period ending on the date of the decedent's death.

(c) Inclusion of transfers made during 3 years before decedent's death for certain purposes.

(1) For purposes of section 303(b) (relating to distribution in redemption of stock to pay death taxes), section 2032A (relating to special valuation of certain farms, etc., real property), and 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 three year period ending on the date of the decedent's death.

(2) An estate shall be treated as meeting the 35-percent of adjusted gross estate requirement of section 6166(a)(1) only if the estate both --

(A) meets such requirement and

(B) would meet such requirement if the value of the gross estate included the value of all property not otherwise included in the gross estate 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.

PART XIV

Proposed revision of IRC section 2038
(new words are underlined)

Sec. 2038. Revocable transfers.

(a) In general. The value of the gross estate shall include the value of all property -

(1) Transfers after June 22, 1936. To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death (except when such relinquishment results from a transfer from a trust which was revocable as described in section 7701(l) by the decedent, determined for this purpose without reference to section 7701(l)(1)(B)(ii).

(2) Transfers on or before June 22, 1936. To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power during the 3-year period ending on the date of the decedent's death (except when such relinquishment results from a transfer from a trust which was revocable as described in section 7701(l) by the decedent, determined for this purpose without reference to section 7701(l)(1)(B)(ii). Except in the case of transfers made after June 22, 1936, no interest of the decedent of which he has made a transfer shall be included in the gross estate under paragraph (1) unless it is includible under this paragraph.

PART XV

Proposed sentence to be added at the end of
IRC section 2056(a)

Any interest in property which passed or has passed from the decedent to any trust which is revocable as described in section 7701(l) by the decedent's surviving spouse, determined for this purpose without reference to section 7701(l)(1)(A)(ii) or section 7701(l)(1)(B)(ii), shall be treated as having passed to the decedent's surviving spouse.

PART XVI

Proposed sentence to be added at the end of
IRC section 2523(a)

Any interest in property which a donor transfers to any trust which is revocable as described in section 7701(l) by the donor's spouse, determined for this purpose without reference to section 7701(l)(1)(A)(ii) or section 7701(l)(1)(B)(ii), shall be treated as having been transferred to the donor's spouse.

PART XVII

Proposed new subsection to be added at the end of
IRC section 2654

(e) Treatment of revocable trusts.

For purposes of this chapter -

(1) General rule. The properties, liabilities, receipts, disbursements, and other attributes of a trust that is revocable (as described in section 7701(l)) by any person shall be treated, while such trust is revocable, as the properties, liabilities, receipts, disbursements, and other attributes of such person.

(2) After revocability ceases by reason of death. If such person dies while such trust is revocable, after that person's death such trust shall be treated as an estate.

PART XVIII

Proposed revision of IRC section 6654(l)(2)(B)
[deleted words are bracketed - added words are underlined]

(B) any trust [-

(i) all of which was treated (under subpart E of part I of subchapter J of chapter 1) as owned by the decedent, and

(ii) to which the residue of the decedent's estate will pass under his will (or, if no will is admitted to probate, which is the trust primarily responsible for paying debts, taxes, and expenses of administration)] <u>which is treated as an estate</u>.

PART XIX

Proposed addition to IRC section 7701
[present subsection (l) would be redesignated as subsection (m)]

(l) Revocable trusts.

(1) Definition.

(A) A trust shall be treated as revocable:

(i) By a person while its property may be withdrawn by such person under applicable law or the terms of the trust and

(ii) By the person who created such trust, either directly or by the lapse of a general power of appointment, while such person (I) is the only permissible distributee of its property and (II) holds any power of appointment with respect to such property.

(B) A trust shall not fail to satisfy the conditions of paragraph (A) because -

(i) Such person is unable under applicable law or the terms of the trust to withdraw trust property or exercise a power of appointment because of incapacity or

(ii) Such person is permitted to withdraw trust property or exercise a power of appointment only with the consent of another (unless the person whose consent is required is an adverse party within the meaning of section 672).

(2) Revocable portions. For purposes of this section, if a portion of a trust is revocable, that portion shall be treated as though it were a separate revocable trust.

(3) Community property revocable trusts. For purposes of this section, any community property held in a trust that is revocable by husband and wife shall be treated in the same manner as nontrust community property is treated under applicable law. If at the time of a spouse's death the terms of the trust or applicable law treat one half of such community property trust as ceasing to be revocable and the other one half as continuing to be revocable by the survivor, such other one half shall be treated as a portion of a trust as provided in paragraph (2).

EXTENSION OF 65-DAY RULE TO ESTATES

Proposed revision of IRC section 663(b)
(added words are underlined)

(b) Distributions in first sixty-five days of taxable year.

(1) General rule. If within the first 65 days of any taxable year of a trust <u>or an estate</u>, an amount is properly paid or credited, such amount shall be considered paid or credited on the last day of the preceding taxable year.

(2) Limitation. Paragraph (1) shall apply with respect to any taxable year of a trust <u>or an estate</u> only if the fiduciary of such trust <u>or estate</u> elects, in such manner and at such time as the Secretary prescribes by regulations, to have paragraph (1) apply for such taxable year.

PREPARED STATEMENT OF PAUL L. POSNER

Mr. Chairman and Members of the Subcommittee: We are pleased to be here to comment on H.R. 2775 and S. 1610—bills which would simplify the payroll tax deposit system. Currently, five rules determine when employers must deposit their payroll taxes. in a report issued in 1990, we said that the deposit rules are difficult to understand and comply with because employers can be subject to more than one deposit rule during a given tax period.[1] Up to one-third of the nation's employers are penalized each year for failure to follow these complex rules.

H.R. 2775 and S. 1610 would simplify these rules by requiring employers to deposit their taxes on the Tuesday or Friday following each payday. Both bills contain an exception to this Tuesday/Friday rule that allows less frequent deposits for small employers. H.R. 2775 would allow quarterly deposits for 2.3 million small employers who have quarterly payroll tax liabilities of $3,500 or less. The small employer exception under S. 1610 would allow 3.7 million employers who have quarterly payroll tax liabilities of less than $18,000 to deposit once a month.

We believe that changes to the deposit rules are urgently needed and that both proposed simplification measures will ease the employers' tasks of understanding and complying with their payroll tax deposit responsibilities. The proposals will also reduce the number of deposits that some employers will have to make. However, we believe that the S. 1610 proposal would be the least burdensome to smaller employers.

BACKGROUND

The routine deposit of federal payroll taxes is the linchpin of the federal tax system. In fiscal year 1989, over 5 million employers deposited $679 billion in withheld income and social security taxes, which represented 67 percent of all revenues collected by IRS that year.

But the current payroll deposit system, which is based on the voluntary compliance of over 5 million small, medium, and large businesses, is distinctly unfriendly to the employers who must make the deposits. About one-third of the nation's employers are assessed at least one payroll deposit penalty annually, and total payroll deposit penalties amounted to $2.8 billion in 1989. According to IRS data, in 1988 approximately 70 percent of the payroll deposit penalties were assessed against relatively small employers. We believe that the complexity of the deposit rules is a major factor in causing this high penalty rate.

Complexity arises when employers must determine the frequency of deposits and the specific dates that deposits are due. Employers accumulate their employment tax liabilities from payday to payday until a deposit rule is triggered—unless they qualify for an exception to a rule. The deposit rules vary according to how much tax has been withheld and how often paydays occur. Under the current deposit rules specified by Treasury regulations, employers pay their employment taxes either quarterly, monthly, or within 3 banking days following the end of one of eight deposit periods within each month. A statutory deposit rule also requires employers with $100,000 or more in employment tax liabilities each payday to deposit within 1 banking day of a pay day.

CURRENT DEPOSIT RULES ARE COMPLEX

In our review of the payroll deposit system, we found that many employers were assessed failure-to-deposit penalties because they had difficulties in understanding the complex requirements of the deposit system.[2] Because deposit rules specify different deposit dates—depending on the amount of accumulated undeposited taxes—and because some employers' payrolls fluctuate over time, many employers struggle to predict with certainty when their payroll deposits are due. Furthermore, because the eight monthly deposit periods vary in length from 3 to 6 days, the amount of time an employer has after a payday to make a deposit can actually vary from 3 to 8 days depending on the length of the deposit period as well as where in an eighth-monthly period the payday falls. To comply, employers must monitor undeposited

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[1] *Tax policy: Federal Tax Deposit Requirements Should Be Simplified* (GAO/GGD-90-102, July 31, 1990).

[2] We developed a penalty data base that showed the rate at which all employers were penalized. We reviewed a random sample of 150 federal tax deposit penalty actions that were taken in fiscal year 1987 at 3 IRS service centers. The sample cases consisted of 25 manual assessments and 25 manual abatements for each service center. We also reviewed IRS guidance and administrative procedures, and discussed the deposit requirements with IRS and Treasury officials.

employment taxes from payday to payday, compare the undeposited amounts to those in the deposit rules, determine whether an earlier deposit requirement has been triggered, and, if an eighth-monthly deposit applies, determine the next such deadline.

In 31 percent of our sample cases, employers were faced with at least one change in their deposit requirement during a given quarter. In over half of these cases, the employers made timely deposits under their initial deposit requirement but were penalized when their payroll and associated employment taxes increased later in the quarter, thus triggering a different deposit requirement.

Perhaps an even more telling indicator of how confusing these complex requirements can be is IRS' error rate for applying deposit rules to determine whether penalties are warranted. In 44 percent of the 75 manually assessed penalty cases we examined, IRS tax examiners miscalculated the flat rate penalty because in most cases they did not properly apply the deposit requirements.[3]

To address these problems, we recommended that the Secretary of the Treasury abandon the complicated eighth-monthly deposit rule and adopt a simplified single deposit rule for all employers not affected by the statutory 1-banking-day requirement. We also suggested that the complex multi-tiered set of exceptions be replaced with a simplified exception rule for smaller employers. We illustrated four alternative deposit thresholds for determining which employers would be excepted from regular deposits, ranging in size from $3,000 to $30,000 in quarterly tax liabilities. In addition, we recommended—regardless of any other changes made—that the Secretary should establish a look back rule, whereby all employers could know their deposit requirements before the start of a quarter. Finally, we said that changes to the deposit rules should include repealing the safe haven provision, which permits employers to delay depositing 5 percent of the taxes that are due because some employers have difficulty in calculating the precise amount. We recommended repealing the safe haven because for some employers it represents a maximum payment target rather than a means to ease legitimate payment calculation problems and because alternative means are available to IRS to address legitimate payment problems.

ANALYSIS OF PROPOSED CHANGES TO THE PAYROLL TAX DEPOSIT RULES

In assessing the reforms proposed in the House simplification bill, H.R. 2775, and the bill introduced in the Senate, S. 1610, we applied four criteria that we consider particularly important. Would the burden experienced by employers, particularly smaller employers, be reduced? Are the proposed requirements simple to understand? Would IRS' administrative burden be manageable? Would the cash flow of the government be maintained?

Based on our assessment, we believe that both H.R. 2775 and S. 1610 represent commendable approaches to bringing fairness and predictability to the federal payroll deposit system. The proposed changes would make it easier for employers to understand the deposit requirements and to comply with the deposit rules. Thus, these bills would undoubtedly reduce the number of penalties that well-meaning employers receive because they cannot understand the current complex deposit requirements.

Both bills would: (1) replace the current eighth-monthly system with a system that requires deposits to be made on Tuesdays or Fridays, (2) permit small employers to deposit less frequently than required under the Tuesday/Friday rule, (3) provide a look back rule for employers to use at the outset of each new quarter for establishing the deposit requirement that they would follow, and (4) increase the amount of taxes an employer must deposit under the safe haven provision.

Tuesday/Friday Rule

The bills would change all but the statutory $100,000 deposit rule and would require employers to deposit taxes on (1) the Tuesday following paydays that occur on a Wednesday, Thursday, or Friday, or (2) the Friday following paydays that occur on a Saturday, Sunday, Monday or Tuesday.

We believe that this Tuesday/Friday rule is a significant improvement over the current eighth-monthly deposit rules. Employers, especially those whose deposit requirements change during a quarter, should have little problem determining when to deposit their payroll taxes. This added certainty should also lead to a substantial reduction in the amount of IRS and taxpayer correspondence that is associated with

[3] For deposits made after January 1, 1990, the Omnibus Budget Reconciliation Act of 1989 changed the deposit penalty from a flat rate to a four-tier, time-sensitive penalty.

failure-to-deposit penalties. Many of these penalties occur because employers are uncertain or confused as to when their deposits are due. We estimate that between 20 and 25 percent of the correspondence that IRS has with businesses deals with failure-to-deposit penalty assessments and abatements.

Exception for Small Employers

Each bill also provides an exception to the Tuesday/Friday rule for small employers, so that they will not be burdened with having to make deposits after each payday. Under H.R. 2775, small employers with quarterly tax liabilities of $3,500 and under—an estimated 2.3 million employers, or 52 percent of employers paying employment taxes—would be allowed to deposit quarterly.[4] Under the current deposit rules, most of these employers are required to make from one to three deposits over the course of the quarter. H.R. 2775 continues to allow small depositors with quarterly liabilities of less than $500 to avoid making deposits and instead pay their taxes with their quarterly employment tax returns.

We endorse exempting small employers from making frequent deposits. The small depositor rule in H.R. 2775 relieves certain small employers from the inherent complexities of the current deposit rules and from increasing the number of deposits they would have to make under the Tuesday/Friday rule. However, the bill would speed up deposits for some employers. For example, those with $3,500 to $9,000 in quarterly tax liabilities who now deposit monthly would have to deposit on the Tuesday or Friday following their paydays. This change could affect about 906,000 employers who would have to make an additional 25 million deposits annually. This increase has prompted concern on the part of the small business community.

The small employer exemption in S. 1610 addresses these concerns. This bill would exempt employers with quarterly tax liabilities of less than $18,000 from the Tuesday/Friday rule. Instead, these employers would be allowed to deposit by the 15th day of the month following the month in which the tax liability was incurred. This threshold would permit all employers currently paying monthly to continue doing so. We estimate that S. 1610 would exempt 3.7 million employers, or 83 percent of all employers from making the Tuesday/Friday deposits.

In addressing the concerns of small businesses, S. 1610 will nevertheless increase federal revenues, although not as much as the House bill. On the basis of data from the first quarter of 1989, which is the most recent data available to us, we estimate that H.R. 2775 would raise $1.4 billion in the initial year. This sum would result principally from accelerating the payments of employers with $3,500 to $9,000 in quarterly tax liabilities who currently pay monthly and would now pay under the Tuesday/Friday rule. In contrast, we estimate that s. 1610 would raise $300 million in the initial year. Although more employers would pay less frequently than they do now, the revenue effect would still be positive because the Tuesday/Friday rule would accelerate payments for certain employers exceeding the $18,000 threshold.

Another possible advantage of retaining monthly depositing, compared to the quarterly deposits proposed under H.R. 2775, has to do with the burgeoning accounts receivable inventory—which totaled $96 billion in 1990, 31 percent of which was due to employment tax delinquencies. As previously noted, about 2.3 million employers have quarterly tax liabilities of $3,500 or less. Under H.R. 2775, we estimate that about 1 million of the 2.3 million employers would shift from making deposits monthly to making one deposit per quarter. However, small employers who face cash flow difficulties often become delinquent in their taxes because they spend withheld tax money. Increasing the time that small employers can retain employment taxes may exacerbate this problem.

Look Back Provisions

We believe that a look back provision is essential to reducing confusion and penalties under the federal payroll deposit system. Such a provision eliminates the need for employers to continually monitor their tax liabilities to determine their next required deposit date.

Both H.R. 2775 and S. 1610 include such a provision. Under H.R. 2775, employers whose quarterly tax liability did not exceed $3,500 in any one of the eight preceding quarters would make quarterly deposits rather than follow the Tuesday/Friday de-

[4] Our estimates of the number of employers making deposits, the number of deposits made, and the change in federal revenues are based on (1) the first quarter 1989 IRS data on the number of Forms 941 filed and the employment tax liability for these returns, and (2) unpublished Bureau of Labor statistics data on employers' payroll frequency. About 5.1 million employers filed Forms 941 in the first quarter of 1989, but about 630,000 of these employers had no tax liability, leaving about 4.5 million making deposits.

posit schedule.[5] Employers would have to make this determination for each quarter. Once an employer who qualifies for the exemption exceeds the $3,500 threshold in one quarter, the employer would have to again build eight consecutive quarters of tax liability under $3,500 before again being exempted from the Tuesday/Friday rule.

S. 1610 has a similar look back provision for exempting employers with quarterly tax liability of less than $18,000 from the Tuesday/Friday rule. Under S. 1610, before each quarter, employers would use four prior quarters' liabilities to determine if they can be exempted from the Tuesday/Friday rule. We believe that seasonal variations in business taxes can be captured just as well with a four quarter look back period as under an eight quarter period. However, we believe that businesses' paperwork requirements could be lessened, and their deposit rules made more stable, by applying the look back rule for a full year. A four quarter look back provision that exempts employers for a full year would be less burdensome, would enable small employers to return to the slower deposit schedule more quickly, and would still achieve certainty in advance about which deposit rules the employer will fall under during the quarter.

Safe Haven Provision

Under current regulations, Treasury has an exemption to the deposit rules, known as the safe haven, which allows employers, who are required to make eighth-monthly deposits, to deposit 95 percent of their accumulated taxes within 3 banking days of the end of an eighth-monthly deposit period. The remaining 5 percent can be deposited with the first deposit, that is otherwise required, after the 15th of the following month. The current safe haven provision exists to benefit large employers who could not determine their actual employment tax liability in time to deposit the exact amount within the required 3 banking days.

In our report, we recommended that the 95 percent safe haven be eliminated because IRS studies show that less than one-half of one percent of the employers use it. Furthermore, studies by IRS and the Railroad Retirement Board indicate that some employers use the safe haven, not because they are unable to pay the exact amount of taxes, but rather to delay depositing their full tax liability. For example, one IRS study showed that 25 percent of the businesses that used the safe haven consistently deposited exactly 95 percent of their tax liability. For these employers, the safe haven represents a maximum payment target rather than a means to ease legitimate payment calculation problems.

Both H.R. 2775 and S. 1610 provide a statutory safe haven for deposit shortfalls. Under H.R. 2775, an employer is considered to have deposited the required taxes if a shortfall does not exceed the greater of $150, or 2 percent of the employment taxes that were required to be deposited. The S. 1610 safe haven is the same exempt the $150 shortfall limit is increased to $250.

In general, both proposed statutory safe haven provisions are better than the current safe haven because the tolerance is lower (i.e., 2 percent instead of 5 percent). However, raising the safe haven from 95 percent to 98 percent only reduces the amount of taxes that employers can delay depositing; it does not eliminate the potential for abuse. We believe that other administrative procedures that are less prone to abuse could be established, thus providing the needed flexibility to accommodate genuine cases where employers cannot accurately determine their tax liability. For example, IRS could grant waivers for depositing the full payroll tax liability to those employers who submit evidence that they could not accurately calculate their entire employment tax liability.

CONCLUSIONS

Mr. Chairman, we believe that both H.R. 2775 and S. 1610 would achieve a major simplification of tax rules for our nation's employers. They would lessen the burden experienced by employers, particularly smaller employers; be simpler than the present rules to understand; would not reduce the federal government's cash flow compared to current rules; and should result in fewer penalties for IRS to administer. We support the basic framework set forth in H.R. 2775, but we believe that S. 1610 would improve this framework by further reducing the burdens experienced by the small business community.

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[5] To qualify as a small depositor, an employer must have quarterly tax liabilities of $3,500 or less in each of the eight calendar quarters, ending with the second quarter preceding the quarter for which deposit requirements are being determined.

PREPARED STATEMENT OF SENATOR WILLIAM V. ROTH, JR.

Mr. Chairman, I want to thank you for holding these hearings today on tax simplification. As we begin this process in the Senate, I want to convey my concerns that all too often Congress has set out on this worthy goal of simplification without result. As a matter of fact, I still get many calls about the kind of "simplification" that was made in the 1986 Tax Reform Act—which everyone seems to remember began with the euphemistic title in May of 1985, "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity."

I doubt if any of our speakers would conclude that Congress reached the goals set by that title. It seems that before that report was ever released, the tax legislative process was turned over to government tax lawyers who had some dream of seeking out just the right number of nickels from every individual, corporation, partnership, small business and product that was available to be taxed.

The result is an incredibly burdensome and complex tax code that no one understands. If we had made the tax code a little simpler, instead of trying to reach the perfect tax system, we would have saved a lot more nickels in preparation and compliance than this government made in tax revenue.

The result in the past has been far too much theory, and not nearly enough common sense. It's time that Congress aimed for a little "rough justice" in the tax system and quit tapdancing on the taxpayer with tax compliance.

It also concerns me that the constant changes being made to the tax code, beginning with annual tax bills in the early 1980's, has resulted in a system that no one can keep pace with, including the best lawyers and accountants in the country. Even small steps, like the mostly revenue neutral proposals in these bills, would result in new changes that the public would have to adjust to. I often question whether the line from so many accountants and lawyers in my state isn't the best rule, "just leave the damn thing alone, for awhile, why don't you." And with that, I'll end my statement and hope some of you can provide us with some "truly simple" approaches.

PREPARED STATEMENT OF MICHAEL O. ROUSH

Mr. Chairman, the National Federation of Independent Business (NFIB), representing over 500,000 small businesses nationwide, thanks you for initiating these hearings to explore ways to simplify the tax code. The shear complexity of the tax code generates more complaints from NFIB members than virtually any other tax-related issue.

This nation's tax collection system is based upon voluntary compliance. Yet nothing harms voluntary compliance more than for taxpayers to be unable to calculate how much they owe the government. Not surprisingly, most small business owners do not appreciate the fact that they have to turn over so much of their working capital to the federal government in taxes. Forcing them to spend hours filling out forms to determine exactly how much they owe only adds insult to injury.

Although NFIB is interested in a variety of tax simplification initiatives, including pension simplification and a new definition of independent contractors, reform of the federal tax deposit rules is the most important simplification because of the vast number of employers that will benefit. According to the General Accounting Office, one out of every three businesses in this country receives a penalty under these rules every year. Such penalties totaled $2.6 billion in 1988. In 1988, over one-half of all the penalty revenue collected was later abated because the IRS itself had erred. Any tax law that neither employers nor the IRS can understand needs dramatic reform.

The federal tax deposit system is the cornerstone of IRS's revenue collection. Last year, over $700 billion was collected through the federal tax deposit system. Current law requires employers to withhold from the pay of their employees enough money to cover the employees' federal income tax and FICA tax liabilities. These withholdings must then be deposited according to schedules spelled out in IRS regulations. The timing of an employer's deposits vary according to how much that employer has collected in withholding.

Described below is how a small business owner determines when withheld taxes must be deposited. As you can see, this system is extraordinarily complex and confusing. Small businesses can rarely afford professional assistance in running their business. The small business owner, himself must perform the tasks of benefits specialist, inventory manager, purchaser, complaint department, and personnel director. Only three out of every four NFIB members use accountants.

Senator Baucus has introduced legislation, S. 1610, that will greatly simplify current law. S. 1610 creates a federal tax deposit system that even small business owners without accountants can understand. If S. 1610 is enacted, small business owners will finally be able to easily make timely deposits of exactly what they owe. A similar simplification was recommended by the 1986 White House Conference on Small Business.

Depositing Withheld Taxes Under Current Law

For most small business owners, the current system for depositing payroll taxes is mindboggling. As the examples

below show, the rules can be very complex, and they are always subject to change. After reviewing current law, it is easy to see how one-third of the employers make a mistake every year.

Employers withholding less than <u>$500 per quarter</u> (roughly the equivalent of one employee earning less than $10,000) need only deposit once a quarter. The deposit is due one month after the end of the quarter.

> Example 1 -- An employer withholds less than $500 in payroll taxes by the end of March. He has until May 1 to deposit the taxes.

Employers withholding between <u>$500 a quarter and $3,000 a month</u> (approximately 1-12 employees) must deposit once a month. The deposit is due on the 15th of the next month.

> Example 2 -- An employer collects $800 in withheld taxes by the end of January. He has until February 15 to deposit the taxes.

> Example 3 -- An employer withholds $300 on wages paid in January. Since he has not exceeded $500, he holds onto the $300. He then withholds $350 in February. As of this point he has collected more than $500 in the first quarter and must now deposit monthly. He must deposit the $650 on March 15.

Now the law gets truly confusing. Employers withholding between <u>$3,000 a month and $100,000</u> must deposit according to eight monthly trigger dates. Employers are required to determine how much they have withheld after each payroll. If accumulated deposits exceed $3,000, they must be deposited three banking days after the next trigger date. The trigger dates are the 3rd, 7th, 11th, 15th, 19th, 22nd, 25th, and the last day of the month.

> Example 4 -- Assume we begin with Jan. 1 of this year. The employer makes payroll every Friday and withholds $1,000 a week. After the first two weeks, no deposits are due. After the third week, however, she now has collected $3,000 and must deposit these withholdings within three banking days after the next trigger date. The third Friday in January was the 18th. The next trigger date is the 19th. Three banking days after the 19th is the 23rd. She must deposit the withheld $3,000 by January 23.
>
> On February 8, our employer will have withheld another $3,000. The first trigger date following the 8th is the 11th. She will have to deposit this $3,000 within three banking days after the 11th (or by February 14).

Employers withholding <u>more than $100,000</u> must deposit by the next banking day.

The confusing nature of deposit rules is complicated by the fact that an employer may be subject to more than one deposit schedule in a year. If within a year an employers' hiring patterns vary widely, that employer could be subject to continually changing deposit requirements.

Example 5 -- An employer withholds $150 in January. She assumes business will remain steady, and she plans on making only one quarterly deposit on May 1. Fortunately, business picks up and she withholds $400 in February. She now switches from being a quarterly depositor to having to deposit once a month because she has accumulated withholdings of $550. She must deposit this $550 by March 15 (not May 1, as she had originally planned).

In the months of April, May, and June, our employer's business is still booming. She makes timely deposits of $1,000, $1,500, and $2,500 on May 15, June 15, and July 15 respectively. By July 19th, however, she realizes that she has already withheld more than $3,000 in the month of July. She now must deposit according to the trigger dates. The 19th is a trigger date, and she has three banking days after the 19th to deposit those taxes. If she mistakenly thought she was still on the monthly system and deposits these taxes on August 15, she will receive a 15% penalty ($450).

As the example above illustrates, employers must continually monitor, from payroll to payroll, how much they have withheld, and they must be prepared to immediately switch their deposit schedules if they cross certain dollar thresholds.

The complexity of the deposit schedules and the fact that employers can switch from one schedule to another result in the high level of penalties in this area. S. 1610 addresses both of the problems by simplifying the deposit schedules and severely limiting the number of business owners who will change from one system to another.

Changes in Deposit Rules Proposed by S. 1610

Legislation introduced by Senator Baucus, S. 1610, simplifies current law, and as a result will eliminate much of the difficulty small business owners experience. This legislation reduces the number of schedules under which an employer must deposit, clarifies the deposit dates, and allows employers to determine their deposit schedule based on past deposit levels.

Senator Baucus's legislation reduces the number of schedules under which an employer must deposit. Eliminating the quarterly deposit rules will require employers who previously withheld less than $500 a quarter, to change from a quarterly deposit schedule to one in which they must deposit at the end of each month. This change will require very small employers (those with one employee) to deposit more frequently. However, these employers are not withholding much more than $150 a month. And since employers regularly pay their bills monthly, the extra administrative burden of filling out a federal tax deposit slip and depositing monthly is slight.

S. 1610 will also allow many small business owners who currently must deposit several times a month to deposit only once a month. Reducing the number of deposits small employers have to make will also reduce the likelihood that they will make inadvertent mistakes.

Yet, S. 1610 does more than just speed up some employers' deposit schedule and slow down others. S. 1610 eliminates one threshold employers could trip over. Reducing from three to two the number of deposit schedules that small employers may have to cope with will add a greater level of certainty to the law and, as a result, should reduce the number of future penalties.

Changes in Deposit Rules Proposed by H.R. 2775

Legislation simplifying deposit rules has also been introduced in the House of Representatives by Ways and Means Chairman Dan Rostenkowski. Although his bill, H.R. 2775, would simplify current law, NFIB is concerned that a large number of small employers will have to deposit much more frequently under H.R. 2775 than they currently do because that legislation eliminates the monthly deposit rules. If H.R. 2775 was enacted, many employers who currently deposit their withheld taxes monthly would be required to deposit them with each payroll -- as often as four times a month -- resulting in four times as much paperwork and a four times greater likelihood of mistakes.

By eliminating the monthly deposit rules, H.R. 2775 would require employers who cross the $3,500 a quarter threshold to change from a quarterly deposit schedule to one in which they must deposit after each payroll. This very large shift in the timing of deposits is bound to generate confusion and inadvertent errors.

Under H.R. 2775, employers who would be required to deposit with every payroll would include some very small businesses. The Small Business Administration has estimated that a small business with $3,500 per quarter in withholdings would have between 2 to 4 employees. Requiring these very small businesses to deposit with every payroll will create a significant administrative burden.

The Best Federal Tax Deposit System for Small Business

NFIB strongly prefers the approach to federal tax deposit simplification taken by S. 1610 over that taken by H.R. 2775 for the following reasons:

1. S. 1610 increases the threshold for small businesses. In both proposals, the deposit deadlines by which small business owners must deposit withheld taxes changes as a business collects more.

   S. 1610, however, increases the threshold to $6,000 a month (approximately 15 employees), placing a more reasonable limit on the number of small business owners who need to constantly monitor whether or not they are approaching the threshold. This threshold would allow 4.3 million employers to deposit their withheld taxes monthly while only the other 700,000 would have to worry about trying to figure out the more complicated Tuesday/Friday rule.

2. S. 1610 has an easier transition between deposit schedules. H.R. 2775 would require small employers who cross over the $3,500 a quarter threshold to begin depositing with each payroll instead of once a quarter. Changing from depositing once a quarter to as many as thirteen times a quarter will be difficult for many small business owners.

3. S. 1610 shortens the look back rule. Under H.R. 2775, small depositors would determine their deposit schedule by looking back to previous deposits. This greatly simplifies current law.

However, NFIB sees no reason to require employers to look back two years to see if they ever crossed over the threshold. This would require an employer who had one very good quarter to deposit under the Tuesday/Friday rule for two years even if business dropped considerably after that quarter.

NFIB considers the approach taken by Senator Baucus -- looking back only to the previous year -- to be more reasonable.

Conclusion

The federal tax deposit system is in great need of revision. Of the simplification proposals introduced to date, Senator Baucus's bill, S. 1610, creates the simplest system for small business owners to comply with. Every employer in this country has to deal with the federal tax deposit system. Simplifying this system will be the most important act of tax code simplification.

Prepared Statement of Murray Scureman

Good morning, Mr. Chairman and members of the Subcommittee. My name is Murray Scureman, and I am Vice President - Government Affairs of Amdahl Corporation. I am here today to present the views of the Coalition on the PFIC Provisions, whose membership list is attached, in connection with the Subcommittee's consideration of S. 1394, the Tax Simplification Act of 1991. In particular, my testimony is directed toward section 302 of the bill, which would replace the current law Passive Foreign Investment Company ("PFIC") provisions with new rules governing so-called Passive Foreign Corporations ("PFCs").

We would like to commend the leaders of the tax-writing committees of Congress for recognizing the overwhelming need to simplify the international provisions of the Code and for their efforts to date in identifying simplification items which merit consideration. We believe the simplification bill now before this Subcommittee contains a number of provisions that represent a start toward reducing the complexity and the administrative burdens with which taxpayers and the Service are grappling. We encourage the Subcommittee to continue its examination of this area with a view to enacting a meaningful simplification package.

One area of particular complexity and inefficiency addressed by the proposal concerns the current PFIC rules and their overlap with other passive income regimes found in the Code. Clearly, a great deal of time and effort was dedicated to consolidating these provisions in the unified PFC provisions proposed in the bill. The proposal is a useful departure point for additional changes which would produce genuine simplification of these complex and inefficient rules.

In that regard, we would like to call your attention to the PFIC asset test of the Code which remains essentially intact in the proposed PFC regime. Under current law, a foreign corporation is considered a PFIC if either 75 percent or more of its gross income is passive or if 50 percent or more of its assets - measured by value - are passive. The 50 percent asset test would be retained under the PFC proposal, and the PFIC gross income threshold would be reduced to 60 percent.

The purpose of the PFIC provisions, like that of the proposed PFC provisions, is to identify foreign corporations whose operations are predominantly those of a passive investment company rather than those of an active business corporation. However, the asset test is incapable of accurately distinguishing between a passive investment company and a corporation conducting primarily active business, and has been a source of significant complexity for taxpayers. Retention of the asset test in the proposed PFC rules would perpetuate both problems.

The level of complexity can be seen from the fact that a United States corporation with foreign subsidiaries must determine quarterly the fair market value (or adjusted basis) of each of the assets of each of its foreign subsidiaries to test whether any of the subsidiaries is a PFIC (or PFC). This involves, under the fair market value method, obtaining a quarterly appraisal for every building, every manufacturing plant, all office equipment, all manufacturing equipment, every truck and car, and all other assets used by each foreign subsidiary in its business.

Additionally, these appraisals must be arranged for and conducted in every foreign country in which these assets are located. The task is incredibly burdensome, frustrating and

expensive, especially when it is recognized that the asset test is wholly inadequate for purposes of distinguishing between companies conducting primarily active businesses and those operating as passive investment companies. This effort is an unproductive use of scarce corporate resources.

To illustrate this point, consider a United States-owned foreign company whose active gross income is more than 70 percent of its total gross income. Under any criterion but the PFIC asset test, such a corporation would unquestionably be considered an active company. A comparison of the relative levels of a company's active versus passive income provides the truest picture, the best litmus test, if you will, of the predominant nature of its activities. A company whose gross income is more than 70 percent active is clearly an active corporation of a type that Congress never intended to sweep into the PFIC net. Yet under the PFIC asset test, this is exactly what happens in many cases. Let me give an example.

Assume that a foreign subsidiary has $10,000 worth of assets and that its active assets have a rate of return of 20 percent, while its passive assets have a rate of return of 8 percent. The higher 20 percent rate of return is an appropriate gross income return on active assets because all expenses of the corporation, other than inventory costs, must be deducted against that return in order to arrive at net income from active business activities. Since there are few additional costs involved in maintaining passive assets such as stocks and bonds, there are virtually no significant expenses to be deducted from that return. Given these rates of return, the foreign corporation's asset and income mix would be as follows:

	Asset Value	Rate of Return	Gross Income	Asset Ratio	Gross Income Ratio
Passive Assets	$ 5,000	8%	$ 400	(50%)	(29%)
Active Assets	$ 5,000	20%	$1,000	(50%)	(71%)
	$10,000		$1,400		

Notwithstanding that 71 percent of the income earned by this company is active business income, the company is treated as though its predominant activity is that of a passive investment company because 50 percent of its assets are passive.

In August Senator Moynihan introduced, along with Senator Packwood, S. 1654, the Passive Foreign Investment Company Tax Simplification Act of 1991, to correct the problem created by the PFIC asset test. This measure would eliminate the asset test on a prospective basis for controlled foreign corporations, which are subject to the Subpart F rules. Eliminating the asset test, a test which is useless in accurately distinguishing truly passive foreign investment companies, would help achieve the major goal of this exercise -- simplicity. At the same time, any passive income earned by a controlled foreign corporation would be fully taxed on a current basis by reason of the Subpart F provisions. The Coalition on the PFIC Provisions, which consists of 17 well-known American companies that are unquestionably engaged in active business activities, respectfully requests that you amend the asset test in the proposed PFC legislation to include the Moynihan-Packwood proposal.

THE COALITION ON THE PFIC PROVISIONS

Amdahl Corporation

Apple Computer, Inc.

Borland, Inc.

Brown-Forman Corporation

The Coca-Cola Company

Digital Equipment Corporation

Johnson & Johnson

Lotus Development Corporation

Measurex Corporation

Mentor Graphics Corporation

Microsoft Corporation

NeXT, Inc.

Novell, Inc.

Pfizer, Inc.

PHH Corporation

Schering-Plough Corporation

Sundstrand Corporation

PREPARED STATEMENT OF RICHARD R. SHAVELL

THE TAX SIMPLIFICATION ACT OF 1991 -- TESTIMONY ON THE LOOK-BACK METHOD OF ACCOUNTING

Good morning Mr. Chairman and members of the Taxation Subcommittee. My name is Richard R. Shavell and I am pleased to be here today as an associate member of the Associated Builders & Contractors (ABC). ABC consists of 17,000 construction contractors, subcontractors and suppliers who share the open shop philosophy of management.

I am a Construction Tax Manager with Zelenkofske, Axelrod & Co., Ltd. (ZA) in Jenkintown, Pennsylvania. ZA is the seventh largest accounting and consulting firm in the Philadelphia area and one of our specialties is construction.

Mr. Chairman, we commend Senator Bentsen and Senator Packwood for their efforts to address the complexities of the Internal Revenue Code. We support your bill, S.1394, and other needed simplification legislation.

Today we are here to speak specifically about the merits of Section 411 of the bill. Section 411 establishes a new 10 percent de minimis rule and simplifies interest computations under the Look-Back Method for long-term contracts. This provision will provide some relief for larger contractors from the burdensome computations and excessive administrative costs imposed by the look-back rule under Section 460 (b) of the tax code.

Unfortunately, smaller contractors will receive very little relief from this provision. This is because Look-back calculations must still be made to determine if you meet the 10% de minimis. Unlike large contractors, they cannot afford the staff and systems needed to peform the complex calculations. Moreover, as we delineate in our testimony, the LBM has had no substantive impact on revenue recognition; it is not an effective compliance tool, and others already exist; there has been no evidence of abuse by small contractors; and, it causes two accelerations of tax and interest that will reverse in the following year(s) of a contract.

It is for these reasons that ABC, along with the Associated Specialty Contractors, which speaks for eight national construction associations representing 26,000 specialty contracting firms, urges Congress to provide a full exemption for small contractors in S.1394. This action will put teeth back into the small contractor exemption granted in the 1986 Tax Reform Act which was subsequently preempted in the same legislation.

Origins of the Look-back Method of Accounting

With the 1986 Act, Congress prevented potential excessive deferral of income available under the Completed Contract Method (CCM) of accounting by replacing it with the Percentage of Completion Method (PCM). There was concern that contractors -- mostly outside the construction industry -- were defering income received on long-term contracts until their completion. However, Congress sought to address the inherent drawbacks of the new Percentage-of-Completion Method (PCM) where contractors must utilize estimates to report income during each year of the project.

Eliminating the use of CCM prevented the possiblity of contractors deferring any substantial income. Nevertheless, Congress implemented the Look-Back Method (LBM) which was intended to both: (1) prevent manipulation of the estimates required under the PCM; and (2) provide relief to taxpayers who inaccurately estimate profits under the PCM.

As the industry expected, real "relief" can never materialize so long as the look-back rule is in place for construction. Our industry's longstanding business practices do not dovetail with the LBM's assumptions or intentions.

Contractors, who survive by making accurate low bids in a highly competitive industry, remain profitable only by completing a project under cost. Thus, it is in their interest not to underestimate costs or overestimate revenue. These business factors prevent the kinds of "manipulations" that are of such needless concern. Instead, the LBM has become a costly, unnecessary burden during a period of steep recession, if not depression, for the construction industry.

The Look-back Rule's Impact on Small Contractors -- When an Exemption's Not an Exemption

When Congress created the LBM, it recognized the complexities faced by small contractors. As a result, it provided an exemption in the 1986 Act for contractors with average annual gross receipts of under $10 million. Unfortunately, the same law requires all contractors to apply the PCM for Alternative Minimum Tax (AMT) purposes -- and PCM requires computing the LBM. Incredibly, this means that while small contractors are exempt from the LBM for regular tax purposes, they must apply it for AMT purposes. In effect, the exemption is nullified by a separate AMT provision.

It is not clear if Congress intended small contractors to apply look-back for AMT purposes after granting an exemption for regular tax purposes. We have found no evidence that it was your intention -- nor would it make sense from a policy or fairness standpoint. It is clear, however, that an immense administrative nightmare has been dealt to all small contractors. The LBM's compliance costs far outstrip any perceived benefits to either the Treasury (the Internal Revenue Service has stated that look-back is revenue neutral) or the taxpayer in the form of a refund.

Two typical examples help drive the point home: A contractor in Austin Texas received an $850 look-back refund in 1988 while paying $1500 in additional administrative and accounting fees. A contractor in Arkansas had to pay $2300 in administrative costs to comply, yet there was zero change in his tax liability.

Yes, some very large contractors are able to manage the Look-back computations, but at a hefty cost. A billion dollar construction firm in Houston spent $250,000 to install an accounting system to track costs, receipts and perform look-back procedures.

Although we believe that the $10 million level is not sufficient as a point of segregating a substantially large contractor versus a small contractor, it has been set by Congress as a point of delineation. Therefore, we believe that those long-term contractors meeting the $10 million exception under IRC Section 460(e) should not be required to compute interest under the LBM. There is no doubt on this point -- regulations issued in 1990 reflect that small contractors are subject to the LBM regardless of whether or not they are also required to pay Alternative Minimum Tax (AMT).

A Huge Compliance Burden With No Real Benefit to the Treasury or the Taxpayer

The typical situation of the small contractor is that regular taxes are computed under either the CCM or the cash method and the contractor is subject to AMT only in situations where a significant deferral is being obtained by these methods over the PCM. However, under the LBM the contractor is required to recalculate their PCM income annually and recalculate the tax to determine if there is a difference in the AMT reported or if the contractor is subject to a hypothetical AMT in the prior years.

These complex calculations must be done even if there is no effect in order to document that the LBM does not apply and for consideration of reversals in future years.

The Look-back Interest Penalty Is Not a Compliance Tool: It has been our firm's experience that the resulting interest payment for small contractors is too small to serve as a legitimate compliance too. More often it is the case that the contractor receives a small refund after computing look-back. Further, the government may actually be losing revenue because the taxpayer's cost to comply with the LBM is deductible and the government must process and audit expanded compliance filings.

For example:

Assume the situation where a small contractor's gross income is $10,000,000. In establishing a range, assume that our results are better than the average or $500,000 ($10,000,000 x .05). The contractor's net earnings are assumed to be 5% of gross income. (The Construction Financial Management Association 1990 Annual Financial Survey shows a 2% average net earnings percentage).

Assume also that this contractor overstated his total costs and consequently, underreported profit by 15% as determined at the end of Year 2 when the job is completed. The result is $75,000 of underreported income on which a hypothetical tax liability must be determined under Step II of the LBM.

Because this is a small contractor, the only liability under the LBM is the AMT. Twenty percent (the AMT rate) is applied to the hypothetical underreported income resulting in $15,000 of hypothetically underreported tax. It would appear that by applying a flat 10% LB interest rate, the effect is $1,500. of LB interest payable to the IRS. This result is .00015 of gross receipts ($1,500 divided by $10 million). However, what is not reflected in these numbers is the percentage-of-completion effect at the end of Year 1. If the contracts were 50% completed at the end of Year 1, the resulting LB interest is less.

Considering the fact that the contracts will reverse in the next year (or years), the only effect is the time value of money of the one-year deferral. Again, this is not the normal situation. It is rare to have such estimates so far from the actual results and gross revenues on average are not $10 million for all small contractors. We thus conclude that the LBM will provide an insignificant result when the LBM is performed for small contractors.

Supporting this conclusion is the Zelenkofske, Axelrod & Co.'s Percentage-of-Completion Method Look-Back Surveys. According to the May 1990 survey we found the following:

a) Nearly 75% of the taxpayers surveyed did not owe the IRS any interest;

b) 50% of those taxpayers meeting the small contractor exception had effect; and

c) Less than 5% of the taxpayers involved in the survey owed LB interest to the IRS of more than $3,000.

As a member of the Continental Association of CPA Firms, Inc. (CACPA), we have solicited similar data from other CACPA firms around the country. These responses are similar to our own findings. Also, the Associated Builders and Contractors, Inc. has had similar responses with their requests for data.

Summary of Arguments For the Small Contractor Exemption

We believe there is a great need to exempt small contractors for the following reasons:

1) The administrative burden is immense to the small contractor:

   (A) Computations must be performed even though there may be no effect;

   (B) Current de minimis rules provide limited, if any, relief;

   (C) Simplified methods available provide limited, if any, relief to the small contractor (see Appendix);

   (D) The proposed de minimis rules provide insufficient relief to the small contractor (Appendix);

2) The LBM is not a "watchdog" on the construction industry as intended. Most small contractors do not fully understand the impact of the LBM and are thus not motivated to change estimates utilized in recognizing income under the PCM.

3) The true "watchdog" on the construction industry is surety and banking requirements imposed on small contractors which motivate them to aggressively report higher income and thus accelerate their tax liabilities.

4) There is no abuse by small contractors in reporting under the PCM as evidenced by the fact that the LBM has not resulted in a windfall to the Treasury. In several surveys, it has been found that the LBM results in minimal interest either payable by, or receivable to, the contractor.

5) The small contractor is now forced to face not one but two tax acceleration mechanisms as a result of choosing the construction industry in which to make a living. Both the AMT and the LBM are accelerations of tax and interest that will reverse in the following year or years.

It appears that it was not the intent of Congress to lay such a heavy administrative burden on the small contractor considering that Congress made available to these same taxpayers the ability to utilize more simplified accounting methods for regular tax purposes.

Conclusion

It is important to note that relief from the LBM for small contractors can be accomplished without delving into larger AMT reform issues. No statutory changes to the Alternative Minimum Tax are necessary -- we are asking simply that the Look-back rule not apply for AMT purposes.

ABC and the Associated Specialty Contractors believe that smaller contractors are subjected to an unnecessary compliance burden and should be exempt fully from the LBM. It is clear that the present exemption fails to serve as such because of the need to perform percentage of completion accounting for AMT purposes.

Strengthening the exemption falls fully within the context of simplification, if not a technical correction, and deserves your support. We urge that the Tax Simplification Act of 1991 be amended to include a provision exempting small contractors from look-back.

DATE: March 15, 1991

TO: Robert Scarborough
Department of the Treasury

FROM: Richard R. Shavell, CPA

RE: SMIM Under Section 1.460(d)

BACKGROUND:

The Simplified Marginal Impact Method (SMIM) simplifies the tax computation for some taxpayers under the Look-Back Method (LBM) by eliminating the need to redetermine their tax liability on a hypothetical basis under Step Two of the LBM. The hypothetical underpayment or overpayment is determined by multiplying the hypothetical amount computed under Step One of the LBM by an assumed marginal rate.

In certain situations the SMIM must be utilized by taxpayers and in other circumstances it can be elected. When SMIM was originally enacted as part of the 1988 Tax Act (TAMRA), the requirement was that all widely-held passthrough entities (S corporations, partnerships, and trusts) that performed domestic contracts were required to use SMIM. This initial provision required that the SMIM be applied at the entity level.

The language found in the Code expressly disallows the use of SMIM by a closely-held passthrough entity. Because of concerns about the administrative burden under Step Two, regulations issued in 1990 extended the use of SMIM to entities performing contracts not covered by the statutory provisions. Chart I reflects in summary form the level at which the SMIM must be determined.

ISSUE:

Whether or not the SMIM provides sufficient benefit to taxpayers who make the election available under Regulation §1.460-6(d).

CONCLUSIONS:

Electing taxpayers under the SMIM are provided limited relief from the administrative burden caused by the LBM.

RECOMMENDATIONS:

1. Small contractors
   a. Exempt small contractors from the LBM;
   b. Alternatively, provide that small contractors electing under SMIM are not liable for look-back interest if they were not subject to AMT in a particular year;
2. Eliminate the overpayment ceiling;
3. Permit all electing taxpayers to apply the SMIM at the entity level;
4. The mandatory use of SMIM by widely-held passthrough entities should be made elective.

DISCUSSION:

Small Contractors

The small contractor under 460(e) who does not utilize the percentage-of-completion method (PCM) for regular tax purposes should carefully consider the election to use the SMIM. The only impact of the LBM is if the small contractor is also subject to AMT

because under the AMT rules PCM is required to be used in determining AMTI (alternative minimum taxable income). A major disadvantage to the small contractor of electing the simplified method is foregoing the benefit in later years of the corresponding increase in the hypothetical AMT credit carryover.

The following analysis mirrors Example 7 under 1.460-6(h)(8), except for the fact that the taxpayer elected the SMIM.

> Should a small contractor be subject to AMT, and under Step One of the LBM determines that he has underreported his gross profit during the prior year (1988) under PCM, he will have a higher hypothetical AMT. LB interest is then charged on this underpayment from the due date of the prior year's return until the due date of this year's return (1989).
>
> Assume that during this year (1989), the contractor's gross profit was to reverse itself and regular tax is higher than tentative minimum tax. During 1990 when the LBM is performed, assume that the Step One calculations looking back to 1989 result in a minimal underpayment or overpayment and that AMT is still not a factor in determining the tax liability for this year (1989).
>
> In performing the LBM, the prior hypothetical calculations are also taken into account. Thus the 1988 increase in hypothetical AMT results in an increased hypothetical AMT credit carryover. Recalculating the tax for 1989 under Step Two of the LBM results in an overpayment of tax for 1989 (this assumes no limitation on the AMT credit during 1989).

For example, assume two situations as follows with differing regular tax liabilities:

	Case 1 AMT	Case 2 No AMT
Regular Tax	$ 5,000	$ 30,000
AMTI	100,000	100,000
Tax Rate	20%	20%
Tentative Minimum Tax	20,000	20,000
Regular Tax	5,000	30,000
AMT	$ 15,000	$ -

Further assume that under Step One of the LBM there is hypothetically underreported income in the amount of $10,000. If the actual method is used, Case 1 would have a hypothetical underpayment of $2,000 ($10,000 X 20%) of tax, whereas in Case 2 there would be no effect. The $2,000 increase to tentative minimum tax will result in no additional taxes under Case 2 ($22,000 versus 30,000 still results in no AMT).

However, if the SMIM was elected under Case 2, there would have been a hypothetical underpayment of $2,000 on which to calculate look-back interest. This is because according to the above quoted sentence, the fact that the taxpayer was not subject to AMT is not taken into account.

One must then question the advantage of SMIM to the small contractor. AMT is the acceleration of tax to the small contractor as a result of a timing difference from using an advantageous recognition method. However, the LBM is aimed at correcting another timing difference, namely estimates being utilized under PCM. Here, SMIM does not provide the correct timing result to the

small contractor because the liability under the LBM may never reverse when the liability under the SMIM arises in a year when the contractor is not in an AMT position.

Limited Benefit of SMIM

ZA experience is that under typical circumstances the SMIM will not significantly reduce the administrative burden of the LBM. This is because the majority of the administrative burden is found under

> With this result, the taxpayer is entitled to LB interest from the due date of the 1989 return until the due date of the 1990 return. This is the same length of time and the same amount of LB interest that was required to be paid by the taxpayer in the prior year. If interest rates do not differ significantly, the true effect is insignificant to the taxpayer - interest went out and was returned one year later in the same amount.

The above example shows the limited effect of the SMIM on the small contractor and further supports the position that small contractors should be exempt from the LBM. Also highlighting this point is the Zelenkofske, Axelrod & Co., Ltd.'s Percentage-of-Completion Method Look-Back Survey which reflects a lack of abuse under PCM by the small contractor and thus minimal impact of the LBM on that class of contractor.

The benefits of the simplified method are the apparent easing of the administrative burden by foregoing the complex calculations found in Step Two of the LBM. However, the typical small contractor electing the SMIM would actually forego any benefits of the increased hypothetical AMT credit, the AMT exemption, and the allowable credits that offset AMT. It appears that this is a major disadvantage in electing the simplified method if you are a small contractor.

Another issue is found in Regulation Section 1.460-6(d)(2)(i) which raises an interesting predicament for the small contractor electing SMIM. This section reads in part:

> The hypothetical underpayment or overpayment of tax for each year of the contract (a "redetermination year") is determined by multiplying the applicable regular tax rate by the increase or decrease in regular taxable income (or, if it produces a greater amount, by multiplying the applicable alternative minimum tax rate by the increase or decrease in alternative minimum taxable income, whether or not the taxpayer would have been subject to the alternative minimum tax) as a result of reallocating income to the tax year under Step One.

Does this mean that the small contractor must pay LB interest on an amount of hypothetical underpayment even if the contractor was not liable for AMT in the prior year? We then must question why would the small contractor consider electing the simplified method under the LBM.

Step One not Step Two of the LBM. This conclusion is echoed by a commentator (W. Eugene Seago) on the LBM:

> Not much is gained in terms of reduced costs of compliance by electing the SMIM, unless the taxpayer has complex credit carryovers. That is, the income for contract years and for those years affected by carryovers to and from contract years must [still] be recomputed. (The Journal of Taxation, December 1990, p.390).

Overpayment Ceiling

Certain taxpayers that experience wide fluctuations in income could be adversely affected by the Overpayment Ceiling. It would appear that this rule is a "heads I win, tails you lose" type of arrangement. With the upside to the IRS and not to the contractor, it is questionable whether a contractor would elect SMIM.

Level of Application

To truly ease the administrative burden under Step Two of the LBM, the SMIM should always be applied at the entity level. The Service's concern that there would be no practical application of the overpayment ceiling (see Preamble to Regulations) should not be an issue. The issue is the timing of income recognition and not tax. It is recognized that permanent differences in tax is not feasibly addressed by the LBM but only timing differences (see Preamble) can be addressed. "Accordingly, the look-back method does not replace the requirements to properly estimate total contract price and contract costs in reporting income under the percentage of completion method for each year of a contract."

If the overpayment ceiling were removed as discussed above, the Service's concern here is unnecessary and all entities could apply SMIM at the entity level.

Mandatory Use of SMIM

It is not clear why widely-held passthrough entities are treated differently than other passthrough entities in that they must utilize the SMIM. This is arbitrary application of the requirements under the SMIM and the LBM and should be corrected.

/mhs:wp19

cc: Stephen F. Deviney, CPA

MEMORANDUM

TO: Ways & Means Committee Staff DATE: 5-8-91

FROM: Michael Bolen and Richard Shavell, CPA, Zelenkofske, Axelrod & Co.

RE: Look-back Method of Accounting - Explanation of why 10% de minimis rule is insufficient relief for small contractors.

The proposed 10% rule will not preclude anyone, including small contractors, from performing the burdensome computations under the Look-back Method (LBM). In fact, Step One of the LBM would now be burdened with an additional requirement where the estimated profit for each contract must be compared to the actual profit of each contract for each prior year of the contract.

Note: There are three basic steps to LBM:

1) Recalculate the percentage of contract completed using actual, not estimated price and costs. Any under or overreported taxable amount is then determined.

2) Compare tax liability for each year based on the income reallocated under Step One with the tax liability previously reported.

3) Apply LBM interest rate to hypothetical underpayment or overpayment, and pay interest or receive interest refund accordingly.

The 10% rule is advantageous in cutting down the necessity of performing computations if the contractor maintains adequate and sufficient records. The burden under Step One of the LBM is immense to the small contractor's accounting system which may not adequately report the data required to perform the computations under the LBM. This will not be the case with the more sophisticated resources available to most large contractors.

It is acknowledged that Step One is a big burden to all taxpayers. However, small contractors also confront significant complications under Step Two. Step Two requires the contractor's liability to be recomputed on a hypothetical basis based on the over or underreported income determined under Step One.

The small contractor is invariably faced with a complicated hypothetical tax picture under Step Two because of the impact of the AMT and the AMT credit. This may not be the case for large contractors who will not have significant adjustments under AMT for the difference in recognition methods available for long-term contracts.

CONCLUSIONS

The proposed 10% rule will not preclude the small contractor from facing the complications under Step Two of the LBM. Further, the proposed rule will exacerbate the administrative burden already facing the small contractor under Step One of the LBM.

The small contractors' exception from LBM provided in the 1986 Tax Reform Act was unintentionally nullified by the requirement that they perform LBM for AMT purposes (we have found no language in the Committee or Conference report to indicate it was intentional policy). The administrative burdens far outweigh the intended and perceived benefits to the Treasury. Simplification is not just warranted here but also desperately needed.

COMMUNICATIONS

STATEMENT OF THE AIRCRAFT OWNERS AND PILOTS ASSOCIATION

Mr. Chairman, my name is Thomas B. Chapman. I am Vice President and Legislative Counsel for the Aircraft Owners and Pilots Association.

AOPA represents the interests of 300,000 individual members who own and fly general aviation aircraft to fulfill their personal and business transportation needs. That is 60% of the active pilots in the United States. AOPA members own or lease 62% of the aircraft in the general aviation fleet.

We appreciate the opportunity to present this statement for the record to the Subcommittee on Taxation and express our views on an issue of great concern to the general aviation community. We ask the Subcommittee to consider, through the tax simplification process, modifying the way the excise tax on aviation gasoline—or avgas—is calculated and levied.

We ask the Subcommittee to make this change because the current tax structure links the aviation gasoline tax to the tax on motor gasoline. As a result of this unnecessary link, the net tax of 15 cents per gallon on aviation gasoline is divided and levied on both the manufacturing and retail levels. Severing the relationship between the avgas and motor fuel taxes would result in a simpler and more manageable collection process.

In addition, maintaining the current tax structure could have a costly and potentially devastating impact in the future. Due to the current relationship between the taxes, it is unlikely that the motor fuel tax rate could be increased without also increasing the avgas tax—even if Congress did not intend to increase the avgas tax. If such a scenario were to occur, Congress would be forced to devise a mechanism to compensate the avgas user for the unintentional increase in the tax. This would probably require the imposition of a burdensome and costly refund system with which the consumer must comply and which the Internal Revenue Service must administer.

The realistic possibility of such a scenario was made apparent just a few weeks ago. The general aviation community was caught in the middle of the heated battle over the five cents per gallon motor fuel tax increase which the House is considering as part of the reauthorization of the Surface Transportation Assistance Act. Because of the link between the motor and avgas taxes, complicated by an erroneous belief that it is impossible to distinguish between motor gasoline and avgas, the House was considering increasing the avgas rate and forcing the user to apply for a refund.

A refund scheme would theoretically address the tax rate problem. But there is no doubt that such a mechanism would unreasonably burden the user, as well as the Internal Revenue Service, should every aviation gasoline consumer be forced to obtain a tax refund.

Again, the unnecessary link between the two taxes is the basis of the problem. There is no reason why avgas and motor fuel cannot be taxed separately. The two fuels are very distinct products. Aviation gasoline is cleaner and more thoroughly refined than motor gasoline, and it is blended to a distinct formula. Because avgas contains small amounts of lead, the two fuels cannot be mixed. They are refined and distributed within separate systems.

Currently, the 15 cents per gallon tax on avgas is levied on two levels. A tax of 14 cents per gallon is imposed on the manufacturers' level under Code Section 4081 and a one cent per gallon retail tax is levied under Code section 4041. Section 4041 establishes the retail portion of the aviation gasoline tax by subtracting the motor tax rate from the net tax rate of 15 cents per gallon on avgas. In other words, the current motor tax of 14 cents is subtracted from the net avgas tax of 15 cents, yielding a retail tax on avgas of 1 cent per gallon.

If this method of calculating the tax is retained, a refund mechanism would be needed to bring the net avgas tax to its intended level of 15 cents—should the highway tax rate ever be increased above 15 cents per gallon. We recognize that an increase in the motor fuel tax is far from becoming law. But eliminating the possibility of a complicated refund mechanism, coupled with the simplification of the collection process, merits consideration of an alternative approach.

One solution to simplify the tax structure and alleviate the potential burden on the IRS and the consumer would be to tax avgas separately under Section 4081, and collect the entire 15 cents at the manufacturers' level. This change could be accomplished by adding a new paragraph setting the manufacturers' tax rate for aviation gasoline at 15 cents per gallon and by also deleting the provisions of Section 4041 that impose a retail tax.

This is only one possible solution. There may be other alternatives, and we would support any approach that would simplify the tax structure and eliminate the necessity of a complicated and burdensome refund mechanism in the future. We certainly offer our assistance.

Other general aviation organizations have expressed their desire, as well, to see change in this area. In addition, initial reaction from the major refiners of aviation gasoline has been supportive of such an action.

Again, Mr. Chairman, we appreciate the opportunity to offer testimony on this subject. We are always available should you have questions or need additional information.

STATEMENT OF AMERICAN COUNCIL ON EDUCATION

The American Council on Education (ACE), the National Association of College and University Business Officers (NACUBO), and the College and University Personnel Association (CUPA) applaud the leadership of Senators Bentsen, Packwood and Pryor on pension simplification issues. ACE, NACUBO, CUPA and other higher education associations that support this statement represent the majority of the nation's colleges and universities.

During the debates surrounding the passage of the Employee Retirement Income Security Act of 1974, the pension plans of higher education were cited by Senator Jacob Javits for their leadership in pension design issues, especially vesting and portability. Since 1974 colleges and universities have amended their retirement plans to comply with numerous changes in the federal tax requirements for pension plans. The most significant change was the Tax Reform Act of 1986 which applied nondiscrimination rules for the first time to the 403(b) retirement plans of educational institutions effective with plan years beginning on or after January 1, 1989.

Higher education believes that equitable pension benefits for all employees is an important public policy goal, but complicated micro-management of retirement plans burdens and frustrates employers and reduces the resources available to provide benefits to employees. The areas targeted for simplification can greatly ease the burden of pension plan administration for colleges and universities and help the individual taxpayers understand and comply with the law. In particular, the "Employee Benefits Simplification and Expansion Act of 1991" (S.1364) provides a workable framework for employers while reinforcing existing pension policy.

Simplifying the 401(m) Matching Test

We encourage the Finance Committee to extend relief to pension plans in which employees share in saving for their future security and to which employers make a substantial matching contribution or a minimum contribution for all employees. Design-based safe harbors, as proposed by Senators Bentsen and Pryor, offer a simple method of compliance yet assure equitable treatment for lower paid workers. The majority (75%) of defined contribution 403(b) pension plans at colleges and universities are contributory, fully vested plans. All but a handful of these plans provide at least a dollar-for-dollar match of employee elective contributions. Many provide an even greater matching contribution.

The 401(m) matching test duplicates, in most aspects, the Average Deferral Percentage (ADP) test under Section 401(k) of the Internal Revenue Code. 401(k) plans primarily supplement the basic pension benefits provided through defined benefit plans. In contrast, the matching 403(b) pension plans provide the basic retirement plans at colleges and universities and other educational employers.

Recent trends in pension plan design show an increasing preference for defined contribution pension plans, especially among midsized and small employers. Design-based safe harbors that require employers to offer fully vested matching contributions as a trade off for relief from administrative complexity should help to make pension benefits more portable.

Since the passage of the Tax Reform Act of 1986, colleges, universities and schools have struggled with the matching test under Section 401(m), with no specific regulatory guidance on how these requirements apply to 403(b) retirement plans. The notices published by the IRS offering safe harbors for 403(b) plans addressed only noncontributory plans and suggested a "good faith" standard for other areas of compliance. In the recently released final regulations covering nondiscrimination testing under Section 401(m) the IRS prohibited the use of restructuring for these plans. Based on the experience of the last two years, many of the academic pension plans met the 401(m) test's current parameters. Some colleges have increased participation in their plans by reminding employees about the many benefits of joining the pension plan and other colleges have offered an across-the-board, base

contribution (acting as a qualified nonelective contribution) for all employees of 3% or more.

Employers in higher education welcome the comfort that design-based safe harbors provide and the corresponding reduction in excessive administrative cost and burden. The employer contributions required under S.1364 would provide meaningful benefits. The 100% match safe harbor would result in a total contribution of at least 6% for participants. The other safe guards of S.1364 would prevent these plans from favoring highly compensated employees. Full and immediate vesting of employer matching contributions represents a significant enhancement to nonhighly compensated employees who make frequent job changes. The 403(b) plans at colleges and universities already fully vest benefits for all plan participants. The bill's written annual notice requirement would guarantee that employers inform employees about plan benefits and would result in broad participation. Complying through a safe harbor would eliminate the massive collection of employee payroll data every year greatly reducing the plan's administrative cost. Already the new layer of complexity imposed by numerical nondiscrimination standards has forced a number of educational institutions to add staff to collect data and test or to pay substantial sums to benefit consultants on a yearly basis.

Importantly the safe harbor approach allows employers who want more flexibility to still test under the existing rules. Representative Rostenkowski has suggest replacing the existing 401(m) matching test. H.R. 2730 would use the average contribution percentage (ACP) for the nonhighly compensated employees in the prior year and limit the current contribution for each highly compensated employee to two times that ACP amount. While this proposal reduces the year-end uncertainty and eliminates adjustments to satisfy the 401(m) test, H.R. 2730 still requires extensive data collection and testing. By replacing the existing test rather than allowing a statutory safe harbor, H.R. 2730 would involve costly reprogramming of testing and payroll systems.

Rollovers and Transfers

A recent report to Congress on mandatory retirement in higher education conducted by the National Research Council cautioned, "In the context of ensuring an adequate pension income over time, allowing faculty to withdraw pension funds at or before retirement is less desirable. The Committee believes the goal of providing pensions for faculty members is to ensure a continuing standard of living in retirement. It believes colleges and universities can best achieve this goal by providing payments over the course of a retirement." We agree that preserving pension assets and guaranteeing lifetime income are crucial aspects of pension plans.

In fact, the higher education pension system has offered a model for pension portability. In recent years, some colleges and universities have introduced flexibility to allow plan participants to "cash out" all or part of their pension funds at retirement or termination. While this option transfers control over pension assets to the employee who can reinvest or spend as he or she desires, it also passes a responsibility. Statistics from the Employee Benefit Research Institute and the Department of Labor analyzing what happened to the $48 billion workers received in 1988 as lump sum distributions from pension plans are disturbing. The numbers suggest that workers may take this responsibility lightly. Inadvertent cash outs from the nation's pension system could weaken footings of a sound national policy that provides income for workers when their careers are over. Premature use of these assets might exert pressure to increase Social Security benefits just when the baby boom generation begins drawing benefits.

Simplifying the rollover rules would provide relief for the individual taxpayer. Participants are often unaware of or may be wrongly advised about the current requirements for a triggering event or at least a 50% distribution for a partial rollover. At times employees can fall unsuspectingly into a tax-trap. Allowing rollovers of any pension distribution, except amounts required under the

minimum distribution rules, would preserve pension assets for their important and intended purpose. The approach in S. 1364 greatly simplifies the complicated rollover rules.

The direct transfer mechanism that Senators Bentsen and Pryor propose in S. 1364 addresses the concern former Labor Secretary Elizabeth Dole expressed for employees who spend their lump sum pension distributions on BMWs rather than save the funds for their future. The benefit of compounding these funds in an IRA or other pension plan is significant and difficult to replace. For example, an employee who saved $2,000 each year in a pension plan between the ages of 31 and 40 with no further contribution would have an accumulation of $191,210 at age 65 based on earning 8.25% annualized investment return. If the employee terminates employment at age 40 and chooses to spend the lump sum rather than preserving it for retirement, a $2,000 contribution every year from age 40 until age 65 would only replace $158,359, assuming the same 8.25% interest rate.

While S. 1364 would not prevent a terminating employee who wanted cash from taking it, the bill would put the brakes on any rash or inadvertent action by requiring the plan to transfer the money to an IRA or other pension plan. This is not a perfect answer, but this step would add an automatic delay and would give lump sum recipients more time to consider the full implications of their actions.

Minimum Distribution Relief

Employees of colleges and universities who decide to continue working beyond age 70 have a difficult time reconciling the conflict that exists between social policy and tax policy. While eliminating the half-year from the starting age criteria would help, the individual taxpayer has more significant problems with the minimum distribution rules. Faculty and staff over age 70 are totally confused when informed that while the Age Discrimination in Employment Act as amended encourages them to stay in the workforce, tax laws require employees over 70 1/2 to start income from the pension plans to which they still contribute. The complicated calculations and adjustments are manual and may take several weeks to finalize. Each year the taxpayer must start over again and adjust the minimum distribution amount to reflect the prior years' contribution. The proposal in S. 1364 to limit the minimum distribution requirement to active employees who are 5% owners and to IRAs would apply more consistent public policies to workers over age 70. With the uncapping of mandatory retirement for tenured faculty, the level of confusion will increase unless Congress provides some relief.

Section 457 and Nonelective Compensation

In recent years, Congress has passed legislation designed to protect the rights of older Americans who remain active in the workforce. Amendments to the Age Discrimination in Employment Act have uncapped the mandatory retirement age for the general workforce but allow an exception for tenured professors until 1993. The Committee on Mandatory Retirement in Higher Education which studied this issue for Congress released its report on May 21, 1991. The Committee found that the evidence did not support continuing the exemption for tenured faculty. They recommended the use of early retirement incentives as an alternative and urged institutions to consider using this important tool to ease the impact of uncapping. Realizing that such incentives pose special challenges for the defined contribution plans prevalent in higher education they recommend that "Congress, the Internal Revenue Service, and the Equal Employment Opportunity Commission permit colleges and universities to offer faculty voluntary retirement incentive programs that: are not classified as an employee benefit, include an upper age limit for participants, and limit participation on the basis of institutional needs."

Defined contribution retirement plans do not have the flexibility to incorporate early retirement incentives similar to those that defined benefit pensions offer. Because of the annual contribution limits under Section 415, there is no directly comparable action that a college's defined contribution pension can provide

equivalent to adding five years of service to a defined benefit formula for early retirees. Generally, under a defined benefit plan additional years of service still fall within the limits of Section 415 while the actual funding for these incentive benefits is spread over several years. Defined contribution plans build-up retirement benefits by compounding contributions with interest over a working career.

Funding an early retirement incentive under a defined contribution retirement plan typically involves purchasing an annuity. An increase in monthly pension income of $100 could easily cost $12,000 for an employee age 60. Even a modest incentive could exceed the $30,000 contribution cap under Section 415 for defined contribution plans. Colleges and universities cannot accelerate several years of contributions into their retirement plans as a voluntary incentive to encourage early retirement.

Prior to the Tax Reform Act of 1986 (TRA86), colleges and universities offered early retirement incentives as deferred compensation. TRA86 applied the limits under Section 457 to deferred compensation plans of nonprofit employers. In addition, the unfunded nature of Section 457 contributions prohibits private colleges and universities from using a 457 plan for the majority of their employees since ERISA requires funding for all but "top hat" plans. We suggest that the Finance Committee enact provisions in H.R. 2641 that would amend Section 457 of the tax code so that the $7,500 limit does not apply to nonelective deferred compensation, as defined by the Secretary. We urge Congress, at a minimum, to specify that nonelective deferred compensation does not include early retirement incentive payments.

Definition of Highly Compensated Employees

We believe that the proposals to simplify the definition of highly compensated employees based on one indexed salary level would reduce the administrative burden and not target middle income employees unfairly. S. 1364 relaxes the requirement that tax-exempt employers have at least one highly compensated employee. This would ease compliance for 74 colleges that according to the 1990-1991 CUPA CEO salary survey have presidents who earned less than $61,000. Among midsized four-year colleges, the average salary for the highest ranking full professors is $45,000 a year. Most importantly, this provision will help the majority of independent schools with compensation levels well below these figures.

Leased Employees

We agree that the current historically performed test to determine if leased employees should be included in nondiscrimination testing is unworkable. Some colleges and universities have always contracted out their food service activities and an increasing number have done so in the last ten or more years. Under this type of contract, the educational institutions have no performance control or information on these employees. We concur that a control test is a more practical standard.

Small Employer Plans

If the experience of the education community is any guide, reducing the complexity for small employers should achieve the goal of all the simplification proposals: expanding pension coverage for the nation's workforce. Most nonprofit colleges and universities are very similar to small employers: they cannot spend large amounts of dollars on plan administration and they seek to maximize every dollar to provide benefits for employees. Based on surveys completed by Teachers

Insurance and Annuity Association and the College Retirement Equity Fund (TIAA-CREF), pension plan coverage is virtually universal in the academic community. By 1980, 97% of four-year colleges employing 99.7% of all full-time faculty and administrative staff had retirement programs. The coverage status of clerical-service employees was equally impressive. 90.2% of institutions which employed 98.9% of clerical-service employees at four-year colleges offered retirement plans. The statistics for two-year colleges are comparable. These figures are significant when compared to the fact that only 55% of the nation's workforce is covered by a pension plan.

The fact that the 403(b) plans that are prevalent in higher education were simple and very inexpensive to administer and easy for employees to understand, encouraged and made possible the broad expansion of pension coverage in higher education. Keeping it simple works. Expanding Simplified Employee Pension Plans to a broader range of small employees or offering PRIME accounts to small employers, should result in expanding the nation's pension coverage.

Statement of the American Petroleum Institute

The American Petroleum Institute (API) represents over 250 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining and marketing. In addition to comments on specific provisions in the captioned bills, API would like to present again several simplification proposals made in the past. API welcomes this opportunity to comment, particularly since it has become increasingly difficult, and disproportionately expensive, for U.S. petroleum companies to discharge their tax compliance obligation in this era of explosive growth of statutory and regulatory complexity.

I. GENERAL COMMENT

Over the years, particularly because of the changes brought about by the Tax Reform Acts of 1984 and 1986, the Internal Revenue Code and the regulations thereunder have created the most complex income tax system in the world. This complexity jeopardizes the efficiency of the system in that the collection cost (both to the government and taxpayer) becomes unreasonable as compared to the revenue; such complexity also jeopardizes viability in that enigmatic or conflicting aspects of the Code or regulations fail to become operative as intended.

Complex statutory provisions bring a tendency to leave the detail to administrative implementation. The latter often takes years, creating long periods of uncertainty and uncontrollable exposure for taxpayers; when administrative guidance is finally issued it is often too biased against the taxpayer. It then may take even longer to correct the administrative excess either through the burdensome regulations comment and hearing process, or sometimes even through further legislation.

As expressed in a submission of last February to the tax-writing committees, API has welcomed Chairman Bentsen's tax simplification initiatives. Despite the rather limited scope of the simplification bill, we highly commend it as a first step in the right direction and hope the process will lead to more extensive simplification improvements. And we would hope that the Committee, when evaluating any simplification proposal, would be mindful of the primary qualities of a sound tax system: simplicity, efficiency (proportionality of compliance cost to incremental revenue), viability (intelligibility and administrability of a rule), and equity.

II. S. 1394, THE TAX SIMPLIFICATION ACT OF 1991

A. Foreign Provisions

1. Substitution of the Passive Foreign Corporation for the current full inclusion rules of present law.

Until the enactment of the passive foreign investment company rules in 1986, there was no overlap between the U.S. taxation of passive versus active foreign corporations. However, in 1986 Congress passed the passive foreign investment company ("PFIC") rules with the intent of imposing current U.S. taxes on the U.S. shareholders of publicly held foreign corporations whose activities or assets were predominantly passive. In essence, the PFIC rules were designed to eliminate U.S. tax deferral for investors in offshore mutual funds. Unfortunately, the statutory definition of a PFIC unwittingly includes certain foreign operating subsidiaries. The PFIC rules overlap the U.S. tax rules

covering controlled foreign corporations. This creates unnecessary complexity and forces U.S. oil companies into costly information gathering and reporting regarding foreign corporations and to make "qualifying elections," but does not raise any additional tax revenues, i.e., active foreign corporations meeting the PFIC definitions typically either have no earnings or all their earnings constitute subpart F income.

Consolidation of the various U.S. tax rules covering investments in passive foreign corporations (PFCs) by individual investors is worthwhile and simplifies the Code. However, such a consolidation should not result in an expansion of the anti-deferral rules, particularly not in the case of controlled foreign corporations (CFCs) which are already subject to the encompassing anti-deferral regime of subpart F. The reduction of the passive income threshold from 75 to 60 percent of gross income is a bad idea, complicates the administration of the Code, and continues the overlap problems of the PFIC regime. Similarly, the elimination of the high-tax exception for CFCs (current Code section 1293(g)) appears to be an unwarranted denial of an established subpart F relief. (The Technical Explanation of the Tax Simplification Act of 1991, JCS 10-91, at page 41, discount the importance of this exception when describing this aspect of the passive foreign corporation regime as preservation of current rules.) The high-tax exception had been added by the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, to coordinate the rules applicable to CGCs under subpart F and under the PFIC regime. (see H.R. Rep. No. 100-795, at 271 et sep.) There is no reason to reverse that result because PFCs replace PFICs.

As indicated in previous API submissions, foreign affiliates of U.S. multinationals actively engaged in foreign oil and gas exploration and production or refining business activities can fall within the definition of a PFIC in a year in which it has no foreign oil production or incurs negative gross margins due to high raw material costs. In order to comply with U.S. PFIC rules, U.S. oil multinationals have had to apply the PFIC asset and income tests to each foreign affiliate and to make "qualifying PFIC elections" for foreign affiliates which fall within the PFIC definition. Typically, such corporations had no earnings and profits or their earnings and profits were already subject to U.S. taxation under the subpart F rules. As proposed, API cannot support the passive foreign corporation rules. Either the rules need to be written so as to apply only to noncontrolled foreign corporations, or the definition of a passive foreign corporation has to be modified so as to exclude foreign affiliates with no earnings and to substitute a gross revenue for the gross income test.

2. Modifications to provisions affecting controlled foreign corporations.

a. Treatment of income from the disposition of the stock of a lower-tier CFC.

API supports the proposal to adjust an upper-tier CFC's basis in a lower-tier controlled foreign corporation to reflect undistributed previously taxed subpart F earnings of the lower-tier corporation. The failure to have such a rule is either a trap for the unwary or necessitates costly and time consuming efforts to restructure a transaction to avoid double inclusion of income. Furthermore, API supports the proposed adjustment to the characterization of certain CFC gains realized on the disposition of stock in a related foreign corporation as dividends under the principles of Code section 1248 but believes that the same country exception set forth in section 954(c)(3) should apply.

API supports the proposed reduction in the subpart F income reportable by a U.S. shareholder in the year it acquires shares in a CFC from another U.S. shareholder.

b. Foreign tax credit in year of receipt of previously taxed income.

API opposes the repeal of rules permitting an indirect foreign tax credit to be claimed with respect to a distribution of previously taxed earnings and profits. Being elective, this provision does not cause compliance problems but serves as a safeguard against double taxation in extraordinary circumstances.

3. Translation of foreign taxes into U.S. dollar amounts.

API supports the concept that section 986(a) of the Code must be amended but believes that the appropriate exchange rate for foreign taxes should be the same rate as used for related income inclusion. The adoption of any rule other than the use of the same rate for taxes and income creates unnecessary complexity and causes a mismatching of income and foreign tax credits.

4. Foreign tax credit limitation under the Alternative Minimum Tax.

API supports the proposal to allow an elective use of regular tax foreign source income in the numerator of the foreign tax credit limitation fraction. However, API believes greater simplification will be achieved through continuing the pre-1990 sourcing rule of former IRC §59(a)(1)(C) for purposes of determining post-1989 ACE calculations.

B. Partnership Proceedings under TEFRA

In the partnership area the TEFRA audit procedure changes are welcome relief from perplexing, and often unfair, results of the current rules. A few comments on particular aspects of the proposal.

1. Expand small partnership exception.

Under the proposal a corporate partner would no longer disqualify a partnership with 10 or fewer partners from being excepted from the TEFRA rules. The removal of the disqualifying taint from corporations is welcome; if for any reason a particular venture wants to be subject to the TEFRA rules, it could still so elect.

2. Extend time for filing of a request for administrative adjustment.

The synchronization of the time for filing a request for administrative adjustment with the statute of limitations for partnership items (i.e., period expires six months after statute has run) is a laudable removal of an unintended trap for the unwary in the current TEFRA. We also commend the retroactive effect of the proposed amendment.

3. Suspend interest upon delay in computational adjustment resulting from TEFRA settlement.

This is another example of a welcome and fair extension of the taxpayer audit and assessment rules to the partnership audit arena.

C. Mandatory Consistency Requirement for Large Partnerships (Act Section 202)

Under current law, a partner may either report all partnership items consistently with the partnership return or notify the IRS of any inconsistency by filing Form 8082 with his tax return. The Act proposes that a partner of a large partnership, as defined for audit purposes, be required to treat partnership items on its tax return consistently with the treatment of such items on the partnership's tax return, even if such partner has knowledge of an error in the partnership's return or in the information return (Form K-1) furnished to such partner. Act Section 202, proposed I.R.C. Section 6241(a). The sole purpose of the consistency requirement is to permit matching of the items on the partnership's return to the items on the partners' returns.

API opposes the proposed mandatory consistency requirement. In the case of oil and gas partnerships, the Code permits, and in some cases requires, items attributable to oil and gas activities to be reported

differently by a partnership and its partners. For example, the amounts of IDC, depletion, items affected by a Section 754 election and items subject to the passive loss rules could be different on the partner's return. A great deal of time and resources would be spent to reconcile inconsistencies that are mandated or permitted by law and yet very little revenue would be generated by such efforts. Current law is sufficient to monitor compliance and to ensure matching between the tax returns of a partnership and its partners to the greatest extent possible.

D. Minimum Tax Provisions

We welcome the substitution of a 120 percent declining balance depreciation method for the current two track depreciation system in computing Alternative Minimum Tax taxable income on the one hand, and Adjusted Current Earnings on the other hand. This is truly a simplification measure which barely affects the present value of the depreciation deduction.

III. RESUBMISSION OF API SIMPLIFICATION PROPOSALS IN THE TAXATION OF FOREIGN SOURCE INCOME

A. Adopt active/passive income dichotomy.

1. For Foreign Tax Credit.

The post-1986 foreign tax credit limitation regime fractionates foreign source income into nine basic baskets, with an unlimited number of separate baskets for dividends from each noncontrolled section 902 corporation, and additional categories for income governed by certain tax treaty provisions, income from certain listed foreign countries, as well as further limitations for foreign oil and gas extraction income and foreign oil related income.

This prodigious set of rules, requiring extensive, nonproductive accounting and reporting efforts, must be viewed against the basic policy goal of preventing the use of foreign taxes on foreign business income to shield foreign passive income from U.S. tax. The substitution of two tax credit categories, business income and revised subpart F "passive income," would suffice to achieve the objective. Unlimited cross-crediting within these respective baskets of active/passive income will restore U.S. tax competitiveness for foreign operations, harmonizing the U.S. with foreign tax systems which either allow unlimited crosscrediting or adhere to territorial taxation.

Taxpayers engaged in an active business should be permitted to cross-credit foreign taxes and to average their effective foreign business tax rates. The location of business operations is determined by non-tax factors; removal of limitations on cross-crediting is a prerequisite for preventing double taxation of foreign source income. Aside from these policy reasons, a substitution of an active/passive basket system for the current fractionalized categories would be one of the most important steps to simplification in the area of foreign source income taxation.

2. Denial of deferral.

Similarly, a simple active/passive dichotomy should be adopted for purposes of denial of deferral. As described in the concise summary of the JCT Technical Explanations to the Simplification Act, at p. 36, there are under present law seven anti-deferral regimes in the Code which obviously overlap. As expressed in our comments <u>above</u>, the proposed simplification is inefficient.

Subpart F alone, the most important of the anti-deferral regimes, comprises five categories of income, with subcategories; for example, foreign base company income (FBCI) itself consists of foreign person holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil related income.

The extension of a workable foreign tax credit passive basket definition to subpart F would be a substantial simplification, would bring about more efficiency and viability of the system, and would still preserve the overall goal of current taxation of offshore passive income. The subpart F categories of foreign base company sales income, foreign base company service income, foreign base company shipping income, and foreign base company oil related income should be eliminated. If there is perceived abuse with respect to sales and service income, there is the arm's length pricing backstop of Code section 482. Also, to penalize shipping and oil related income with deferral loss is in conflict with the basic notion of subpart F being designed to capture movable passive income which would be earned at any rate by the U.S. taxpayer. Obviously, oceangoing vessels are operated on the high-seas not for tax avoidance purposes; similarly, the location of downstream processing and distribution of oil and gas are governed by business requirement and not tax regimes (for example, the European refineries, although highly taxed, may still give rise to subpart F income because under present law the high taxed income exception does not apply).

B. Eliminate separate limitation categories for dividends from noncontrolled section 902 companies.

Simplification of the multiple foreign tax credit basket limitations must include the elimination of separate limitation baskets for dividends from each noncontrolled section 902 corporation (a foreign corporation with at least ten percent and not more than fifty percent of the stock owned by U.S. persons holding not less than ten percent each). Since each noncontrolled section 902 corporation requires a separate limitation, U.S. multinationals with ownership interests in hundreds of such foreign corporations have a corresponding number of separate FTC baskets.

Conducting foreign operations through such corporate participation has been mandatory in the past because of host country laws or simply because of economic (e.g., risk) considerations. Joint ventures in the newly opening markets of Eastern Europe make the "normalization" of the U.S. tax treatment of such venture participation through less than controlling stock ownership even more important. Since in these situations business activities carried out through noncontrolled section 902 corporations do not differ from those carried out through CFCs, dividends from either should be categorized in the same manner for purposes of the FTC limitation. All dividends eligible for the section 902 deemed paid credit should be subject to the same FTC look-through rules as dividends received from CFCs.

C. Extend look-through to right to income stream.

While present law in certain instances "looks through" the apparently passive income at the underlying business activity, the piercing of the "passive" veil should become a general principle. Consequently, characterization of income from disposition of business investments must not depend on the legal form of the disposed asset. If the underlying income stream qualified as business income, the realization from the disposition of this earning opportunity (merely an acceleration of the future income stream) should also be treated as active income.

1. Look-through upon sale of stock of a controlled foreign corporation.

Gain from the sale of stock in a foreign corporation is "passive income" for foreign tax credit limitation purposes. On the other hand, dividends from controlled foreign corporations are treated like the underlying earnings and profits.

As to sourcing, gain from the sale of stock of an at least 80 percent owned foreign subsidiary is sourced foreign if sold in the foreign country of an active business which was the source of more than 50 percent the of gross income (during the last three years) of the corporation. Different, more stringent requirements apply for the sourcing of gain from the sale of stock in a lesser holding.

An extension of the look-through rules from the dividend treatment to the gain on the sale of the stock (the right to future dividends) would mean simplification and fairness. Similarly, instead of having two sets of sourcing rules for controlled foreign corporations, it would be simpler to extend the set of rules for at least 80 percent owned foreign corporations to all controlled foreign corporations.

2. Partnership look-through

Consistent with the look-through for the income stream from partnerships, clarification is needed that gain on the disposition of the right to such income streams, i.e., the disposition of the partnership interest, should be active or passive income, depending on the nature of the underlying partnership assets. This look-through reflects appropriate aspects of the aggregate theory of partnership taxation and continues to be applied in related contexts. To illustrate, according to Rev. Rul. 91-32, 1991-20 I.R.B. 20, a foreign partner's gain or loss upon the disposition of an interest in a partnership is considered effectively connected with the partnership's U.S. business operations to the extent the partnership's disposition of its assets would have resulted in effectively connected U.S. gain or loss. The clarification should apply for purposes of the foreign tax credit categories, sourcing, and the rules on loss of deferral.

D. Repeal the High-Tax Kick-out

Code section 904(d)(2)(A)(iii)(III) excludes from passive income any "high-taxed" income, i.e., income subject to an effective foreign tax rate in excess of the U.S. rate. Congress expected a balance of administrative convenience against the increased sheltering opportunities that might be gained from fewer groupings (1986 Blue Book, at 881).

Undoubtedly the Internal Revenue Service and the Treasury Department were mindful of that goal of administrative convenience. Nevertheless, Reg. section 1.904-4(c) still leads into a byzantine implementation regimen which includes the creation of separate groupings to which the high-tax test is applied. Unfortunately, the statutorily mandated rule is complex per se and was not made simpler through regulations.

The following mandated income groupings require allocation and apportionment of taxes and expenses to determine the effective rate. First, if received or accrued by a U.S. person other than through a foreign qualified business unit (QBU) or because of subpart F, the following income shall be treated as separate items of income, depending on whether the particular amount was subject to
- no foreign withholding tax;
- a foreign withholding tax of less than 15%; or,
- a foreign withholding tax of 15% or greater.

Second, amounts included in the gross income of a U.S. person because of subpart F or through a foreign QBU shall be grouped according to CFC or QBU. Moreover, certain rents and royalties and partnership distributions to which look-through does not apply are also grouped separately.

Only foreign taxes payable in the year of income inclusion have to be considered for the test; thus, foreign taxes which became due upon distribution of previously taxed income, section 959 of the Code, do not have to be considered with respect to the earlier inclusion. However, subsequent adjustments due to differences in accrued and actual payable taxes have to be considered with respect to the earlier income inclusion. Similarly, if the effective rate of the foreign tax is reduced upon distribution of the underlying income (e.g., German split-rate system) and the distribution adjusted rate would not be within the high-tax test, then the taxpayer may recategorize the income as passive income. The regulations also prescribe the same principle for the high-tax exception from subpart F income inclusion under section 954(b)(4).

Every attempt to state these rules illustrates the innate complexity. The underlying policy goals of the rule seem to have been twofold: to prevent taxpayers from 1) cross crediting high withholding taxes on portfolio dividends, and 2) diverting expense allocations from active income to manipulatively shifted passive income (Cf., 1986 Blue Book, at 879; these concerns apparently are still alive, see JCT, FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES at 127, et seq., JCS 6-91). We respectfully question these tax policy concerns as speculative because the projected tax avoidance would be rather sporadic and does not justify a complex set of rules that is difficult to administer. Why would a U.S. taxpayer invest in a country with a higher than the U.S. rate? [Cf., Tillinghast, INTERNATIONAL TAX SIMPLIFICATION, 8 The American Journal of Tax Policy, at 220 (1990)]. While one can see why there should be no cross-crediting between business income and passive income, we see no reason why there should not be cross-crediting within an active and passive basket, respectively. After all, while the U.S. adheres to worldwide taxation of her citizens and corporations, she also does not want double-taxation which in turn presupposes liberal cross-crediting rules.

E. Foreign exchange gains/losses by CFCs

Short of adopting extensive, expensive, and complex accounting systems, a U.S. shareholder has to report with respect to a controlled foreign corporation the net foreign currency gains as foreign personal holding company income under subpart F and categorize it as passive income for foreign tax credit limitation purposes. Only if a U.S. shareholder is willing to keep the detailed accounting, tracing and testing of each transaction under the qualified business and hedging tests, can it report the gain or loss from a currency transaction in the course of an active business as general limitation income. Considering that the number of currency transactions of a larger foreign operation may be legion, one can easily see the complexity, often bordering on practical impossibility.

The current regime appears to be unjustified because most, if not all, currency transactions of a foreign operating company are connected with conduct of the business. Thus, the current system pays a high price in efficiency for the dubious success in preventing unjustified tax deferral for true speculative transactions. We believe that the benefits from simplification for the majority of the transactions should prevail over the concerns of not capturing all perceived abusive deferrals. Moreover, since tax deferral on net currency gains would be consistent with generally accepted tax and accounting principles, excepting currency gains from loss of deferral would be a positive response to the Chairman's fourth criterion for simplification.

F. Repeal the limitation on use of Foreign Tax Credit against Alternative Minimum Tax.

The 90 percent of Alternative Minimum Tax limitation on the use of the Foreign Tax Credit was part of a general floor in the use of loss carry-overs and tax credits. The concern was that absent a special rule, a U.S. taxpayer with substantial economic income for a taxable year potentially could avoid all U.S. tax liability for such year so long as it had sufficient such credit and losses available.[1]

However, the FTC serves a function distinct and different from the net operating loss carryover or the investment tax credit, the other tax attributes whose utilization is limited for AMT purposes. The net operating loss carryover rules are designed to overcome the hardships that may result from the annual accounting concept. The investment tax credit is designed to foster investment in productive capital. Both provisions developed only over time and do not have the systematic cogency of the FTC.

[1] 1986 Blue Book, at 436.

As the logical and systematical result of the U.S. claiming world wide taxing jurisdiction over U.S. corporations, the FTC has been a fixture of the U.S. tax system since 1918. With the adoption of worldwide taxing jurisdiction, the U.S. ceded primary taxing jurisdiction to the host country. To deny a full offset of AMT with FTC violates this principle of secondary U.S. taxation of foreign source income.

The AMT's rationale to assure U.S. tax payments on economic income is inappropriate with respect to foreign source economic income because the result is double taxation. While the AMT envisions acceleration of tax payments which otherwise will become due in the future (only deferred because of preferences), the availability of FTCs reflects that an appropriate tax has already been paid by the particular taxpayer. There is no economic income which escapes taxation. The AMT FTC cap should be repealed.

G. Except foreign persons without effectively connected U.S. income from the Uniform Capitalization Rules.

The application of the UNICAP rules to foreign persons was not a concern of Congress; it emanated from the Service's regulatory implementation[2] which violates all criteria of sound tax policy, i.e., simplicity, equity, efficiency and viability.

The superimposition of UNICAP compliance rules creates unnecessary additional complexity. While the rationale of UNICAP is equity, the attempt to equalize the tax postures of foreign persons is futile because of the ever changing tax regimes imposed by the foreign sovereigns.

Nor is the extension of UNICAP criteria to foreign persons, with no effectively connected U.S. income, cost effective; while the additional administrative costs are evident, U.S. tax revenue acceleration is extremely doubtful. In fact, the prevailing excess foreign tax credit position of U.S. taxpayers with foreign operations cancels out any U.S. tax acceleration from increased earnings and profits in foreign corporations from a deferral of cost recovery.

When it comes to testing the effectiveness in promoting the nation's economic goals, burdening foreign operations with UNICAP rules, in addition to the local cost recovery regimes, is counterproductive. It places the foreign operations of U.S. taxpayers at a competitive disadvantage.

Compliance with Code section 263A requires the addition and maintenance of a layer of accounting, the cost of which is, in the case of a foreign person with no effectively connected U.S. income, not only disproportionate to the benefits from the envisioned policy goal of uniformity, but also adds to the disadvantages foreign operations of U.S taxpayers face from overreaching U.S. regulations. Moreover, uniformity in application of U.S. costing rules (as a means to neutralize any differences in tax treatment as an investment criterion) becomes meaningless in view of host country rules which in themselves create unsurmountable differences affecting the investment decisions. Therefore, API recommends the statutory exemption of foreign persons without effectively connected U.S. income from the UNICAP rules.

H. Dual consolidated loss rules.

Code section 1503(d) denies the use of net operating losses (dual consolidated losses) of U.S. companies that could reduce foreign taxes of other entities. Section 1503(d)(2)(B) authorizes regulations that would except U.S. corporations from this loss disallowance to the extent their losses do not offset the income of foreign corporations for foreign tax law purposes. The dual consolidated loss provisions were enacted to correct a perceived abuse where taxpayers formed a dual resident corporation ("DRC", i.e., a U.S. corporation taxed as a resident by a foreign country) to isolate expenses in the DRC and use

[2] Preamble of Temp. Reg. section 1.263A-1T, 52 F.R. 10059.

the consolidation rules of both the U.S. and the foreign country to offset the income of companies in different taxing jurisdictions with the DRC's loss.

Temporary regulations issued in 1989[9] ignore the above Congressional authorization, significantly expand the definition of DRCs and dual consolidated losses beyond Congressional intent, and impose burdensome administrative requirements on taxpayers with foreign operations.
API believes Congress should amend section 1503(d) to clearly define abusive cases and limit loss utilization only in such cases. API recognizes the Congressional purpose underlying section 1503(d) and believes regulations are appropriate to deal with truly abusive cases. There is no abuse where losses incurred by U.S. companies engaged in active business operations in a foreign country may be utilized by other related taxpayers in the same country.

Furthermore, API believes the implied exemption of Code section 1504(d) corporations from the application of section 1503(d) should be clarified. Alternatively, if section 1503(d) was meant to include section 1504(d) corporations, the dual consolidated loss rules should apply to a Canadian corporation under a section 1504(d) election only if and when such a Canadian corporation is merged or amalgamated with another Canadian corporation. Under Canadian income tax law, merger or amalgamation are the only ways in which one corporation can avail itself of the losses of another corporation.

I. Repeal of Code section 1491.

Code Section 1491 imposes a 35 percent excise tax on transfers of appreciated property to foreign partnerships, trusts, and corporations. This regime represents an obsolete, unnecessary complexity which can be dispensed with because of subsequently developed mechanisms for the appropriate taxation and reporting of transfers of appreciated property to (1) partnerships under section 704(c), (2) trusts under section 668, and (3) corporations under section 367. Thus, the regime should be repealed as obsolete and superfluous.

[9] T.D. 8261, 9-7-89.

STATEMENT OF THE AMERICAN PUBLIC POWER ASSOCIATION

The American Public Power Association, the national service organization representing more than 1,750 municipally or other local publicly owned electric owner systems, believes that there is much that can be done to simplify the tax code provisions governing the use of municipal bonds. Some changes made in the Tax Reform Act of 1986 have had a negative impact on the ability of state and local governments to issue tax-exempt bonds to finance essential public services and infrastructure.

We applaud the efforts of the Committee to simplify the tax code and commend Chairman Bentsen and Senator Baucus for their leadership and commitment to make meaningful change. We view the efforts begun by this Committee as a positive step in the right direction, but we caution the Committee to recognize that these efforts, while they are appreciated, are only a beginning. Long-term and truly meaningful reform can only occur when the Committee goes the full mile and enacts reforms included in the Final Report by the Anthony Commission on Public Finance. We believe that this document holds the key for a healthy and productive tax-exempt bond market that will serve the needs of state and local government capital improvement programs, while eliminating the opportunity for abusive transactions.

The American Public Power Association is pleased to join with the Government Finance Officers Association and other state and local government organizations in submitting a joint statement for the record. In addition to the comments presented in that joint statement S. 1394 and other tax simplification legislation, APPA submits this statement for the record concerning an issue of unique concern to public power -- the singling out of public power by placing more stringent private use restrictions on public power issuers. This statement addresses that concern and urges the Committee to carefully reconsider this issue as it continues its efforts toward simplification. In addition, our testimony endorses S. 913, legislation introduced by Sen. Baucus, in particular, those provisions addressing current restrictions on arbitrage earnings. We urge this Committee to consider S. 913 as you continue your efforts toward reform.

A WORD ABOUT PUBLIC POWER

Public power systems are electric utilities owned and operated by local and state government -- cities, counties, and other public bodies. The rates and policies of public power systems are set by locally elected or appointed governing boards. As such, public power systems are directly accountable to the public -- local citizens they serve. Public power systems differ from "investor-owned utilities" (IOUs) in that publicly owned systems are non-profit organizations operated by and for the local community, while investor-owned systems are owned by private stock holders and provide electricity for a profit.

There are 1,982 publicly owned local electric systems in the United States today, and 63 publicly owned joint action agencies. Joint action agencies are organizations formed by several public power systems, acting in concert, to plan, build and operate efficiently sized power plants and other facilities and coordinate power contracts to meet the needs of their member systems. Through economies of scale, these joint action agencies have enabled public power systems in small communities to provide electric service at reasonable rates that would not otherwise be possible.

Small public power systems are not uncommon. In fact, the bulk of public power systems are small: 75 percent of our public power systems today serve communities under 10,000 people. The median size public power system serves 1,696 customers.

Combined, small and large public power systems serve 15 percent of all power customers in the United States. From the largest system, the Los Angeles

Department of Water and Power, serving 1.3 million customers, to one of the smallest, Radium, Kansas, serving 17 customers, they have one common thread -- each system was created through the efforts of local citizens to control what they deemed was important -- all through local referendum and action.

The reason for creating public power systems vary, but the benefits they offer are generally the same. Unlike IOUs, public power systems have only one constituency: their customer-owner. On average, residential rates for customers of local public power systems are 23 percent below those charged by investor-owned utilities. We believe there are a variety of reasons for this. For example, as local public agencies, they are accountable directly to their customer-owners, and are practitioners of rigorous cost control measures.

Because they are consumer-owned, public power systems offer the consumer a direct voice in the establishment of service policies and rate structures as well as the design and siting of utility facilities. In addition, because they are publicly owned and accountable to their local and state governments, local officials can integrate utility operations with other local government services.

TAX-EXEMPT BONDS: THE ESSENTIAL LINCHPIN FOR LOCAL INFRASTRUCTURE PROGRAMS

Public power, an important part of the capital intensive, local governmental infrastructure system, is heavily dependent on the use of tax-exempt financing in building and operating essential public facilities. Like locally owned solid waste disposal systems, water and wastewater systems, local roads and bridges, these high cost public works projects traditionally have been financed by tax-exempt bonds to keep project costs feasible and permit issuers to amortize the costs of the projects over time.

Tax-exempt municipal bonds have served an important role in meeting the nation's infrastructure needs. Yet, there is little question that the state of the nation's public infrastructure -- highways, bridges, water and waste systems to name a few -- is deplorable. Studies have clearly indicated that our failure to invest in public infrastructure has led to a national crisis. This lack of investment has affected the nation's productivity and our ability to compete in the global market place. A recently released study by the Economic Policy Institute substantiates that infrastructure investment has a direct relationship to our rate of productivity growth, a rate which has steadily declined over the past decade.

What has led us to this state? Under fiscal retrenchment policies of the 1980's, the federal government steadily withdrew its support to state and local governments for infrastructure programs, slowly dismantling them. During this same period of time, the federal government exacerbated the state and local government fiscal condition by increasing direct mandates on these governments. States and localities could not make up the difference. According to a survey of City Fiscal Conditions in 1989 conducted by the National League of Cities, 36 percent of municipalities reduced capital spending that year. The majority of the cities participating in this survey cited the lack of federal funding as the major reason for this drop.

Local governments are being squeezed on one hand by the radical decrease in federal support and on the other by the rising demand for services. To cope, most state and local governments have had no choice but to moved increasingly to debt financing. In 1981, 37.5 percent of infrastructure investment was financed by debt. By 1989, the figure had increased to 53.9 percent. Today, the use of tax-exempt municipal bonds is more important than ever before.

But local communities are finding that the financing of important capital improvements has become increasingly difficult. Many local communities have reached the limit of their ability to raise revenue through local taxes. These tax limitations place restrictions on borrowing. At the same time, recent changes in the tax code have encumbered the ability of local governments to finance projects with tax-exempt bonds due to restrictions placed on the use of the bonds or because certain changes have reduced the market for such bonds.

We believe public power, and all such traditional governmentally-owned operations, should be able to access the tax-exempt bond market in a reasonable manner. The Rebuild America Coalition, in its November, 1989 report, called on Congress to eliminate unnecessary federal restrictions on the use of tax-exempt financing for infrastructure purposes as one of five legislative goals. APPA, a member of the Rebuild America Coalition, urges Congress to carefully consider this report and to remove certain unnecessary and burdensome restrictions.

PROBLEMS ARISING FROM THE 1986 TAX REFORM ACT EFFECTING TAX-EXEMPT BONDS

The Tax Reform Act of 1986 (TRA '86) made a number of sweeping changes affecting the municipal bond market. TRA '86 fundamentally altered the supply of and demand for municipal bonds that make up the two sides of the municipal bond market. On the demand side of the market, for example, these tax law changes essentially eliminated the commercial bank demand for tax-exempt bonds. Changes in the Alternative Minimum Tax (AMT) affected other institutional demand sectors of the market for municipal securities, leaving the individual investor as essentially the sole major source of demand for municipal bonds.

APPA is concerned about the effect TRA 86 has had on the market demand for municipal securities and we urge you to give serious consideration to improving market conditions for municipal bonds as you continue your efforts toward simplification.

We believe that, without increasing the supply of municipal bonds, market administration can be simplified, and demand can be diversified by adopting more universally applicable provisions applied to institutional investors and loss provisions that target specific demand factors to the detriment of market vitality.

There are two other areas of concern arising from changes made in the 1986 Act, specifically the private use restrictions -- in particular the $15 million private use restriction placed <u>only</u> on public power, and no other traditional, publicly owned issuer of tax-exempt bonds -- and the burdensome and extremely complex arbitrage rebate provisions.

Private Use Restrictions

Before TRA '86, up to 25 percent of the proceeds of tax-exempt bonds could be used in a trade or business other than that of a state or local governmental body. TRA '86 reduced this percentage to 10 percent for all issuers of tax-exempt bonds including, of course, public power.

However, the 1986 Act also required that public power issuers meet a more stringent test of the lesser of 10 percent, or $15 million, which can be used in a trade or business other than a state or local government or public body. Because power systems are highly capital intensive, with new power plants often costing between $500 million and $1 billion, and because the scale and cost of facilities are so large, this additional limit on public power projects is almost always $15 million, rather than the 10 percent. The percentage limit on public power, consequently, is far less than the 10 percent placed on all other general purpose traditional governmental issuers of tax-exempt bonds.

We believe that this arbitrary singling out of public power is unwarranted and ignores the basic economic and technical realities of providing electric energy from publicly owned facilities. We also believe that limitation is not grounded in any sound public policy rationale.

A utility's service area may grow at a rate of only 2 to 3 percent each year, but electric power plants take from five to twelve years to build. It would be extremely cost inefficient and a waste of local taxpayers' dollars to attempt to build a system at the same rate as the rate of growth. Therefore, prior to 1986, public power systems would sell some of the output of a new plant to neighboring electric utilities, most of whom were investor-owned or cooperatively owned, who needed the power during the plant's early years of operation so the system can plan for growth while providing a cost efficient service. This type of planning is traditional in the electric utility industry

and economically imperative for facilities that have relatively long lead times. It's really no different than deciding a master school facilities plan that a community "grows into". Yet public power -- unlike all other local government infrastructure activities -- has this additional $15 million restriction, making it almost impossible to conduct such long term planning and inter-utility cooperation in a cost effective way.

Also, due to economic conditions or other factors, a public power utility may find that facilities started ten years ago to meet their forecasted customer needs, in fact, will not be required fully for several years. The special $15 million private use restriction for public power prevents the effective sale of the output of such facilities during such periods by public power systems to neighboring investor-owned or cooperatively-owned utilities even though those neighboring utilities could economically use such facilities for their customers' needs. In summary, the combination of the capital intensive nature of electric utilities and the special $15 million private use restriction on public power severely inhibit the ability of utilities to optimize the economic efficiency of their planning for the benefit of all electric consumers and the economy generally.

In fact, the Anthony Commission recognized the arbitrary nature of this provision in its final report, "Preserving the Federal-State-Local Partnership: The Role of Tax-Exempt Financing" issued last fall. The report asserts that "the Commission is unaware of a valid public policy reason to apply the private business test differently for different types of facilities," and "to limit the private use portion of bonds issued to finance public power and other output facilities to $15 million appears to be totally without merit." The Commission called for the elimination of the $15 million restriction recognizing that "in an era when central power plants routinely cost hundreds of millions of dollars, this $15 million restriction effectively eliminates the private use percentage threshold." APPA urges the committee to give serious consideration to this report and its recommendations.

The special public power private use restriction, as well as the absence to date of private use regulations, adversely impacts planning and operations. While no legislation has been introduced that would ease the private use restriction, we continue to urge this committee to consider this issue as you pursue simplification legislation.

A partial solution proposed by members of APPA's Ad Hoc Task Force on Bond Issues is to provide a safeharbor of five years where a public power system could sell power to an investor owned utility or a rural electric cooperative exceeding the $15 million restriction without penalty. At the end of the five year period, the utility would be required to comply with the $15 million restriction. This would give the issuer the opportunity to grow into the facility while permitting a far more efficient use of the facility and taxpayers dollars which financed it.

Arbitrage Rebate Requirements

In passing the 1986 tax changes, Congress stipulated that all arbitrage earnings on all types of municipal bonds proceeds be rebated to the U.S. Treasury, while providing an exception for small issuers, defined as government units and their subordinates that issue not more than $5 million in governmental bonds in any one calendar year.

The Treasury Department issued proposed rules to implement the law in May of 1989. These rules were administratively burdensome and unnecessarily complex. As such, the arbitrage requirements have significantly increased the cost of borrowing by adding to the cost of issuance and administration.

In 1989, Congress responded to the problems arising from this complex set of regulations by enacting the "two-year rebate rule", permitting issuers of bonds for construction projects to avoid some of the rules' administrative burdens by meeting a set spend-out schedule in dispersing the proceeds. We appreciate this Congressional response, but the passage of the two-year rule did not significantly reduce the costs or lessen the administrative burden. Part of the problem is that construction bond issuers often split one bond issue into two or more in order to meet the two year spend-out schedule. Issuers enter

the market more frequently to comply with the requirement that no more than 25 percent of bond proceeds be spent on equipment. These additional bond sales increase costs of issuance.

Until this past April when the IRS released revised regulations, most issuers required the assistance of financial advisors, bond counsel, and accounting firms to decipher the arbitrage regulations and to establish appropriate tracking programs in order to meet compliance. The small issuer exception has been only partially beneficial. Many small municipalities issue more than what is currently allowed under the exception provision. Increasing the exception would greatly benefit a large number of smaller issuers.

The arbitrage requirements have discouraged refunding. In some cases, issuers fail to refund pre-1986 debt when refunding could lower their debt, because the issuer simply wants to avoid the arbitrage rebate regulations and the resultant administrative burdens implicit in them. If arbitrage rebate were not a factor, the savings on debt service could be put to better use for other priority projects.

Because of issuer complaints and Congressional attention to the complexity of the arbitrage regulations, the IRS revised its regulations. While the revisions appear to be a definite improvement, they remain incomplete and do not relieve issuers from the burdens of hiring outside financial advisors, bond counsels, and of establishing expensive tracking systems to ensure that compliance is met. Yet to be issued are provisions implementing the "two-year rule" and the transfer proceeds rule. We urge IRS to move expeditiously in promulgating rules covering these provisions.

THE TAX-EXEMPT BOND SIMPLIFICATION ACT IS A STEP TOWARD REDUCING THESE BURDENS

S. 913, legislation introduced by Sen. Baucus, makes a number of improvements which will reduce the administrative costs to issuers and alleviate some of the administrative burdens. This legislation makes sense because it eases restrictions on issuers at a time when state and local government, particularly small jurisdictions, need the support of the federal government to meet the rising costs of infrastructure programs.

Specifically, we endorse the provisions that increase the small issuer rebate and bank deductibility exceptions. These two provisions will make a marked improvement in the ability of smaller entities to issue bonds, lowering issuance costs and expanding the market for such bonds. Increasing the bank deductibility exception provides a safe investment vehicle for local banks ensuring the security of their investment portfolios. By bringing banks back into the market, this legislation would reduce interest rates, thereby lowering project costs. Everyone benefits -- the issuer, the banks and the entire local community.

The provision permitting issuers to retain 10% of arbitrage earnings providing an incentive for issuers to earn as much investment income as possible without placing the investment at risk is an important step toward recognizing the costs implicit in these regulations and reimbursing issuers for their administrative costs. While the issuer is give the opportunity to recoup administrative costs, the federal government increases its revenue as issuers place their bond proceeds in higher yield investments. This determines provision benefits the federal treasury, the local issuer and the community served by the issuer.

CONCLUSION

We believe that the tax simplification process provides an excellent opportunity to remove burdensome requirements and to make tax-exempt financing more efficient. The need for tax-exempt financing has never been as important as it is today. The time has come to wrestle with the hard issues of meaningful reform. APPA believes that reform lies in the framework established by the recommendations included in the Final Report of the Anthony Commission on Public Finance and legislation introduced by Sen. Baucus, S. 913. We urge Congress to enact this important legislation which will ease some of the financial and administrative burdens placed on tax-exempt municipal bonds without increasing the potential for abuse or rolling back the tax code to pre 1986. S. 913 is a sensible approach and it deserves Congress' full support.

JOSEPH G. DILORENZO
Vice President of Finance

September 10, 1991

Wayne Hosier
Committee on Finance
United States Senate
SD-205 Dirksen Building
Washington, D.C. 20510

Re: Section 107 of the Tax Simplification Act of 1991

Dear Mr. Hosier:

Boston Celtics Limited Partnership ("BCLP") is a master limited partnership with in excess of 80,000 partners. BCLP has a taxable year ending June 30. As discussed below, we believe that with respect to a fiscal year partnership such as BCLP, requiring information to be provided by the 15th day of the third month following the close of the partnership's tax year (June 30 for BCLP) does not further the purposes behind the proposed change and will place an unnecessary burden on the partnership and its partners.

Section 107 of the Tax Simplification Act of 1991 proposes to amend the Internal Revenue Code to require that partnerships with over 250 partners furnish information returns to their partners by the 15th day of the third month following the close of the partnership's tax year. The stated reason for this provision is that the receipt of such information returns by individual partners on April 15 or later as is currently allowed makes it difficult for such individuals to use the information contained in such information returns in filing their personal tax returns or making tax payments on April 15. Thus, the provision will require calendar year partnerships to file such information returns no later than March 15, thereby providing individuals sufficient time to properly file their returns on April 15.

A centralized reporting system has been developed under which brokers report changes in ownership of units in master limited partnerships held in street name to a single firm, which sends the appropriate information to the various master limited partnerships. This reporting is done generally on an annual basis in February in order to provide such information to the various master limited partnerships in time for filing information returns with partners.

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BCLP is one of only two fiscal year master limited partnerships of which we are aware. Because reporting of transactions involving units held in street name is generally done annually to allow calendar year partnerships to timely file their information returns for partners, BCLP does not receive information concerning transactions in units held in street name until approximately seven months after the end of its taxable year. To require BCLP to furnish the information by the 15th day of the third month following the close of its fiscal year (September 15) would result in BCLP having to send out information returns to its partners which would be incorrect for any partner that either acquired or disposed of partnership units between December 31 and the end of the fiscal year. Moreover, sending out information returns in September will result in greater risk that such returns will be misplaced prior to the time for completing the individual's return.

We request that consideration be given to amending the proposed provision to provide that the due date for information returns to partners include extensions of time for filing the partnership return, but in no event may the due date be later than March 15 following the calendar year in which the partnership's taxable year closes. Such a provision would provide partners with required return information in sufficient time to allow timely filing of returns, while eliminating the undue burdens placed upon fiscal year partnerships and their partners by the current proposal.

Thank you for your consideration of this matter. If you have any questions, please call.

Sincerely,

Joseph G. DiLorenzo

JGD:bjr

STATEMENT OF THE CEO TAX STUDY GROUP

Proposals for Simplification of U.S. International Tax Rules

In connection with the renewed joint Congressional effort to develop tax simplification proposals and the introduction of S. 1394, the Tax Simplification Act of 1991, the Tax Study Group has identified certain priority concerns that it believes should be addressed in any simplification legislation:

1. Translation of Foreign Tax Payments. For purposes of calculating both the indirect and direct foreign tax credit, we propose that the general rule, which requires income and expense items to be translated at the appropriate exchange rate as defined in section 989, be extended to the translation of foreign taxes.

2. Uniform Inventory Capitalization. We propose eliminating the application of the uniform inventory capitalization rules of section 263A to foreign corporations not engaged in a U.S. trade or business. In our view, the revenue gained by applying these rules to foreign persons not engaged in a U.S. trade or business do not justify the costs and complexities these rules generate.

3. Elimination of Unnecessary E&P Computations. We propose the grant of authority (or confirmation of existing authority) to the Treasury Department to equate the earnings and profits of U.S. owned foreign corporations with restated foreign book income calculated in accordance with U.S. generally accepted accounting principles ("GAAP").

4. Passive Foreign Investment Company (PFIC) Rules. We propose that the PFIC provisions of existing law, or the unified anti-deferral proposal contained in S. 1394 for passive foreign corporations, be amended to exclude controlled foreign corporations (CFCs), the passive and other types of income from which is already subject to current taxation under Subpart F.

5. Non-Controlled Section 902 Corporations. Because non-majority investment in foreign corporations is a common, and many times essential, practice for U.S. companies competing in a global marketplace, we recommend that shareholders of section 902 non-controlled corporations be allowed a modified look-through to the income earned by the foreign corporation in order to categorize income for foreign tax credit purposes, with a single foreign tax credit basket combining all such corporations for which look-through is not elected.

6. High Tax Kick-out Rule. We recommend that the high-tax kick-out rule for passive income for purposes of calculating the foreign tax credit be eliminated.

7. Section 6046 Information Reporting. We propose that the section 6046 information reporting requirements be revised to reduce the burden of tracking insubstantial foreign minority investments.

Below is an expanded discussion of these recommendations.

1. <u>Reconsider the Approach to Translation of Foreign Tax Payments</u>

Where a U.S. corporation operates overseas through a foreign subsidiary, the income earned by the foreign subsidiary is generally not subject to U.S. taxation until a deemed or actual dividend is paid. The U.S. parent is eligible for an indirect foreign tax credit for foreign taxes associated with the income out of which the dividend is paid.

Prior to the Tax Reform Act of 1986 ("TRA of 1986"), the foreign taxes associated with a deemed or actual dividend were translated into U.S. dollars, under authority of <u>Bon Ami Co.</u>, 39 BTA 825 (1939), at the exchange rate prevailing at the date of the distribution. The TRA of 1986 changed the translation method for foreign taxes to the spot rate on the date the foreign taxes are paid to the foreign tax authorities. This separate transaction translation rule (which also applies to translations by foreign branches) is an exception to the fundamental foreign currency principle adopted in TRA of 1986. The fundamental principle provides that foreign subsidiaries and foreign branches constituting a Qualified Business Unit (QBU) are generally to utilize a functional currency approach for translating their income and liabilities at the appropriate exchange rate as defined in section 989(b) of the Internal Revenue Code of 1986 (all section references hereafter are to the Internal Revenue Code of 1986).

The effect of the transaction method for foreign taxes is to require hundreds, and for some companies thousands, of separate calculations. This is due to the required translation of the multitude of tax payments at all foreign government levels and the required retranslation and adjustment of a taxpayer's prior tax filings whenever the tax is accrued and paid on different dates under different prevailing exchange rates.*

We propose that, as in the case of all other translations, a QBU or a U.S. shareholder of a controlled foreign corporation determine the foreign taxes in the functional currency of the QBU or CFC for purposes of both the direct and indirect foreign tax credit computations in the same manner as any other liability. A QBU or CFC would use the rules that generally govern the translation of income and expense under the appropriate exchange rate as defined in section 989. The result would be:

1. A U.S. shareholder of a CFC using a foreign functional currency would translate foreign taxes at the spot rate on the date the distribution is included in income (section 989(b)(1));

2. In the case of an actual or deemed sale of stock in such a CFC, the foreign taxes would be translated at the spot rate on the date the dividend is included in income (section 989(b)(2));

3. Foreign taxes attributable to subpart F income (and to other types of income that are deemed remitted) would be translated at the weighted average exchange rate for the CFC's taxable year (just as the subpart F inclusions are translated under section 989(b)(3));

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*This is a very real problem since many foreign countries require taxes associated with a particular tax year to be paid over a different twelve month or longer time period.

4. Foreign taxes claimed as direct credits would be translated for entities with a foreign functional currency at the weighted average exchange rate for the taxable year of the QBU (section 989(b)(4)); and

5. Where a CFC's or QBU's functional currency is the dollar, the translation would be based on the tax payment date consistent with current law.

The result of this proposal for entities with a foreign functional currency is to preserve the effective foreign tax rate for foreign tax credit purposes rather than, as under present law, fix an amount of tax in U.S. dollars at a point in time when the amount of foreign currency units convertible into U.S. dollars is not relevant to the U.S. taxpayer and the U.S. Treasury because the earnings upon which those taxes are paid have not been remitted into the U.S. tax system. Thus, current law results in increases or decreases in foreign tax credits purely as a result of movements in exchange rates, rather than on the basis of payments to or refunds from foreign taxing authorities. The proposal, on the other hand, properly preserves the ability of the U.S. to always collect the residual tax on income that incurs foreign tax at less than the U.S. rate but not on income that incurs foreign tax at higher than the U.S. rate. Moreover, the proposal takes into account the exchange rate that should be relevant to both the U.S. taxpayer and the U.S. Treasury -- the rate on the date the earnings are remitted (or deemed remitted) to the U.S. taxpayer and convertible into U.S. dollars.

S. 1394 proposes that the Treasury Department be given regulatory authority to permit payments by foreign corporations to be translated into U.S. dollar amounts using the average U.S. dollar exchange rate for the taxable year during which the tax payments were <u>made</u>. Such change would achieve some degree of simplification, but would still leave taxpayers who do business in many different countries with a substantial record keeping and compliance burden. In the year taxes accrue, they would have to be translated at two rates: the average rate for taxes paid during the year and the year-end spot rate for taxes accrued but unpaid. Payments in years following would have to be tracked by year and adjustments to the pools of creditable taxes would have to be calculated. This proposal would be improved if the translation of foreign taxes were made at the average rate for the year in which the foreign taxes accrue. This would significantly reduce the administrative effort of tracking payments by year and recalculating the pools of foreign tax credits. Since most foreign taxes are paid in the year they accrue and the following year, the resulting tax credits would not be substantially different than under the present law rule of translation as of the payment date.

2. **<u>Eliminate Application of Section 263A to Foreign Persons</u>**

Section 263A provides uniform capitalization rules for costs incurred with respect to property produced and property acquired for resale. This section was enacted in TRA of 1986 because it was thought that prior law capitalization rules did not adequately ensure correct matching of income and expense. The preamble to the temporary regulations to section 263A, which were published in March and August, 1987, made it clear that the rules apply to any person producing or acquiring property, whether or not that person was engaged in a U.S. trade or business.

U.S. corporations have already incurred considerable administrative costs in attempting to apply these rules to domestic activities. It is our view that the revenue gained by

applying these rules to foreign persons not engaged in a U.S. trade or business, such as CFCs, does not justify the costs and complexities these rules generate. The additional complexities and costs are due to the fact that the uniform capitalization rules generally must be applied by foreign nationals who often have little familiarity with U.S. accounting and tax principles and with the English language. Moreover, particularly in the case of non-controlled section 902 corporations, there is much difficulty in forcing these foreign corporations to apply these rules because it does not have any beneficial impact on their business. Although the Internal Revenue Service ostensibly has provided some relief in this area, through the issuance of Notice 88-104, 1988-2 C.B. 443, little use has been made of this administrative relief. This is because the Notice does not provide any adjustments for timing differences that are not present in the case of foreign assets, namely depreciation.

Applying these rules to foreign persons not engaged in a U.S. trade or business impacts U.S. corporations with CFCs primarily in three ways: (1) determining the amount of a taxable distribution under section 316; (2) determining the amount of deemed paid foreign taxes under sections 902 and 960; and (3) determining the amount of the earnings and profits adjustment under section 864(e). Because corporations generally do not distribute all of their earnings and profits, and most affected U.S. multinationals (e.g., capital intensive rather than financial companies) are currently in excess foreign tax credit positions, we believe that the revenue effect of not applying section 263A to foreign persons not engaged in a U.S. trade or business should be minimal.

Because the revenue effect in not applying section 263A to foreign persons not engaged in a U.S. trade or business should be minimal, but the costs and complexities under current law, both for the Internal Revenue Service and taxpayers, are tremendous, we recommend that application of section 263A be limited only to those persons that are engaged in a U.S. trade or business.

3. Unnecessary E&P Computations: Use of GAAP

Earnings and profits (E&P) is relevant in a number of contexts in the foreign tax area. E&P is used, for example, to measure the amount of a distribution received from a foreign corporation that is a dividend, the amount of foreign taxes deemed paid for purposes of the deemed paid foreign tax credit, the amount of subpart F inclusions, and the amount of section 1248 gain treated as a dividend.

Under section 964, E&P of a foreign corporation must generally be computed according to rules substantially similar to those applicable to domestic corporations. A foreign corporation, however, cannot normally calculate E&P in the same manner as a domestic corporation. Generally, a domestic corporation calculates E&P by making adjustments to U.S. taxable income. A foreign corporation, however, must use foreign book income or foreign taxable income as a base, as it does not have a comparable U.S. taxable income figure. This adds tremendously to the complexity of computing E&P. In addition, particularly in the case of a non-controlled foreign corporation, or in the case of pre-acquisition years of a controlled foreign corporation, it may be difficult or impossible for the U.S. shareholder to obtain the information necessary to compute E&P.

While foreign corporations do not compute U.S. taxable income, they frequently adjust foreign book income to conform with U.S. generally accepted accounting principles (GAAP) for financial

statement reporting purposes. There are numerous differences between GAAP and E&P. Many, if not most of these relate to timing differences. These timing differences may have little or no impact on the U.S. tax paid, particularly in light of the Tax Reform Act of 1986 which reduced U.S. tax rates and eliminated many potential areas of abuse. As an example, the Tax Reform Act of 1986 modified the section 902 deemed paid credit so that the credit is computed by reference to a pool of post-1986 undistributed earnings. This change has greatly reduced the significance of adjustments which merely shift income and deductions between periods.

In summary, the current E&P rules for foreign corporations result in significant complexity, and compliance is burdensome, and in some cases impossible. We therefore propose that the book income of foreign corporations, as adjusted for U.S. GAAP, be permitted as a measure of E&P. Exceptions could be permitted for a limited number of extraordinary items. This will significantly reduce the complexity of the existing rules and the administrative burden on taxpayers. The Treasury Department may currently have sufficient regulatory authority to implement this proposal.** We would ask that Congress take the appropriate steps to confirm that Treasury has such authority and direct Treasury to develop regulations effecting this change.

4. Eliminate Passive Foreign Investment Company and Controlled Foreign Corporation Overlap

Current taxation is generally required for passive investments in the United States (whether made directly or through a regulated investment company). U.S. investors holding passive investments through a foreign corporation, however, are generally subject to U.S. tax only when the corporation's earnings are remitted as a dividend or when the investor sells his shares in the foreign corporation. The Foreign Personal Holding Company (FPHC) rules and later, the subpart F rules, were enacted to limit the incentive for U.S. investors to invest abroad rather than within the U.S. by taxing U.S. shareholders currently on certain categories of foreign income even though such income was not distributed to them. Nevertheless, many U.S. individuals with portfolio investments abroad (*e.g.*, in foreign mutual funds) were able to escape current taxation as the FPHC and subpart F provisions apply only where there is a significant concentration of U.S. ownership and other conditions are met.

The Passive Foreign Investment Company (PFIC) rules attempt to put U.S. and foreign passive investments on equal footing. The rules apply without regard to ownership or control but by reference solely to the level of passive income or passive income producing assets within the foreign corporation. Under the rules, current or the equivalent of current taxation is imposed on the U.S. shareholder's entire portion of income from a PFIC. Income taxed under subpart F rules continues to be so taxed with the balance of the income taxed under the PFIC rules.

Although intended to curtail the tax advantage of income deferral for U.S. investors in foreign mutual funds, the PFIC provisions can also apply to CFCs that are basically operating companies and which are not the intended target of the PFIC legislation.

**Regulatory action to utilize GAAP rules for foreign income simplification has been advocated for their utility in other contexts including calculating currency gain or loss under the dollar approximate separate transactions method under I.R.C. section 985.

The PFIC provisions should be amended to exclude CFCs, the passive and other types of income from which is already subject to the subpart F taxing regime. This would limit the PFIC provisions to their intended purpose of eliminating perceived abuses relating to overseas mutual funds. An alternative that would significantly reduce the CFC/PFIC overlap would be the elimination of the asset test, thereby limiting application of the PFIC rules to corporations earning the measure of passive investment income originally targeted by the legislation.

5. Change Separate Income Limitation for Non-controlled Section 902 Corporations

A section 902 non-controlled corporation is a foreign corporation the voting stock of which is 10 percent or more owned by a single U.S. company, yet is not a CFC since 50 percent or less of either the total combined voting power of all classes of voting stock or the total value of the corporation is owned directly, indirectly or constructively by U.S. shareholders. Under current law, a separate foreign tax credit calculation is required for dividends received from each section 902 corporation. That is, only the foreign taxes associated with the dividends from each section 902 corporation are creditable against the U.S. tax on that income. The justification for this rule appears to be that Congress does not consider non-majority ownership interests to be an integral part of a company's worldwide business (General Explanation of the Tax Reform Act of 1986, page 868).

The separate limitation for dividends from each section 902 non-CFC creates a considerable compliance burden for U.S. corporations and their affiliates, which may have dozens, or even hundreds of investments in section 902 non-CFCs. We believe that it is appropriate to examine whether, in the light of other provisions such as passive foreign investment company rules and the complexity involved, it is really necessary to retain a separate limitation for minority investments. If a minority investment rule is retained, it should be modified.

Under present law, a separate allocation of expenses under the section 861-8 regulations must be made to each non-controlled entity (whether or not dividends are paid). Moreover, if no dividend is received from a section 902 non-CFC for the year, then the separate foreign tax credit calculation for each such entity will show a foreign source loss after the required allocation of expenses under the section 861-8 regulations. Each such foreign source loss must be reallocated to each of the other separate limitation baskets with foreign source income under section 904(f)(5). In a later year, when there is a dividend from the particular section 902 non-CFC, the prior losses in such separate limitation basket must be reallocated back from each of the other separate limitation baskets initially affected.

In contrast, a U.S. taxpayer in a CFC is allowed, for foreign tax credit purposes, to allocate dividends from the CFC to the separate foreign tax credit baskets based on the underlying nature of the income out of which the dividends are paid. This look-through for CFCs is premised on the notion that the CFC is an extended arm of the U.S. taxpayer's business. Expanding this concept to include non-majority interests would be wholly consistent with today's business environment in which U.S. companies find it necessary to combine efforts with other domestic entities or with foreign companies in order to better compete in today's global marketplace.

We recommend, therefore, that shareholders of section 902 non-controlled corporations be allowed to look through and categorize dividend income for foreign tax credit purposes based on the type

of income earned by the dividend paying entity. Because of the potential difficulty a non-majority shareholder may have in accessing information from the non-controlled entity, we would propose that a simplified look-through rule be adopted. The simplified look-through rule would permit dividend income to be categorized based on the nature of the income earned by the foreign corporation as classified in a standardized report, such as its foreign tax return or financial statements. This would relieve non-majority shareholders from the difficult task of ascertaining the nature of income earned by subsidiaries and sub-subsidiaries of the foreign corporation, a requirement that exists in the present look-through rules for CFCs.

Substantial further simplification would be achieved by aggregating non-controlled foreign corporations for which a look-through election is not made by a taxpayer into a single separate foreign tax credit limitation rather than a foreign corporation-by-corporation limitation. This would further address the problem of requiring, as under present law, an inordinate number of expense allocations, loss reallocations and other calculations.

6. <u>Eliminate the High Tax Kick-Out Rule for Passive Income</u>

The TRA of 1986 established separate income "baskets" for foreign income for purposes of calculating an individual's or a corporation's foreign tax credit for U.S. tax purposes. The separate categories were established to prevent taxpayers from using high foreign taxes paid on one type of income to reduce or eliminate the residual U.S. tax on other types on income.

The separate passive income basket generally includes dividends, interest, annuities and certain rents and royalties. To further ensure that there is no substantial averaging of foreign tax rates within the passive basket, the 1986 Act adopted a mechanical rule to recategorize high-taxed passive income (income taxed at a foreign rate in excess of the highest U.S. rate) as general limitation basket income.

Very complicated rules exist for purposes of determining whether an item of income is high-taxed. Generally, income from each defined Qualified Business Unit (QBU) and individual QBU of each CFC is allocated to one of three categories. The income is then either subgrouped with other income based on rate of withholding tax incurred, bifurcated based on whether the income is from within or without the QBU's foreign country of operation, or further isolated depending on the specific nature of the income. Once this lengthy dissection is complete, the taxpayer must then allocate and apportion expenses among each separate grouping to determine whether the income in that grouping is highly taxed. The analysis is further complicated by special rules that apply to the extent additional foreign tax is incurred on income previously taxed for U.S. purposes.

We recommend that the high-tax kick-out rule for passive income be eliminated to reduce the inordinate compliance burden associated with administering a rule designed to deal with a rather theoretical abuse situation.

We offer an alternative recommendation in order to address the apparent concern that absent the high-tax kick-out rule, a CFC might intentionally borrow to incur high taxed passive income to achieve an averaging of foreign tax credits with low taxed passive income. As has been done in other cases, the current rules could be replaced with anti-abuse authority that gives the Internal Revenue Service the ability to disregard a transaction that is motivated solely by tax avoidance. Such authority, with

an illustrative example (e.g., the example provided in the General Explanation of the TRA of 1986 (p. 879)), would be vastly preferable to the complex machinery of the current high-tax kick-out rule.

7. **Revised Section 6046 Reporting for Foreign Minority Investments**

Section 6046, adopted in 1962, requires that U.S. shareholders owning or acquiring direct or indirect interests (by value) in foreign corporations file information returns reporting (i) each direct or indirect acquisition of a 5 percent or greater interest, (ii) each 5 percent or greater interest, (iii) any reduction of an existing interest below 5 percent. Shareholders required to file under this provision must report information consisting of income statements, balance sheets, costs of goods sold, taxes paid or accrued and other information. U.S. persons who are or become officers or directors of such foreign corporations must also file information returns. The 5 percent investment threshold for filing is not otherwise relevant for U.S. tax purposes and creates administrative complexity for taxpayers.

Failure to file required information returns carries a monetary penalty for each such interest for which there is a failure to file.

In contrast to the 5 percent tests under section 6046, indirect foreign tax credits are available for taxes paid by first, second or third tier foreign corporations at least 10 percent directly or indirectly owned (by voting stock) by a U.S. corporate shareholder. Foreign tax credits are not available for taxes paid by foreign corporations below the third tier. The proliferation of corporate owned foreign subsidiaries and joint ventures involving minority U.S. investments has greatly increased the problem of monitoring the transactions subject to section 6046 reporting and obtaining required information. For example, a foreign subsidiary of a U.S. company may enter into a foreign joint venture that has or subsequently will acquire numerous small investments in foreign suppliers or distributors. It is difficult or impossible for the U.S. investor to obtain timely information on such investments.

In the case of U.S. corporate shareholders, the threshold for reporting acquisitions of foreign stock under section 6046 should be increased to the 10 percent voting stock threshold that is relevant for the foreign tax credit. It is also recommended that reporting not be required where the foreign corporation is in a tier lower than that permitted for indirect foreign tax credits and the investment is de minimis in amount.

CEO Tax Study Group Member Companies

Baxter International

Du Pont Company

Emerson Electric Co.

Genentech, Inc.

General Electric Company

General Motors Corporation

Hallmark Cards, Inc.

Hewlett-Packard Company

Honeywell, Inc.

IBM Corporation

Levi Strauss & Company

Merck & Company, Inc.

3M Company

PepsiCo, Inc.

Philip Morris Companies, Inc.

The Pillsbury Company

The Procter & Gamble Company

Quaker Oats Company

Sara Lee Corporation

Westinghouse Electric Corporation

STATEMENT OF THE COMMONWEALTH EDISON COMPANY

INTRODUCTION

Commonwealth Edison Company is an investor-owned electric utility serving 3.2 million customers in the northern third of Illinois, including the City of Chicago, and has nearly 20,000 common law employes.

The Edison Electric Institute (EEI) is the association of electric companies. Its members serve ninety-six percent of all customers served by the investor-owned segment of the industry. They generate approximately seventy-eight percent of all electric energy in the country and provide service to more than seventy-four percent of all ultimate customers of electricity in the nation.

Commonwealth Edison Company and EEI support simplification of the employe benefits rules because many provisions of the Internal Revenue Code have increased the administrative burden imposed on employers while having little effect on the amount of benefits ultimately furnished to employes. In particular, we believe that Congress should simplify the leased employe rules to relieve employers of the enormous administrative burden created under these rules. The sponsors of the Employee Benefits Simplification and Expansion Bill of 1991, S. 1364, which was introduced by Chairman Bentsen on June 25, 1991, are to be commended for the bill's significant change to the leased employe rules.

BACKGROUND

Under the current leased employe rules, individuals who perform services for an employer (recipient) and meet the definition of a leased employe are required to be treated as employes of the recipient for purposes of determining whether the recipient's plans are qualified for certain tax benefits. To be considered a leased employe of the recipient, an individual must not be a common law employe of the recipient and must meet three other requirements. First, the individual must provide services pursuant to an agreement between the recipient and a third party. Second, the individual must provide services to the recipient on a substantially full-time basis for at least one year. Third, the individual's services must be of a type historically performed by common law employes in the business field of the recipient.

SECTION 301 OF S. 1364

Section 301 of the bill would replace the third requirement, the "historically performed" test, with a control test. Under this test, an individual would be considered a recipient's leased employe only if the individual performing the services is under the control of the recipient. This test more accurately reflects the original intent of the leased employe rules because only individuals who perform services similar to the services performed by the recipient's common law employes would be the recipient's leased employes. Commonwealth Edison Company and EEI support this change.

PROPOSALS TO LESSEN ADMINISTRATIVE BURDEN

Even though the control test change contained in the bill is both desired and needed, it does not directly address the administrative burden imposed by the leased employe rules. We urge Congress to enact two additional changes to the leased employe rules that will greatly reduce this burden.

First, legislation is needed to provide that workers who are members of a collective bargaining unit ("union employes") and who perform services for a recipient pursuant to an agreement with an unrelated third party are not leased employes of the recipient. The current requirement that a recipient treat union workers who satisfy the definition of leased employe as its common law employes does not result in any additional plan coverage for any of those union workers. Nevertheless, the recipient is required to incur the expense of gathering employment data to determine if any of the union workers have satisfied the requirement that they perform services for the recipient on a substantially full-time basis for at least one year.

The basis for this proposal is that the most fundamental of the plan qualification rules permits an employer to exclude union employes in determining whether its plan discriminates in favor of highly compensated employes, as long as the plan does not benefit any union employes.[1] The unstated rationale for the exclusion is that the federal government should not interfere with the collective bargaining process by mandating whether or to what extent retirement benefits must be provided to union employes. The definition of union employes who may be excluded does not require that the employer maintaining a plan be a party to the collective bargaining agreement covering the union employes.[2] Rather, the law merely requires that the collective bargaining agreement be between employe representatives and one or more employers.

Congress could not have intended that a recipient would be required to provide qualified plan benefits to union employes outside of the collective bargaining process. The purpose of the leased employe rules is to prevent a recipient from excluding from plan coverage workers who would be covered if they were common law employes of the recipient. Because an employer is not required to provide benefits to union employes unless the collective bargaining agreement so provides, the policy underlying the leased employe rules is not frustrated by excluding union employes from the definition of leased employe.

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[1] If the plan benefits union employes, or if a separate plan is maintained for the benefit of union employes, all nonunion employes may be disregarded in determining whether the plan satisfies the nondiscrimination rules with respect to the union employes. *See* Code Section 413; Proposed Treasury Regulation Sections 1.401(a)(4)-1(c)(6); 1.410(b)-6(e)(1).

[2] In most cases the collective bargaining agreement is between an employer and an international union. For example, employes of a tree trimming company whose services are used by Commonwealth Edison are represented by the International Brotherhood of Electrical Workers.

Accordingly, if retirement benefits are the subject of good faith bargaining with a leasing organization, the employer who is the recipient of the union employe's services should be able to exclude such employes in determining whether its plans satisfy the nondiscrimination rules. Such an exclusion would significantly reduce a recipient's administrative costs of maintaining qualified plans.

The second change to the leased employe rules that we urge Congress to enact is a provision permitting a recipient to disregard its leased employes in determining whether its plans are qualified if the number of leased employes performing services for the recipient is less than 10 percent of the recipient's common law employes. If a recipient with a large workforce has such a small number of leased employes, the recipient should be relieved of the enormous task of collecting from unrelated third parties the detailed employment data that is necessary for it to determine whether any of its contract workers is a leased employe[3].

This proposal is a straightforward safe harbor similar to the recordkeeping exception under the proposed regulations under Section 414(n) of the Code for recipients who have a de minimis number of leased employes. Under the regulations, a recipient is not required to maintain employment records for its leased employes if their number is less than 5 percent of the number of the recipient's nonhighly compensated workforce.[4] Because the recordkeeping exception operates as an exclusion, the basis for the exception must be that if a small percentage of a recipient's workforce is comprised of leased employes, the recipient's intent in hiring such workers is not to increase the benefits it may provide to highly compensated employes.

Although this proposal would increase the number of leased employes that may be excluded under present law, it greatly simplifies the conditions under which a recipient may exclude leased employes. In addition, the increase in the number of leased employes that may be excluded is necessary to provide a recipient with a reasonable margin of error for those workers who escape identification because, for instance, they provide installation or maintenance services in connection with an asset purchase contract or for some other valid reason do not come to the attention of the personnel department. The proposal does not enable a recipient to provide its highly compensated employes with benefits that would be significantly greater than is possible under the proposed regulations; it merely provides

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[3] Although we believe that this proposal to exclude leased employes if their number is less than 10 percent of a recipient's common law employes is not abusive regardless of the size of the recipient's workforce, the change is really needed in the case of a recipient with a large workforce. Thus, if Congress decides to limit the applicability of this exception, we suggest that it be available to recipients with more than 500 employes.

[4] The proposed regulations also require that all plans of a service recipient provide that all leased employes are not eligible to participate and that none of the plans of the service recipient is a top-heavy plan. _See_ proposed Treasury Regulation Section 1.414(n)-3(a)(2)(ii).

recipients with some assurance that they are complying with the law. Moreover, the proposal does not undercut the policy underlying the leased employe rules, and significantly reduces administrative costs.

Furthermore, the proposal would recognize that, in the case of large employers such as electric utilities, there are valid reasons to use the service of independent contractors and outside firms to supplement their normal workforce during peak periods or to perform services that are seasonal in nature. For example, when a new electric generating station or transmission line is being constructed the services of engineers and construction workers are required, but once the project is ompleted their services are not required any longer. Also, due weapons training and certification requirements by the Nuclear ;ulatory Commission, Commonwealth Edison Company chooses to use the services of outside security firms to provide the required security of its nuclear generating facilities because Edison does not have the expertise in that important area.

CONCLUSION

Commonwealth Edison Company and EEI sincerely appreciate this opportunity to present our views on the leased employe rules. Your consideration of our concerns and proposals is appreciated. Because our proposals greatly reduce the cost of maintaining a qualified plan without sacrificing the underlying principles of the leased employe rules, we urge this Committee to support these proposals and include them in any pension simplification legislation that may be enacted.

COMPUTER DEALERS &
LESSORS ASSOCIATION

September 12, 1991

Mr. Ed Mihalski
Chief of Staff
Committee on Finance
205 Dirksen Senate Office Building
Washington, D.C. 20510

Re: S.1394, The "Tax Simplification Act of 1991"

Dear Mr. Mihalski:

The Computer Dealers and Lessors Association ("CDLA") is pleased to submit written comments on Section 421 of S.1394, the "Tax Simplification Act of 1991," concerning the corporate alternative minimum tax ("AMT"). We respectfully request the inclusion of this letter in the record of hearings.

The CDLA is the nation's largest association of computer leasing companies. Our 350 member companies engage in the business of buying, selling and leasing new and used high-technology equipment. CDLA members account for 75 percent of all computer equipment leased and used in the United States, a volume estimated to have reached $25 billion in 1990.

We have concentrated our comments below on the "simplification" goals of the bill. We have not addressed "policy" issues in this context, but note for the record the CDLA's longstanding view that slow depreciation, including the proposed 120 percent declining balance method for determining the AMT of a corporation, has a negative impact on the cost of computer ownership. The CDLA continues to urge Congress to adopt the 150 percent declining balance method for depreciating computer equipment to approximate economic reality and reflect the impact of rapid technological obsolescence on the cost of computer ownership.

The CDLA welcomes the simplification and streamlining of the corporate AMT proposed in Section 421 of the bill. Since 1989, the CDLA has appeared before Congress in support of legislation to eliminate the adjusted current earnings ("ACE") adjustment to the AMT and integrate its component items into the corporate AMT system. The bill takes a significant step in this direction by integrating the depreciation calculations required for ACE and AMT. The amendments proposed in Section 421 of the bill will, if

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enacted, reduce some of the inordinate and unnecessary time and expense required for the calculation of, and the recordkeeping for, the corporate AMT under the present law.

The CDLA is concerned that the simplification proposed in the bill is prospective only. The simplified AMT provisions would apply to property placed in service in taxable years beginning after 1990. The current AMT rules would remain in effect for property placed in service for taxable years beginning before 1991. As a result, all corporate taxpayers would continue to be required to use both the current AMT and ACE rules for the remaining AMT lives of assets placed in service before the effective date of the "simplification" reforms in the bill. For these "pre-enactment" assets, the benefits of "simplification" would not be realized. The burden of maintaining five or more depreciation schedules for these assets would not be diminished.[1]

The CDLA believes it is both possible and desirable to simplify the rules governing depreciation for pre-enactment assets. Specifically, taxpayers should be permitted, on an elective basis, to adopt for these assets a unified depreciation schedule that will apply for purposes of both AMTI and ACE.[2] Such further simplification would provide additional administrative benefits to many taxpayers and to the Internal Revenue Service.

The unified schedule for pre-enactment assets must be crafted in such a way that it is easy to implement and produces results

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[1] Three different schedules are used to compute federal tax liability. One is used in computing depreciation for purposes of regular taxable income, a second is used in computing depreciation for purposes of alternative minimum taxable income ("AMTI"), and a third is used in computing depreciation for purposes of ACE, which is a component of the overall minimum tax computation. Additional schedules are required for financial accounting purposes and in determining state tax liability. The bill would cause AMTI depreciation and ACE depreciation to be calculated under the same set of rules, permitting corporate taxpayers to eliminate one of these sets of depreciation records.

[2] The shift to a unified schedule should be elective with the taxpayer, as some corporations are likely to find that their compliance burden is minimized if they are permitted to continue using depreciation schedules already established for pre-enactment assets.

equivalent to those produced under the present system. This goal can be achieved in any of several ways. The following discussion sets forth some alternatives and the policy considerations that may influence the Committee's choice of one over another. It should be understood that we do not advocate a system in which the taxpayer can elect from among all the alternatives discussed; instead, we anticipate that the Committee would choose one of these alternatives as a unified method of depreciation a taxpayer can elect in lieu of continued use of dual schedules for AMTI and ACE.

Method 1. The cost recovery allowance for pre-enactment assets of electing taxpayers, for purposes of both AMTI and ACE, would be determined as follows. Starting basis (i.e., basis as of the start of the taxpayer's first taxable year beginning after 1990) would be 25 percent of AMTI basis plus 75 percent of ACE basis. A starting basis determined in this manner would reflect the effect of the ACE adjustment to date. This basis would be recovered by applying the 120 percent declining balance method, switching to straight line, over the remaining AMTI/ACE life of the asset. The 120 percent declining balance method would be used to align this method with the method prescribed under the bill for post-enactment assets.

Method 2. This method is the same as method 1, except the starting basis would be ACE basis as of the end of the last taxable year beginning before 1991. The results are similar to the results under the more theoretically correct method 1, and additional simplification is achieved through use of a figure for starting basis that is readily available from prior year calculations.

Method 3. Commencing with the first taxable year beginning after 1990, pre-enactment assets of electing taxpayers would be treated as if they had been under the unified system set forth in the bill from the date they were first placed in service.[3] In some respects this alternative is the simplest, because it would permit electing taxpayers to apply the same depreciation schedules to all assets (pre-enactment and post-enactment) for purposes of AMTI and ACE. Our preliminary analysis indicates that this alternative produces results similar to the theoretically correct results of method 1.

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[3] It may be appropriate to permit taxpayers making this election to amend prior year returns in keeping with this treatment.

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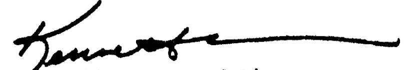
In conclusion, CDLA believes a significant improvement in the treatment of pre-enactment assets under the bill can be achieved without harm to taxpayers or detriment to federal revenue.[4] We would be pleased to assist the Committee and its staff in addressing any technical issues the Committee encounters in the implementation of a unified cost recovery schedule for pre-enactment assets.

Sincerely,



Kenneth A. Bouldin
President

[4] We note that many taxpayers will effectively leave dollars "trapped" in the AMTI credit over an indefinite period of time under any of the alternatives discussed above, including under present law. Consideration should be given to providing relief from this inequity.

STATEMENT OF THE DEPOSIT GUARANTY CORP.

These comments are in response to S. 1394, otherwise known as the Tax Simplification Act of 1991 (hereinafter, "the Act"). Deposit Guaranty Corp. and subsidiaries generally support the provisions of Section 422 of the Act, which repeal the special change in ownership rules applicable in determining adjusted current earnings (ACE). The application of these provisions, which require certain taxpayers to restate the basis of their assets exclusively for ACE purposes, is perhaps the most complex and burdensome requirement contained in the Internal Revenue Code. Through the enactment of the Omnibus Reconciliation Act of 1989, Congress strengthened Internal Revenue Code Sections 382 and 384, thereby increasing the reliance upon these Code sections to restrict the use of the built-in losses. The strengthening of these Code sections has relegated the importance of the ACE change of ownership rules to the role of being merely onerous back-up provisions, and the repeal of these rules will remove these burdensome provisions of diminished importance.

Section 422 of the Act is effective for changes in ownership occurring after the date of enactment. We urge that the Committee modify the effective date of these provisions so that the ACE change of ownership rules be repealed for all changes in ownership occurring after December 31, 1989, as if the rules had never been included in the Internal Revenue Code. The repeal of the ACE change of ownership rules recognizes that these rules are not necessary; however, limiting repeal to changes in ownership occurring after the date of enactment will effectively continue to apply these burdensome and unnecessary provisions to a limited number of taxpayers who have undergone changes in ownership within the two-year period of time during which the rules were in effect. We feel that the resources of the Internal Revenue Service, taxpayers, and their representatives are better devoted to understanding and interpreting permanent provisions of the law, rather than calculating the effect of a repealed provisions that would have been effective for a period of less than two years.

Deposit Guaranty Corp., a one-bank bank holding company, acquired an additional banking operation (which included a holding company, a bank, and other subsidiaries) during 1990. The acquisition resulted in a change in ownership under the Section 382 rules. As a result of the ACE rules, the acquired banking operation is required to restate its basis in all of its assets to reflect each asset's fair market value as of the date of the change in ownership. The impact of implementing the ACE rules in the banking environment is staggering. The basis of every loan, regardless of face value, must be restated as of the date of change. Similarly, the basis of every marketable security held by the bank and every fixed asset owned by the bank must be restated. ACE adjustments are necessary whenever a loan is written off, a marketable security is sold, a discount is accreted or a premium is amortized, and a fixed asset is sold or depreciated. The restated basis is used only for ACE purposes—historical tax basis is used for regular tax purposes. At this point, it appears that the built-in loss limitations will also apply for regular tax purposes; therefore, implementing the rules for ACE purposes as well adds an additional layer of compliance which will have little if any revenue effect.

Efforts to comply with the ACE rules have thus far had a profound effect on Deposit Guaranty Corp. and its subsidiaries. The taxpayer, which has historically maintained a tax department of three persons, has expanded to four full-time persons and hired a fifth temporary full-time person in order to comply with the provisions. Approximately $14,000 has been incurred for the extra personnel in the tax department. The taxpayer has been unable to find support from outside computer software vendors to comply with the ACE rules because of the limited number of taxpayers actually subject to the rules. Two computer programmers worked full-time from May 1991 to August 1991 in order to capture the information necessary to compute the major ACE adjustments pertaining to just the bank's fixed assets. Programmers from the bank's loan operations department are currently being utilized to write the necessary portfolio. In addition, two temporary data entry clerks have been hired to create the necessary data base for making the ACE computations for loans. Other bank personnel set up programs to compute the ACE adjustments for the investment portfolio and other real estate held. Programming costs were budgeted to be $12,000 and $16,000, respectively, for the fixed asset and the loan portfolio compliance requirements; to date costs are exceeding budget. The computer programming problems are compounded by the fact that, due to time constraints, the programs written for 1990 are makeshift in nature and cannot be incorporated as part of the bank's overall computer production system. The programs written for 1990 will thus have to be written for 1991.

The Honorable Dan Rostenkowski, Chairman of the Committee on Ways and Means for the United States House of Representatives, has through a press release identified seven criteria to be applied in assessing proposals to be included in the H.R. 2777, a companion bill to the Act:

1. Whether the proposal would significantly reduce mechanical complexity or recordkeeping requirements.
2. Whether the proposal would significantly reduce compliance and administrative costs.
3. Whether the proposal would preserve underlying policy objectives of current law and not create or reopen opportunities for abusive tax planning.
4. Whether the proposal comports with generally accepted tax principles.
5. Whether the proposal would avoid significant dislocations of tax burdens among taxpayers.
6. Whether the simplification that the proposal would achieve outweighs the instability resulting from making any statutory change, as opposed to permitting statutory repose.
7. Whether revenue effects of the proposal would comport with current revenue and budgetary constraints.

In closing, we would like to apply the above criteria to show why the repeal of the ACE change in ownership rules should be retroactive to changes in ownership occurring after December 31, 1989. We have previously established the effect that the implementation of the ACE rules is having on our tax department, as well as the massive computer applications required to implement the rules. The retroactive repeal of the rules would therefore significantly reduce mechanical complexity, recordkeeping requirements, and compliance and administrative costs.

We feel that our proposal will preserve underlying policy objectives of current law and will comport with generally accepted tax principles, as evidenced by the fact that the repeal of the rules is already included in the Act. Changing the effective date of the repeal to ownership changes occurring after December 31, 1989, instead of using the date of enactment as the effective date, will not undermine policy objectives.

We do not believe that our proposal will result in significant dislocations of tax burdens among taxpayers, nor will the revenue effect of our proposal materially effect current revenue and budgetary constraints. The fact that we have found little support from outside software vendors is an indication that the ACE rules thus far have had limited applicability.

Finally, the simplification that the proposal would achieve clearly outweighs any instability resulting from making the statutory change. Since the Act already includes the statutory change, any instability resulting from the change has already been taken into account by the Committee. Changing the effective date of the repeal to ownership changes occurring after December 31, 1989, instead of using the date of enactment as the effective date, will not result in any additional instability, but will achieve additional simplification.

Statement of Eastman Kodak Company

Mr. Chairman and Members of the Subcommittee: I appreciate this opportunity to submit comments on behalf of Eastman Kodak Company on pension simplification. My statement will address specific provision in S. 1364, the Employee Benefits Simplification Act, introduced by Senators Bentsen, Pryor, and others, as well as H.R. 2730, the Pension Access and Simplification Act of 1991, introduced by Chairman Rostenkowski of the House Ways and Means Committee and H.R. 2641, the Employee Benefits Simplification Act of 1991, introduced by Congressman Chandler and others. I will direct my comments to only a few specific provisions in each bill. Most of my comments discuss those provisions in the bills affecting the proposed pension coverage and nondiscrimination regulations as they relate to Kodaks retirement plans.

KODAK PLAN—GENERAL BACKGROUND

Treating all levels of employees equally for retirement benefits is Kodaks long standing general philosophy. Kodak therefore maintains one defined benefit pension plan, the Kodak Retirement Income Plan (KRIP), for the great majority of its employees without regard to business unit or location. (Sterling Drug Company employees participate in KRIP under the formula carried over from their own plan prior to acquisition by Kodak in 1988.) The KRIP was adopted in 1928 and currently covers

more than 70,000 active employees and 30,000 terminated vested and retired employees and their beneficiaries (plus the roughly 5,000 Sterling participants). Since 1981, the KRIP benefit formula has provided a pension at age 65 (normal retirement age) for each year of participation of 1.3 percent of pay up to the integration level and 1.6 percent of pay over the integration level. The benefit formula is designed so that in combination with social security it replaces on an after-tax basis a participants final pay at the lower salary levels.

The following examples of final pay replacement on an after-tax basis (including social security) are illustrative:

Age 65/35 Years of Service	Age 62/30 Years of Service
$30,000 = 100%	$30,000 = 87%
$50,000 = 92%	$50,000 = 78%
$100,000 = 75%	$100,000 = 64%
$200,000 = 62%	$200,000 = 53%

Kodak has historically provided a partially subsidized early retirement benefit. Prior to Septemberl, 1990, the KRIP provided a 100 percent benefit at age 60 with 30 years of service. For earlier retirements, there was a 5 percent per year actuarial reduction from eligibility for a 100 percent benefit. Age 55 was the minimum early retirement age.

September 1, 1990 KRIP Changes. On September 1, 1990 significant (and costly) improvements were made in the plan. A 75/85 early retirement benefit was added, giving participants with a combination of service and age of 75 a 50 percent benefit and participants with a combination of service and age of 85 a 100 percent benefit. A lump sum optional form of benefit was also added for all participants. These improvements were made to reflect Kodaks need for a more flexible and mobile workforce to meet the competitive demands of emerging technologies.

SPECIFIC COMMENTS

1. Average accruals under the proposed 401(a)(4) regulations

Last year, the Treasury Department issued proposed regulations under Code sections 410(b) and 401(a)(4). The Department has stated that the proposed rules are designed to be a single coordinated nondiscrimination rule. Under section 410(b), an employers plan must meet a minimum coverage requirement. This requirement can be met in one of three ways:

(1) 70 percent test. The plan covers 70 percent of the employers nonexcludable non-highly compensated employees (NHCEs).

(2) 70 percent ratio percentage test. The percentage of NHCEs benefitting under the plan (stated as a percentage of all nonexcludable NHCEs) is at least 70 percent of the percentage of the highly compensated employees (HCEs) benefitting under the plan (stated as a percentage of all nonexcludable HCEs).

(3) Average Benefits Test. The plan meets a two pronged test:

(a)Nondiscriminatory classification test. The plan covers a classification of employees that (i) is a reasonable bona fide business classification and that (ii) satisfies either an objective safe harbor test or an unsafe harbor test.

(b) Average benefits percentage test. Under all plans of the employer, the average benefits of the NHCEs as a percent of compensation equals at least 70 percent of the average benefits of the HCEs, as a percent of compensation.

In addition to satisfying section 410(b), under Code section 401(a)(4) a plan must not discriminate in favor of HCEs. Under the general rule as provided by proposed regulations, a plan satisfies this test only if there is no HCE under the plan with an accrual rate that exceeds the accrual rate for any NHCE. This test must be met separately for both the normal accrual rate under the plan (generally, the rate at which a participant accrues a benefit at normal retirement age) and the plans most valuable accrual rate (generally, the rate at which a participant accrues subsidized early retirement and other optional benefit forms under the plan.) A number of safe harbors are provided, some of them design-based. These are so restrictive, however, that many plans, particularly plans of large employers with subsidized early retirement benefits like Kodak, will not meet them. Such nonqualifying plans must be tested under the general rule.

For the purpose of section 401(a)(4) testing the regulations permit an employer to restructure any plan into a number of smaller plans, each one with the same accru-

al rate (or alternatively, with the same accrual rate segments).[1] Restructuring ostensibly permits employers to create plans each of which by definition passes section 401(a)(4), since within each 401(a)(4) plan created by restructuring, no employee has an accrual rate more valuable than any other. The purpose of the restructuring rules apparently is to recognize that, even in the absence of these rules, employers could amend their existing plans to create separate plans, a practice that would accomplish the same objective at greater cost.

Each 401(a)(4) plan created by restructuring must pass the minimum coverage rules of section 410(b). Because of an employers ability to restructure in this manner, it could be said that a plans failure to pass section 401(a)(4) ultimately is a failure only of section 410(b). Each plan can be restructured so that each component 401(a)(4) plan consists of all benefits with a single accrual rate. A plan can fail only if a highly compensated employee is in a component plan that lacks a sufficient number of NHCEs to pass the minimum coverage requirements.[2]

PROBLEMS WITH THE PROPOSED TEST

The basic problem with the proposed section 401(a)(4) test is that a plan can flunk if any HCE accrues a bigger benefit than any NHCE in any year. This means that if a formula produces nonuniform accrual rates [3] for employees of different ages and lengths of service, a plan is virtually certain to fail. Any plan covers HCEs and NHCEs of varying ages and lengths of service; if the accrual rate (normal or most valuable) is nonuniform it is very likely that in some year one HCE will have a higher accrual rate (normal or most valuable) than some NHCE. Most defined benefit plans have accrual rates that are to some degree contingent on age and years of participation—and therefore nonuniform.

Just about the only kind of defined benefit plan with a uniform accrual rate, unaffected by contingencies of age and service, is one with a normal retirement age of 65 (regardless of when participation begins), with no subsidized early retirement benefit, no caps on years of credited service, and no actuarial increases for individuals who work past the normal retirement age. Plans with enhanced benefit features are certain to have nonuniform accrual rates; a common example is seen in plans with subsidized early retirement based on a combination of age and years of service (such as the Kodak plan). Differing most valuable accrual rates occur in such plans for the simple fact that individuals hired at younger ages with potentially longer periods of service will be nearer to the time of full unreduced early retirement than others; they will accrue early retirement (i.e., most valuable) benefits faster than individuals hired at older ages who are projected to have relatively shorter periods of service.

For example, consider the following plan of employer X. The plan is a defined benefit plan that provides a benefit at age 65 equal to 1 percent of compensation, times a participants high 3-years average compensation, times years of service. A subsidized early retirement benefit is available equal to 100 percent of the normal retirement benefit for participants whose age and service equals a total of 75 years. The plan covers the following participants: [4]

Participant	Compensation	Age At Hire
A	$75,000	35
B	$40,000	30
C	$40,000	35
D	$40,000	50

While the normal accrual rate is nondiscriminatory,[5] the most valuable rates may be discriminatory under the proposed regulations. This is because A's most valuable

[1] Under a de minimis "grouping" rule, a permissibly restructured 401(a)(4) plan is created if all accrual rates in each component plan fall within a range of 5 percent (not 5 percentage points) above or below a midpoint rate selected by the employer.

[2] If the restructured component plan does not pass the 70 percent ratio percentage test, the average benefits test (with its attendant complex tests) would have to be met.

[3] This applies to either the normal accrual rate or the most valuable accrual rate.

[4] This participant group could either be the actual employer population or it could be merely one component of a restructured "plan."

[5] The plan's benefit formula may for any number of reasons not meet any of the design based safe harbors under the proposed section 401(a)(4) regulations. For instance, the compensation

Continued

accrual rate (that is, for early retirement benefits) is greater than D's most valuable accrual rate (for early retirement benefits). This is because A will be eligible for unreduced early retirement at 55, which D will not be eligible for unreduced early retirement until age 62½.

The example here is of most valuable accrual rates that are discriminatory under the proposed regulations. But a similar problem exists for many plans that follow common methods of computing normal retirement rates. For example, in a plan using the typical 30-and-out formula, credited service is limited to 30 years. Employees with more than 30 years of service have a lower accrual rate than employees with less than 30 years of service. If any HCE has less than 30 years of service, and any NHCE has more than 30 years of service, the plan will flunk the basic test. A similar problem exists with respect to plans that provide actuarially increased benefits for employees who retire after age 65, and plans that in any way link full retirement benefits to years of participation.

USE OF AVERAGE ACCRUAL RATES WOULD SOLVE THE PROBLEM

Restructuring is an inadequate solution. The problems of the proposed section 401(a)(4) test are apparently intended to be addressed by the proposed restructuring provisions. Restructuring does help with some testing problems (for example, it permits testing of plans where different benefit formulas apply to employees in different plants or divisions). But restructuring does not address the two fundamental problems of the proposed rule. The first is its extraordinary cost and complexity. Even after restructuring, the test has to be run twice—once for a plans normal accrual rate, and once for its most valuable accrual rate. *Because accrual rates may change every year, a plan may have to be restructured every year, even if the formula remains unchanged.*

The more basic problem unsolved by restructuring is the highly arbitrary nature of the proposed test. Because of his or her age and service with the employer, a highly compensated employee may accrue a benefit at a higher rate than any NHCE under the plan. This means a plan with a nondiscriminatory design can fail to pass merely because of accidents in the composition of the ages and lengths of service of plan participants. Because the result is the accidental outcome of a plans demographics, a plan that has passed in any one year—or many years in a row—may fail to pass in any year.

The arbitrariness of the test is compounded by the proposed requirement that—even though a plan must pass section 401(a)(4) for both normal and most valuable accruals—restructuring can be performed only *once.* That is, the same 401(a)(4) plans that result from one restructuring (for example, to pass the test for most valuable accruals) must also be tested for normal accruals. It is easy to see that the benefits of any group of employees in a restructured plan, selected because they pass for most valuable accruals, might by chance happen to fail the test for normal accruals (or vice versa). Of course, they might also happen to pass both tests. The point is that whether the restructured plan passes or fails is the result of demographic accident, rather than of the fairness of the plans design.

The Kodak plan is an example of these points. Among the 70,000 employees covered by the plan, one is a relatively lower paid HCE who began work with Kodak at the age of 16 and is now in his young 30's. His most valuable accrual rate (the rate at which he is earning a subsidized early retirement under the 75/85 early retirement feature added in September of 1990) is projected to vastly outpace the most valuable accrual rate of all but a few NHCEs. Restructuring does not help this problem, because an insufficient number of NHCEs happen to have this individuals particular work history.[6] The benefit accrued by this single individual could disqualify the whole plan, even though subsidized early retirement is available to all on a nondiscriminatory basis.

H.R. 2641 (Chandler) would permit a plan to pass if the average accruals of HCEs were no greater than the average accruals of NHCEs. Kodak strongly supports this approach. Under this test, if a plan has a nondiscriminatory design, the accidental occurrence of a high accrual rate for a small number of HCEs will not disqualify the plan. In testimony before the House Ways and Means Subcommittee on Select Revenue Measures, Kenneth Gideon, Assistant Secretary of the Department of the Treasury ("Assistant Secretary Gideon statement"), urged that Congress not adopt an av-

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definition may not comply with the necessary requirements for safe harbor treatment because of the use of rate of pay.

[6] The number of NHCEs is insufficient for the KRIP to meet the 70% ratio percentage test of section 410(b).

erage accrual rule because the Department is in the process of modifying the restructuring rules. It is my firm belief that tinkering with the restructuring rules is inferior to replacing the basic test with an averaging rule. *The basic problem is with the proposed 401(a)(4) test itself. None of the proposed modifications I have seen (such as so-called matrix restructuring) address the fundamental problem of the test: it is complicated, expensive and arbitrary.*

An average accruals test—or a modified average accruals test—will prevent discrimination as well, at much less cost, than the proposed test

Some have objected that to permit a test for average accruals would defeat the policy objectives of the proposed section 401(a)(4) test: to forestall an unjustly high accrual rate by a few HCEs, and to prevent the hiding of disproportionately generous benefits for a few HCEs behind the otherwise acceptable average accrual rates of other HCEs. Viewed in this light, the proposed test is consistent with the overall thrust of other parts of the rules governing qualified plans (for example, the section 415 limits and the $200,000 compensation limit under section 401(a)(17)).

But if this is the purpose of the proposed rule, it accomplishes its objective very badly. That is, the proposed test is complex, costly and arbitrary in its results, but these disadvantages are not justified by any significant reduction in discrimination. In fact, because the rule is so rigid, drafters of the proposed regulation have included looseners to offset its harshness. These looseners permit really egregious discrimination, especially by small plans. At the same time, the basic test can by accident disqualify plans providing very good benefits to rank and file employees. If Congress is concerned with enforcing fairness in pensions, this goal could be accomplished just as well, and at much less cost, by a rule permitting testing of average accruals, accompanied by a simple rule to prevent disproportionately generous accruals for a small number of highly paid individuals. These points are explored in the next few paragraphs.

Without testing average accruals, a de minimus failure can disqualify even a plan providing very generous benefits to rank and file employees. This statement has already pointed out how accidents of demographics can cause a plan to flunk the proposed test. This can happen even if on average benefits provided to NHCEs are significantly more generous than those required under the minimum coverage rules. For example, even if an employer plan provided benefits for NHCEs that were twice as generous (as a percent of pay) as the benefits provided for HCEs, the plan could be disqualified because of one failure involving a de minimus amount of benefits.

De minimus accidental disparity should not be offensive in benefits that are available without discrimination. Of course, Congress wouldn't have retained section 401(a)(4) if its objectives were merely to ensure that benefits in the aggregate satisfied some target. But it seems that if in the aggregate a plan delivers significant benefits to nonhighly paid employees—benefits in excess of the minimum required under section 410(b)—and if on average high paid employees accrue the same benefit as low paid employees, it does not offend public policy if a very small number of highly paid employees receive high benefit accrual rates.[7] This appears fundamentally different from a small plan designed with the specific intent of benefitting only a few top management personnel, and which is in fact available in a discriminatory manner.

While proposed test does little to increase fairness of plans such as the Kodak plan, it permits significant discrimination elsewhere. If the intent of the proposed rules is to deny the opportunity of a small number of highly paid employees to design discriminatory benefit packages, they fail spectacularly in their objective. A provision of the regulation permits defined contribution plans to be tested on a defined benefit basis (and vice versa).[8] The result of this rule may in certain circumstances be viewed as discriminatory. Under this rule, a highly paid professional can easily design a defined contribution plan in which contributions for herself are more than four times the contributions (as a percentage of compensation) for any nonhighly paid support staff in the plan. This disparity is allowed even though defined contributions plans have none of the policy safeguards associated with defined benefit plans: notably, risk shifting, and a tax on excess reversions. This feature of the

[7] This assumes that the accruals come from plan features that are available to a nondiscriminatory group of employees and that the benefitted employees themselves are not in the position to influence the benefits package.

[8] This testing methodology is not new. It merely follows longstanding Service and Treasury policy which is consistent with the section 401(a)(4) statutory mandate that there be no discrimination in favor of highly compensated employees in "contributions or benefits."

proposed regulations is already being touted in estate planning magazines as a significant wealth accumulation device for owners of small business.

This particular feature of the proposed regulations is not an accidental oversight, but part of the overall package of features designed to soften the impact of the substantive rule by allowing greater design flexibility. This is a significant symptom of the Section 89 syndrome: A rigid numerical rule is accompanied by a myriad of adjunct rules and exceptions, all designed to make the basic rule politically more acceptable. But the effect of all these rules is twofold: First, they create a complicated and expensive test. Second, they have unintended results—in this case, ludicrous results. To my mind a rule is not defensible when it potentially disqualifies a plan such as Kodaks, that covers large numbers of nonhighly compensated employees, with enhanced benefits that are available to all. At the same time, it deliberately blesses an estate planning technique for high income professionals with inadequate plans.

If Congress wishes to prevent undesirable discrimination, a better rule would permit averaging of accruals, but with a limitation on accruals by any high paid employee. The proposed rule accomplishes little in the way of real reduction in discrimination, and accomplishes this meager result at great cost. This problem is intrinsic with the basic proposed rule. Restructuring is an inadequate solution. And variations of restructuring (such as matrix restructuring which has been suggested by some benefits consultants and apparently accepted by the Service, according to recent press accounts) only pile complication upon complexity, without addressing the fundamental problem of the proposed test. Permitting testing of average accruals would avoid these problems. If Congress is concerned that testing average accruals would permit accrual of inequitably rich benefits for some high paid individuals, a simpler approach would address this problem directly. For example, one rule might limit the accruals of any NCE in the plan to a multiple (for example 200%) of the average accruals by the NHCEs.

A similar solution is suggested by the pension simplification pamphlet prepared by the staff of the Joint Committee on Taxation.[9] The pamphlet suggests that each NHCE accrue a benefit no less than the average benefit accrued by the HCEs.

While I believe this kind of approach is useful, I am concerned about the exact rule as suggested by the Joint Committee staff. The biggest problem with the proposed approach is that it doesn't work for most plans.[10] It can work only if all the NHCEs accrue a benefit at a *uniform* rate that is equal to or greater than the average accrual rate of all HCEs. The uniformity requirement is absolute. If the average NHCE accrual rate equals the average HCE accrual rate, *no* NHCE can accrue at a lesser rate. This is true even in a plan in which the average accrual rate of the NHCEs vastly exceeds the average of the HCEs, so most NHCEs accrue bigger benefits than most HCEs. Even in this plan any NHCE that accrued a lower rate than average could potentially disqualify the whole plan.

In addition, the philosophy underlying the rule is a new departure from traditional pension policy. The fact that certain individual NHCEs receive low benefits is not the explicit concern of pension policy even as reformulated in the Tax Reform Act of 1986, provided that on average low paid employees in a (restructured) plan receive a benefit commensurate with that received by high paid employees. This can be seen in the essential structure of the coverage rules, which permit an employer to exclude a significant number of low paid employees from any pension participation at all. For example, an employer that covers all of its HCEs in a single plan can exclude up to 30 percent of its NHCEs. The pension coverage and nondiscrimination rules have been designed first to ensure that aggregate benefits are spread fairly among high paid and low paid employees, and second to ensure that no high paid employee receives an unfairly rich pension benefit compared to the employers rank and file. But except for top heavy plans, the rules have not been designed to ensure a minimum benefit for each NHCE

Because of these objections, I believe a more acceptable variant of the Joint Committee staff suggestion would involve a cap on the permissible accrual of any HCE. This rule might be particularly effective if combined with the restructuring rules. Many defined benefit pension plans provide benefits to employees of different divisions, locations, plants, etc., under different formulas. These varying benefit formulas may provide vastly disparate benefits. The restructuring rules under the pro-

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[9] Simplification of Present Law Tax Rules Relating to Qualified Pension Plans, prepared by the Staff of the Joint Committee on Taxation, JCS-24-90. August 6, 1990.

[10] There are many reasons why a participant may not accrue a benefit in a particular year. For example, a participant may be required to work 1,000 hours to get an accrual so that any participant who does not have 1,000 hours in a year will accrue no benefit.

posed 401(a)(4) regulations have been designed to deal with this type of situation. If the restructuring rules (especially the group restructuring rules of Prop. Reg. section 1.401(a)(4)-9(d)(2)(i)(A)) were permitted to be applied before the application of the suggested variant of the proposed Joint Committee staff rule, there may well be a workable alternative to the general rule of the proposed regulations.

2. Rate of pay

Last year Treasury also issued proposed and temporary regulations defining participants compensation for purposes of the pension nondiscrimination rules under section 414(s). The proposed rules provide an acceptable definition of compensation and several safe harbor definitions. In addition, an employer may use any definition of compensation provided it is reasonable and does not by design favor highly compensated employees. In addition, the definition must satisfy an objective test for discrimination.

A definition passes this test only if the percentage of compensation included under the alternative definition for HCEs (as a percent of compensation calculated under the basic method) does not exceed by more than a de minimus amount the percentage of compensation included for NHCEs (as a percent of compensation calculated under the basic method). Put another way, the alternative definition cant include a higher proportion of pay (as calculated under the general rule) for HCEs than for NHCEs.

However, under the proposed regulations, employers must use actual compensation, rather than rate of pay—even if the use of rate of pay would be nondiscriminatory. This adds to the complexity of the rules without having an effect on discrimination. A brief description of the Kodak plan may explain this point. Under the Kodak plans compensation formula benefits are based on a participants high 3-years *actual* compensation, generally excluding bonuses paid to eligible employees based on company performance (defined as a return on assets). In certain limited situations, however, actual compensation is adjusted upward for any affected participant to take into account a participants rate of pay. These situations include but are not limited to breaks in service because of unpaid leave for military duties, parental leave, and family leave; and reduction in pay because of disability.

In these types of situations, Kodak provides benefits based on an individuals rate of pay before the break in service. We believe that allowing Kodak to define compensation as rate of pay to accommodate this practice would greatly reduce the testing burden of the new rules. H.R. 2641 would require that employees rate of pay be among the acceptable definitions of compensation included in Treasury regulations under section 414(s). Kodak supports this provision. Of course, as for any other alternative definition of compensation, rate of pay should be acceptable only if it is reasonable and nondiscriminatory, and meets the objective test set forth in the proposed regulation. Kodak has determined the use of rate of pay by its plan in these situations would satisfy all these principles.[11]

The Joint Committee Staff pamphlet on pension simplification notes that some observers argue that the compensation used for plan testing purposes should be actual pay, not approximations thereof. If the use of rate of pay is nondiscriminatory in design and in effect (as defined under the objective test), it is difficult to see an overwhelming public policy justification for the use of actual pay, rather than a reasonable approximation. As with other elements of the rules, I believe a balancing test in this case is appropriate. *A rule that excludes the use of rate of pay promotes only very small increases in accuracy in return for an enormous increase in the cost of the test.*[12]

An alternative approach would be to expand the rule provided in S. 1364 and H.R. 2641 governing contributions to a qualified plan for an employee who becomes permanently and totally disabled. Under the provision as proposed in the two bills, if a plan provides for continuation of contributions on behalf of all participants who are permanently and totally disabled, contributions may be based on participants pre-

[11] This assumption is based on Kodak's ability to use the aggregate testing method set forth in the preamble to the proposed regulations. The preamble, however, conditions the use of the aggregate averaging method "only if it does not produce distortion as a result of the extra weight given employees with higher compensation in the relevant group." It has been suggested by some individuals in the Service and Treasury that the aggregate method may not be appropriate in certain cases and that individual percentages may need to be done, in which case the test would not be met if there is any one participant who receives no actual compensation for a year, because, for example, the person was on family leave.

[12] If a nondiscriminatory definition of rate of pay cannot be use in testing for nondiscrimination under section 401(a)(4), other compensation data will need to be gathered to perform the required tests. This can greatly increase administrative costs.

disability compensation without regard to whether the participant is highly compensated. A similar rule could be fashioned for plans that provide benefits based on preleave compensation for all employees who are absent for a variety of reasons, including family leaves, or leaves for military service; and for all participants who take disability pay. Because the rule would be available only if the employer adopted the practice with respect to all employees in like situations, it would not be discriminatory.

In his statement before the House Ways and Means Subcommittee on Select Revenue Measures, Assistant Secretary Gideon expressed concern that the proposed modification would permit plans to make contributions during disability only during years when the only disabled participants in a plan are highly compensated, and to delete the contribution provision in years when the only disabled participants are nonhighly compensated. Kodak would support a reasonable rule prohibiting abuse or manipulation of this provision.

3. Social Security Supplements

Kodak also supports the provision of H.R. 2641 that would modify the proposed regulations governing the use of social security supplements. For any employer that provides generous early retirement benefits, as does Kodak, the use of social security supplements is a rational way of providing benefits for individuals who have not attained social security retirement age. Social security supplements deliver benefits to those participants most in need of benefit supplementation (early retirees) without inappropriately raising the replacement income ratios for benefits provided after normal retirement. Without using social security supplements, it can be difficult to provide a generous early retirement package and still avoid a benefit formula that delivers a replacement ratio (when social security is included) in excess of 100 percent for benefits after social security retirement age.

The proposed regulations would make it difficult for Kodak to deliver early retirement benefits through the use of social security supplements. The proposed regulations adopt a position that differs from current practice under Revenue Ruling 81-202, 1981-2 C.B. 93 with respect to social security supplements and other ancillary benefits. Under Revenue Ruling 81-202, ancillary benefits are normalized in testing employer-provided benefits for discrimination. (Generally, a normalized ancillary benefit is the benefit expressed as the actuarially equivalent life annuity commencing at age 65). Under proposed regulations, by contrast, ancillary benefits are subject to separate discrimination testing, and may not be tested as part of the regular employer-provided benefit. As a result, if Kodak were to enhance its early retirement benefit package with the use of social security supplements, these supplements could not be tested with the rest of the benefit package.

We believe that it is appropriate to treat social security supplements like subsidized early retirement benefits, rather than as ancillary benefits, for purposes of testing plans for discrimination. With one notable exception (discussed below), social security supplements are treated like early retirement supplements for every other provision of the Code. They are treated as early retirement subsidies for purposes of the funding rules of section 412; the limitations on contributions and benefits of section 415; and the calculation of liabilities under section 401(a)(2). Like early retirement subsidies, social security supplements are guaranteed as retirement benefits under Title IV of ERISA. The two are treated the same under the Age Discrimination Act in Employment (ADEA).

Social security supplements are treated differently from other early retirement subsidies in one important respect: social security supplements are not protected from cutback under section 411(d)(6). Kodak supports the provision in H.R. 2641 that would permit social security supplements to be taken into account for general nondiscrimination testing only if protected against reduction or elimination under section 411(d)(6). We note that Assistant Secretary Gideon's statement before the House Ways and Means Subcommittee on Select Revenue Measures does not oppose a statutory provision subjecting certain social security supplements to the anti-cutback rules, provided social security supplements are appropriately defined. We applaud this endorsement and urge the Subcommittee to adopt this position.

However, we have reservations about another portion of the provision under H.R. 2641, which provides that social security supplements are disregarded in testing permitted disparity under section 401(l). We believe that, if protected against cutback, supplements should be treated like early retirement subsidies for all purposes. Accordingly, we believe that a social security supplement should be treated as an employer provided benefit in determining the extent to which a plan provides an integrated benefit before social security retirement age.

4. 401(k) testing

S. 1364, H.R. 2730 and H.R. 2641 contain modified rules for testing elective deferrals to a cash or deferred arrangement under section 401(k). Kodak has serious reservations about all the proposed methods. It is Kodaks position that the proposed average deferral percentage (ADP) test governing 401(k) deferrals adequately meets the task of preventing discrimination; there is no reason for adopting new or alternative rules. In particular, Kodak is concerned about the new test proposed in H.R. 2730.

Under present law, contributions to a 401(k) plan are tested by comparing the average deferrals of HCEs with the average deferrals of NHCEs. H.R. 2730 replaces the present law tests with a test under which no HCE can defer an amount in excess of 200 percent of the average deferral percentage of the NHCEs in the previous year. Unlike the test of present law, the proposed test in H.R. 2730 would act as a cap on the deferrals of each HCE.

Our primary concern is that the provision as proposed by H.R. 2730 is not simplification, but the creation of substantive new pension policy. Its primary effect will be significantly to reduce allowable deferrals by certain members of the class of HCEs. To understand this, it is important to remember that the $7000 (indexed) cap on 401(k) deferrals is the most significant constraint on the deferrals of the most highly paid among the HCEs. Even with the $200,000 limitation on includable compensation, the $7000 cap means that the highly paid employees are effectively limited to a deferral of 3.5 percent of compensation. Clearly, this is not the category of employees whose deferrals will be affected by the proposed test provided in H.R. 2730. The category of HCEs whose deferrals will be most significantly reduced by the proposed test are those middle income employees whose wages are just high enough to classify them as highly compensated. For those in this category who have reached middle age, elective deferrals under a 401(k) plan are an important source of retirement savings in the years following savings for other purposes, such as a house and children's college education.

It is also my belief that none of the proposed tests is simpler than the test of present law. A uniform cap based on NHCEs deferrals of the previous year has the deceptive appearance of being less error prone than the present law ADP test. But because under present law the deferrals of the HCEs are averaged against one another, it is quite possible that in any-one year no excess deferrals will occur. With a single cap applied to every HCE, deferrals do not offset one another. It is almost certain that at least some HCEs every year will defer excess amounts. This is more likely than might at first appear for several reasons. Some HCEs will overestimate the amount of income they will earn during the year, and underestimate wage reductions because of disability, job relocations and so forth, and will defer too much as a percent of compensation. Some participants with compensation near the HCE dividing line will not know they are HCEs until the end of the year. In a large plan such as that maintained by Kodak that covers thousands of HCEs, mistaken estimates of this kind are certain to occur.

In sum, I believe the proposed test as stated in H.R. 2730 is a shift in policy, rather than simplification. It will significantly affect the pattern of deferrals, and will not affect the tendency of elective deferrals to yield errors resulting in excess deferrals.

5. Mandatory Plan Transfers

Kodak has significant concerns about the provision in S. 1364 that would require a plan administrator to transfer all preretirement distributions in excess of $500 to an IRA or qualified defined contribution plan that accepts such transfers. This requirement would be imposed whether or not the participant requested such a transfer, and whether or not the participant had designated a transferee plan or IRA. This proposal would create an administrative burden that far exceeds its value in promoting pension portability. In particular, Kodak is concerned about the cost of setting up and administering IRAs for participants who did not establish them. We are concerned that the scope of an employers responsibilities under this kind of requirement have not been thought through. It is Kodaks strongly held position that maintaining individual financial arrangements for plan participants goes far beyond the proper scope of a plan fiduciary and administrator.

The transfer provision as provided in H.R. 2730, and recommended by the Administration in its POWER proposal, is a much more sensible approach to encouraging retention of pension money in retirement arrangements. The proposal would enable employees to request the transfer of funds to a qualified plan or IRA. The plan administrators responsibility would begin and end with ensuring the proper transfer.

The burden of establishing a suitable IRA would be on the plan participant, which is where it belongs.

6. Lump Sum Distributions

Another provision contained in S. 1364 and H.R. 2730 is of significant concern to Kodak. In the Tax Reform Act of 1986, Congress enacted a 15 percent excise tax on excess pension distributions. For 1991, the tax is imposed on annual distributions in excess of $150,000. (This amount is scheduled to increase with inflation in the first year after the year that $112,500 as adjusted for post-1986 inflation equals $150,000). The purpose of the tax is to limit the amount of tax favored savings that any high income individual can accumulate. As part of the provision, Congress also provided a special alternative limit for lump sum distributions, equal to 5 times the limit on annual distributions (i.e., equal to $750,000 in 1991). As a technical provision accompanying the elimination of forward averaging for lump sum distributions, the two bills would eliminate the special alternative limitation on excess pension distributions.

I believe that elimination of the special limitation is not appropriate in the context of pension simplification. While the special alternative limitation is technically linked to the lump sum provisions of the Code, there is no policy connection between the two provisions. Elimination of forward averaging for lump sum distributions is provided by the three bills as part of a package rationalizing pension distribution policy generally. In return for an elimination of forward averaging, affected individuals receive more liberal treatment of rollovers among qualified plans and IRAs. On the whole, the package is designed to make pension distribution policy more simple and rational.

The $750,000 limitation, on the other hand, was enacted as part of an overall package in which Congress determined the equitable treatment of large pension accruals. Many individuals have acted in reliance on the availability of this special limitation. Elimination of the special limitation merely defeats these justifiable and settled expectations, without any offsetting provision providing more rational pension policy. Unlike individuals affected by the elimination of forward averaging, individuals affected by this provision are given no compensating pension relief.

The elimination of the $750,000 limitation cannot in fairness be labelled pension simplification. It represents a substantive policy change in the treatment of individuals who have accrued large pension benefits. It defeats expectations with regard to a matter that was viewed as settled by the Tax Reform Act, and frustrates the legitimate planning of individuals who acted in justifiable reliance on the provisions of that Act. The provision does not belong in this simplification package.

CONCLUSION

Thank you for the opportunity to present these comments.

STATEMENT OF THE ERISA INDUSTRY COMMITTEE

The ERISA Industry Committee (ERIC) is an association of over 120 of America's largest corporations. ERIC represents a broad cross-section of major employers that collectively maintain comprehensive benefit plans for over 25 million employees and their dependents. ERIC has a vital interest in legislation affecting the maintenance and operation of voluntary employer-provided benefit plans.

THE PROPOSED LEGISLATION

We appreciate the opportunity to present our views on S.1364, the Employee Benefits Simplification and Expansion Act, introduced by Sens. Bentsen, Pryor, et al.

In this statement we also present our views on certain aspects of the Administration's "POWER" proposal (Pension Opportunities for Workers' Expanded Retirement), on H.R.2730 (the Pension Access and Simplification Act of 1991, introduced by Rep. Dan Rostenkowski, D-IL), and on H.R.2641 (the Employee Benefits Simplification Act of 1991, introduced by Rep Rod Chandler, R-WA). We may in the future supplement this testimony with additional comments on these and other pension access and simplification proposals.

Each of the bills contains both provisions that we favor and provisions that we oppose. A number of the provisions that we favor will help employee benefit plans to provide benefits more effectively and efficiently. We very much appreciate the efforts of the bills' sponsors to propose legislation that is intended to make it easier for an employer to provide its employees with retirement security benefits and to make it easier for employees to understand what their benefits are. Each of the bills contains provisions that will allow employers to spend more of their budgets on benefits and less on plan administration.

However, the bills also contain provisions that will hurt our employees, and hurt them substantially. Some of the proposed provisions will reduce what employees can save for retirement. Others will severely reduce the value of the benefits that retirement plans provide. Still other provisions will damage the employee benefit system as a whole by further eroding the confidence that employees and employers have in the system's stability and integrity.

While S 1364 and H R 2641 do not contain many of the provisions that we oppose, we are also concerned that both S 1364 and H R 2641 will lose federal revenues and, if enacted, will in the course of the legislative process be coupled with provisions that will cut back retirement benefits. Thus, when the bills are considered in their entirety, we believe that they will damage our employees and the plans in which they participate.

As a result, we cannot support the bills in their present form. The bills would sacrifice the interests of our employees in order to make it easier to administer our plans. We are committed to legislation that facilitates plan administration, but not at the expense -- or the potential expense -- of our employees.

In addition, we have strong reservations about broad-based pension legislation at this time. Our reservations are based on the constant changes required by the overwhelming volume of pension legislation enacted in recent years. Taken together, the three bills contain over 30 new changes to pension law.

We also are concerned that many recent amendments have provided little or no lead time for employers to comply or employees to adjust. The proposed effective dates for many of the provisions in all of the bills now before the Subcommittee have heightened our concern about the lack of sufficient time to comply.

These problems are more than mere inconveniences. Providing retirement income security to employees requires long-term planning. But constant change prevents long-term planning. In many cases, employers and employees may actually be better off with current law, even if current law appears more complex.

Constant change is costly for major employers and even prohibitive for medium and small employers. Each revision required in computer systems, administrative procedures, employee communications, and plan design costs money that would be better spent on benefits. Small and medium-sized employers often drop their plans rather than pay attorneys' and consultants' fees for yet another round of changes. Moreover, constant change is upsetting to employees who look to retirement security programs as a safe, non-volatile program that they understand. It is unreasonable to expect employees to participate in plans when they are being told that their savings will no longer enjoy the tax

treatment that was promised to them in the past as an inducement to save. "Bait and switch" legislation discourages participation in the employee benefit system. Faced with the confusion of shifting ground rules, employers and employees alike lose their incentive to get into or to stay in the system.

We believe it is possible to fashion legislation that would simplify plan administration and employee communications without disrupting established systems and employee expectations. We would support such legislation. We believe it is possible to make some progress toward these goals without raising revenue concerns for the Committee or the Congress. Each of the proposed bills contains provisions that will meet these goals. There is no need to couple those provisions with others that raise serious policy concerns or break promises to employees.

A number of the proposals being considered by the Subcommittee are designed to increase access to the employee benefits system, not to simplify it. We favor increasing the access of employees to 401(k) plans and other plans, and we look forward to working with the Subcommittee to achieve this objective. However, as we have explained, we believe that there is a significant risk the bills before the Subcommittee will cause fewer employers to sponsor retirement plans and fewer employees to participate in existing plans. Constant change coupled with the withdrawal of important incentives on which employees have relied will strongly discourage the continuation and growth of employer-sponsored plans and may nullify the positive effect of new access proposals.

Thus, each proposed change in the law should be analyzed carefully to determine whether the proposal is likely to enhance or diminish the benefit system. If Congress is determined to reduce the burden on employers and the confusion among employees in the benefits area, Congress should follow the guidelines that ERIC presented to the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Senate Finance Committee in a statement for hearings held August 3, 1990:

-- Identify discrete areas (such as the leased employee rules) where simplification will reduce the administrative and compliance burdens on plan sponsors, the Internal Revenue Service, and the public without imposing rigid constraints on plan design,

-- carefully consider the costs, including the compliance costs, of imposing any new rules on employee benefit plans;

-- reject proposals that will upset the retirement planning of employees, retirees, and their families;

-- reject proposals that are likely to curtail existing plans or discourage the formation of new plans;

-- select more realistic effective dates for any new rules that are enacted, and insist that the Internal Revenue Service allow taxpayers to act on the basis of a reasonable good faith interpretation of the law until a reasonable period of time after a complete set of final regulations is issued, and

-- insist that the Internal Revenue Service comply with the Administrative Procedure Act when issuing legislative regulations.

We believe that adherence to these guidelines will dramatically reduce the confusion, uncertainty, and complexity that now envelop the administration of employee benefit plans and that discourage employers from establishing plans for their employees and employees from enrolling in them. Although some of the provisions of the bills before the Subcommittee meet these guidelines, many do not.

SPECIFIC COMMENTS

I. **We oppose the following specific proposals:**

1. Repeal of Averaging and Capital Gain Provisions.

Under current law, an employee who receives his or her full account balance in a single lump-sum distribution is entitled to have the tax on the distribution calculated on the basis of five-year averaging. In addition, an employee who attained age 50 before January 1, 1986, may have the tax on a lump-sum distribution determined on the basis of ten-year averaging, and may also treat part of the distribution as long-term capital gain.

Each of the bills, as well as the Administration's POWER proposal, would repeal these provisions, either in full or in part. We strongly oppose repeal of the lump-sum distribution provisions.

Employees have saved and made their retirement plans on the basis of the lump-sum distribution provisions. Congress should not now pull the rug out from under the many thousands of employees who have relied on these provisions in choosing to participate in employer-sponsored savings and 401(k) plans and in making their financial plans. Particularly for an individual who intends to retire in the next few years and who has planned his or her retirement savings with the intent of taking a lump-sum distribution, repeal will be extremely disruptive and could result in the loss of thousands of dollars of retirement savings. This is the type of precipitous change that has, in recent years, dramatically reduced employee confidence in the pension system and employer interest in providing pension plans.

Repeal of the averaging provisions is particularly inappropriate because Congress has addressed the treatment of lump-sums twice in recent years.

In 1984, as part of the Retirement Equity Act, Congress prohibited an employer from completely eliminating a lump-sum option from a plan. Having protected lump-sums in 1984, Congress should not now do a 180 degree turn and eliminate the tax provisions that make lump-sums so important to employees.

In 1986, as part of the Tax Reform Act, Congress revamped the tax treatment of lump-sum distributions: it substituted five-year averaging for ten-year averaging and long-term capital gain treatment, and protected older employees (those who had reached age 50 by January 1, 1986) with a "grandfather" rule that allows them to continue to rely on the ten-year averaging and long-term capital gain provisions. Congress should not renege on the compact that it entered into less than five years ago. The proposed changes in the tax treatment of lump-sum distributions represent the very kind of constant tinkering with employee benefits that has led to so much uncertainty and has distressed employers and employees alike during the past ten years. Employees have a right to expect the Congress to provide stable rules for their retirement-savings arrangements.

S. 1364 and H.R. 2730 also repeal the special "5 times" rule for purposes of the 15 percent excise tax on large distributions. Under current law, distributions in any year in excess of $150,000 (indexed) are subject to a 15 percent excise tax. Under the "5 times" rule, the $150,000 threshold for the tax is multiplied by five for lump-sum distributions. We oppose this proposal. The "5 times" rule should be retained.

The 15 percent tax and the "5 times" rule were enacted only recently as part of the Tax Reform Act of 1986. Precipitous reversal of these rules upsets the expectations of employees who have planned for their retirement on the basis of current law. There is no reason, in the name of "simplification," to disrupt and complicate the lives of thousands of employees by changing rules that were so recently enacted. To the affected employees, this will be disruption, not simplification.

Precipitous changes such as these may also lead long service workers to retire earlier than either they or their employers had expected in order to receive the after-tax benefits they had been promised. This disrupts the lives of the affected workers and their families, disrupts the workplace, and reduces productivity.

The averaging provisions are of greatest importance to employees and retirees who receive relatively modest lump-sum distributions. For example, our preliminary calculations show that under H.R.2730, the increase in tax levied on a lump-sum distribution could range from a 114 percent tax increase on a $100,000 distribution to a 409 percent tax increase on a $20,000 distribution. A retiree receiving a $200,000 distribution of lifetime savings could face a marginal tax rate of 46 percent.

2. Repeal of Employer Stock Rules.

Under current law, when a qualified plan distributes employer stock that has appreciated in value in a lump-sum distribution, the "net unrealized appreciation" ("NUA") is not immediately included in the employee's income; taxation of the NUA may be deferred until the employee sells the stock. In addition, in the case of employer stock attributable to employee contributions, taxation of the NUA is postponed even if the stock is not distributed in a lump-sum distribution.

Both H.R. 2730 and the Administration's POWER proposal would repeal the NUA provisions. We strongly oppose repeal.

The NUA provisions have been in the Internal Revenue Code for many years as an incentive for employees to invest in employer stock. Repeal of the NUA provisions will shock and upset the many thousands of employees who, in reliance on the existing tax rules, have invested in employer stock through their employee benefit plans. Employees may have chosen employer stock over other investment choices on the basis of these tax provisions. Employees and retirees will deeply resent

this turn-about, especially if they find they must sell the stock in order to pay the income tax levied on them when the stock is distributed. Moreover, not all institutions that offer individual retirement arrangements (IRAs) will accept rollovers of employer stock and others may impose maintenance fees that employees and retirees do not now incur. To the thousands of employees who have invested in employer stock, repeal of the NUA provisions will represent betrayal, not simplification.

Repeal of the NUA provisions also will subvert the objectives of the employee stock ownership (ESOP) provisions that Congress enacted to encourage employees to invest in employer stock. Repeal of the NUA provisions will eliminate an important incentive to invest in employer stock and will encourage employees to sell the stock as soon as it is distributed to them -- contrary to the objectives of the ESOP provisions.

3. Revision of 401(k) and 401(m) Nondiscrimination Tests.

Under current law, section 401(k) plans and plans that accept either after-tax employee contributions or matching employer contributions are subject to nondiscrimination tests that require annual testing to compare the aggregate deferrals and contributions on behalf of highly compensated employees ("HCEs") with the aggregate deferrals and contributions on behalf of non-highly compensated employees ("NHCEs").

S. 1364 and H.R. 2641 provide design-based safe harbors to permit certain plans to satisfy the nondiscrimination requirements without reliance on annual testing. The preliminary indications from our members are that the proposed safe harbors are unlikely to be of any value to virtually all of them. This will definitely be the case if, in order to use the safe harbor, a plan must cover every one of the employer's NHCEs. As drafted, both bills appear to require coverage of all NHCEs. A large employer (which typically will have some leased employees and other NHCEs who cannot be covered) simply cannot meet a 100 percent coverage requirement.

Although we have no objection to the creation of a safe harbor under the deferral percentage and contribution percentage tests, we vigorously oppose the creation of any safe harbor that results in a federal revenue loss. We are concerned that amendments to the nondiscrimination tests might require a reduction in either the current-law deferral percentage and contribution percentage tests or in the $7,000 (indexed) limit on 401(k) deferrals. We strongly prefer the current rules to any reduction in these limits.

H.R. 2730 replaces the current-law tests with a single test under which the maximum rate at which each HCE can defer or contribute is 200 percent of the average deferral or contribution percentage for the NHCEs in the previous year.

We oppose the substitution of the 200 percent per-HCE test for the current-law tests. Although the 200 percent per-HCE test might make it easier for a small number of our members to meet the nondiscrimination tests, it will substantially reduce the amounts that can be deferred or contributed under the vast majority of our members' plans. Our members report that the impact will be felt most severely by middle income employees whose wages fall just over the threshold for the highly compensated category. Preliminary indications are that many middle-aged employees will have their allowable contributions cut by one half just as they move into the time in their life when they are trying to save for retirement.

Moreover, although the proposed 200 percent test has the appearance of simplification, it will be substantially more burdensome than the current-law tests. The 200 percent test is a per-employee limit; by contrast, the current-law tests rely on the average deferral and contribution rates of both NHCEs and HCEs. Because a per-employee limit makes it essential to identify every single HCE and to determine his or her precise deferral and contribution rates, the proposed 200 percent test is far more difficult to administer than the current-law tests. Because the current-law tests are based on average deferral and contribution rates, they are far more tolerant of minor calculation errors and are therefore far easier for a large plan to administer.

One aspect of the proposed 200 percent test would be helpful, however. Under H.R. 2730, the current year's limit for HCEs is based on the deferrals and contributions by NHCEs in the previous year. This aspect of the proposal would help to simplify the administration of section 401(k) and savings plans; we favor its adoption.

4. Effective Dates.

Many of the provisions in the bills are proposed to become effective as early as 1992. We strongly oppose these accelerated effective dates.

The proposed effective dates will not give employers enough lead time to determine what changes the new provisions will require in each employer's specific circumstances and make the changes in the plan documents, computer programs, employee communications, and plan administration that the bills require. Moreover, the proposed effective dates will require plans to make changes in their operations while they are still in the midst of conforming to previous changes in the law.

Accelerated effective dates make even apparently minor changes burdensome. For example, S. 1364 changes ages 70½ and 59½ to ages 70 and 59 wherever they appear in the statutory provisions that apply to benefit plans. As proposed, this provision will become effective on January 1, 1992. This does not give plan administrators the time they need to change their computer systems to conform to the change. As a result, for a significant period of time, the affected employees will have to be identified by hand, rather than by computer, and employees will be confused by rule changes for which they have had little, if any, warning. There is no need to put employers in this position. The more far-reaching the change, the greater the problems that are caused for employers and employees alike.

We recommend that, as a general rule, no provision become effective before the beginning of the second plan year that begins after the date of enactment, and that in the case of a collectively-bargained plan, the effective date should not occur before the expiration of the last-to-expire of the bargaining agreements in effect when the bill is enacted. Of course, the effective date for collectively-bargained plans should not be earlier than the effective date for nonbargained plans. This effective date will give employers a minimum of one year to draft plan amendments, prepare revisions to plan literature, and make changes in plan administration in order to conform to the new law. Exceptions to this general rule for a delayed effective date would include the employee leasing provisions, the provision regarding permissive aggregation of represented employees, and other provisions where an earlier effective date is practical.

Any changes in the tax treatment of lump-sum distributions and distributions of employer stock should be subject, however, to an even later effective date. As we have explained, we oppose the proposed changes in the tax treatment of lump-sum distributions and in distributions of employer stock. However, if any changes are made, it is imperative that a long lead time be provided so that employees and their beneficiaries will have ample opportunity to adjust to new rules. We urge that the "grandfather" rule in the 1986 Act for ten-year averaging and long-term capital gain be preserved and that a similar rule be adopted for any other changes that Congress decides to adopt. H.R. 2742 makes a substantial step in this direction by delaying the repeal of five-year averaging for five years.

S. 1364 and H.R. 2641 attempt to address the effective date problem by delaying any requirement to amend a plan until 1993, provided that the plan is operated, in the interim, in accordance with the changes required by the bill. While we appreciate the intentions of the sponsors of these bills, a delay in the deadline for adopting plan amendments does not solve the problem. Even before the changes become effective, plans must revise their descriptive literature and administrative systems to reflect the changes in the law. The need to amend the official plan document is only a part of a much larger problem.

II. We have significant concerns about the following provisions:

1. Rollovers and Transfers

All of the proposals, including the Administration's POWER proposal, relax the restrictions on rollovers. In addition, H.R. 2730 requires a plan to transfer distributions to an IRA or qualified plan at the participant's request. By contrast, S. 1364 requires most distributions to be transferred directly to an IRA or a qualified defined contribution plan.

Although we have no objection to liberalization of the rollover provisions, we are concerned that the price for liberalizing the provisions at this time will be too high and will primarily hurt the lower and middle-income individuals the bills seek to protect. Our members generally report that their employees have not had significant difficulty in coping with the existing rollover rules. To the extent that their employees have encountered problems, the problems have just as often stemmed from the 60-day limit on rollovers, which the bills would not repeal, and from other provisions remaining in the law, such as the arbitrary two-year limit that applies to distributions following the sale of a business, as they have from provisions liberalized by the bills.

We are particularly concerned about the effect of using the elimination of the special rules for lump-sum distributions to "pay for" liberalization of the rollover rules. For example, under the expanded excess distributions tax in S.1364 and H.R.2730, a retiree can suffer a 46 percent marginal tax rate if the retiree receives a total distribution of over $150,000 from all plans in which he or she

participated. Few, if any, retirees know there is such a tax and most will assume it does not apply to them. These retirees' income security can be decimated if they do not make the appropriate calculations and roll their money over into an IRA within 60 days.

We also have significant concerns regarding the trustee-to-trustee transfer proposals. H.R. 2730 fails to make clear that the administrator of the transferor plan has no obligation to verify that the transferee plan is an IRA or a qualified plan. If the bill is not revised to make this clear, the provision will impose intolerable burdens and potential fiduciary liabilities on plan administrators; it will not be a simplification.

We oppose the mandatory trustee-to-trustee transfer provision in S. 1364. This provision does not simplify the law. Indeed, it imposes a new policy that may result in complex regulation and certainly will require massive re-education of employees.

We are particularly concerned that the proposed mandatory transfer provision will expose employers and plan administrators to the risk of substantial additional litigation under ERISA. For example, employees who are disappointed with a transferee IRA's investment performance might institute litigation against the employer for having chosen a transferee IRA that has not performed as well as the employees believe it should have.

2. Separate Lines of Business.

H.R. 2641 amends the separate-line-of-business provisions to eliminate the nondiscriminatory classification test and to allow certain headquarters operations to be treated as separate lines of business.

Although we appreciate the concern about the separate-line-of-business provisions reflected in this proposal, we have reservations about the proposal. The proposed provision would significantly change the policies that Congress adopted when it enacted the separate-line-of-business rules as part of the Tax Reform Act of 1986. If the Treasury Department responds appropriately to the comments that have been made on its proposed regulations under the separate-line-of-business provisions, a statutory change should not be necessary. We will appreciate any efforts that the Subcommittee makes to see to it that the Treasury Department's final regulations faithfully implement the intent of Congress to make the separate-line-of-business provisions practical and meaningful.

III. We favor the following proposals:

1. Leased Employees.

Under current law, leased employees are treated as though they are common law employees for certain purposes. Each of the bills that has been introduced replaces the unworkable "historically-performed test" in the current definition of a leased employee with some type of "control" test. S. 1364 relies on a "control" test; H.R. 2730 refers to "any significant direction or control," and H.R. 2641 refers to "primary control of the manner in which services are performed."

We strongly support the "control" test in S. 1364. Current law is both overreaching in scope and incomprehensible in practice. The "control" test in S. 1364 solves these problems by imposing a test that is targeted at the abuses at which the leased employee provisions were originally aimed and by imposing a standard that employers can understand and that the Internal Revenue Service can administer. Because this provision corrects a statutory provision that has never worked properly, the provision is effective January 1, 1984, when the employee leasing provision originally became effective.

We have strong concerns about the "any significant direction or control" test in H.R. 2730. We are concerned that the proposed test could be just as overreaching as current law. Many employers who rely on the services of outside contractors exercise some influence over how the contractors perform their services. We are concerned that the "any significant direction or control" test is so broad that it will inappropriately cause many of the employees of those outside contractors to be treated as leased employees.

We also are concerned about the technical explanation of the leased employee provision in H.R. 2730. The technical explanation provides that under the bill,

> . . . clerical and similar support staff (e.g., secretaries and nurses) generally would be considered to be subject to the direction or control of the service recipient and would be leased employees provided the other requirements of section 414(n) are met.

137 Cong. Rec. H4926 (June 24, 1991). We have no objection to this explanation to the extent that it indicates that a firm that leases its secretaries or nurses will be required to treat the secretaries or nurses as its leased employees. However, the technical explanation could be interpreted to go beyond this point and to require that any secretaries or nurses employed by an outside contractor must be treated as leased employees. If this provision is enacted, the legislative history should make it clear that this is not what Congress intends.

2. Permissive Aggregation of Represented Employees.

Proposed Treasury Department regulations require that, in testing the coverage of nonunion employees, employers must disregard their union-represented employees.

H.R. 2641 allows an employer to aggregate its union and nonunion employees for coverage purposes if both groups benefit under the plan on the same terms. We strongly support the thrust of this provision. The Treasury's proposed ban on permissive aggregation of union and nonunion employees is contrary to sound tax and employee benefits policy, and produces anomalous results: two employers providing identical benefits to their employees may receive different tax treatment merely because a portion of one employer's workforce is represented by a union, while the other's workforce is entirely nonunion.

By permitting an employer to elect to aggregate its union and nonunion employees, H.R. 2641 provides a constructive and sensible solution to this problem. We recommend, however, that the provision be revised to make clear that an employer is not required to cover its union and nonunion employees under the same plan in order to be able to rely on the permissive aggregation rule. If the employer provides the same benefits to its union and nonunion employees, it should be irrelevant whether those benefits are provided under a single plan or under multiple plans. Substance, not form, should control.

3. Required Distributions.

Under current law, employees who participate in tax-qualified plans must begin receiving distributions at age 70½, regardless of whether they have retired. S. 1364 permits a 70-year-old employee to defer distributions until he or she is actually retired, except for five percent owners and distributions from IRAs. S. 1364 also requires an actuarial increase in the amount of the employee's accrued benefit where he or she continues to work beyond age 70.

H.R. 2641 includes a provision that is similar to the provision in S. 1364, except that it retains the requirement that distributions begin at age 70 for five percent owners and for individuals with account balances exceeding $750,000.

ERIC supports the provision in S. 1364. There is no reason to require most employees to begin receiving retirement plan distributions when they have not, in fact, retired. S. 1364 resolves this problem in an appropriate fashion.

The solution proposed by H.R. 2641 is preferable to current law, but is not ideal. H.R. 2641 would require plan administrators to determine the present value of each employee's accrued benefit to determine whether he or she is above or below the $750,000 threshold. This introduces a complexity that is both unnecessary and burdensome. As a result, we prefer the solution proposed by S. 1364 to the solution proposed by H.R. 2641.

4. Highly Compensated Employees.

S. 1364 and H.R. 2641 would limit the definition of HCE to five percent owners, individuals earning at least $50,000, and family members of five percent owners. H.R. 2641 permits the $50,000 test to be applied to the prior year's compensation, while S. 1364 requires the $50,000 test to be applied to the current year's compensation.

H.R. 2730 would limit the definition of HCE to five percent owners, individuals earning at least $65,000 (indexed) in the prior year, individuals in the top 100 of the payroll and who earn at least $65,000 (indexed) in the current year, spouses and lineal descendants (under age 19) of five percent owners, and the highest-paid individual.

Because H.R. 2730 would significantly simplify the definition of HCE, we support this provision. By combining the elimination of the 20 percent test prescribed by current law with a reasonable dollar threshold, H.R. 2730 proposes an administrable and reasonable definition of HCE.

By contrast, coupled with the elimination of the 20 percent test, the $50,000 threshold in S. 1364 and H.R. 2641 is unrealistically low; it treats many employees as HCEs who are not treated as HCEs under current law and who should not be so treated under any realistic view of their compensation levels. Moreover, although it might not have been intended, S. 1364 bases the definition on current year's (rather than prior year's) compensation. The use of current year's compensation is not a simplification; it is an unnecessary complication.

5. Cost-of-Living Adjustments.

Each of the bills amends the Internal Revenue Code (I.R.C.) section 415 limits to provide that cost-of-living adjustments will be made as of September 30 of each year and that increases will be rounded to the nearest $1,000 (or, in the case of the limit on elective deferrals under section 401(k), to the nearest $100).

We support this provision. Indexation as of September 30 will significantly simplify the administration of calendar year plans; it will permit these plans to determine the indexed limits before the beginning of each year. The rounding of the dollar limits will simplify plan administration and will help to make the limits more understandable to employees.

6. Normal Retirement Age.

H.R. 2730 and H.R. 2641 amend the definition of normal retirement age by replacing age 65 with the social security retirement age. The revised definition will help to coordinate the benefits provided by employer-sponsored plans with the benefits provided by social security. With technical modifications, we support this proposal.

7. Minimum Participation Requirements.

S. 1364 and H.R. 2641 amend the minimum participation rule by limiting the application of the rule to defined benefit plans, by reducing the 50-employee requirement to 25 employees, and by changing the 40 percent requirement to the greater of 40 percent or 2 employees. In addition, H.R. 2641 allows a plan to meet the minimum participation requirement on the basis of once-a-year testing. We support this provision, particularly support the once-a-year testing provision in H.R. 2641. Testing on a once-a-year basis is far more reasonable and sensible than the daily testing requirement that the Treasury Department has proposed. We urge the Subcommittee to consider extending the once-a-year testing concept to other statutory requirements, including particularly the coverage and nondiscrimination rules.

8. Nondiscrimination.

H.R. 2641 overrides the "worst case" requirement, now set forth in the Treasury Department's proposed regulations, which require that no HCE have an accrual rate that exceeds the accrual rate of any NHCE. Instead, H.R. 2641 imposes a test that compares the average accrual rates of HCEs with the average accrual rates of NHCEs. We support this provision, which is consistent with the way in which the nondiscrimination rules traditionally have been applied.

9. Social Security Supplements.

H.R. 2641 allows a social security supplement to be taken into account as a benefit under the nondiscrimination rules if the supplement is protected against reduction or elimination by the anticutback rule. However, as written, the bill requires a social security supplement to be disregarded in determining whether a plan exceeds the limits on permitted disparity under the integration rules. We support the portion of this provision that amends the nondiscrimination rules, but believe the provision should be amended insofar as it modifies the permitted disparity rules to provide that social security supplements may be taken into account in determining whether a plan exceeds the disparity rules.

10. Employee Transfers.

H.R. 2641 amends the nondiscrimination rules to permit an employee to transfer to a full-career final-pay plan without violating the nondiscrimination rules. We support this provision.

STATEMENT OF THE FEDERATION OF TAX ADMINISTRATORS

The Federation of Tax Administrators is an association of the tax collection agencies in the fifty states, District of Columbia, and New York City. The FTA believes enactment of S 1394, the Tax Simplification Act of 1991, can make a real contribution toward reducing the complexity facing those taxpayers who faithfully attempt to comply with both state and federal tax law. As state tax administrators, we have a commitment to simplification and applaud Congress' efforts in that regard. Specifically, the FTA would like to urge favorable consideration Section 721 of the Tax Simplification Act.

Section 721 would permit the Internal Revenue Service to enter into cooperative agreements with State tax authorities for purposes of enhancing joint tax administration. These agreements could include the joint filing of federal and state income tax returns, single processing of such returns, and joint collection of taxes other than federal income taxes as well as a number of other ventures which could be accomplished on a joint basis. Agreements entered into may require the reimbursement of services provided by either party to the agreement.

State tax administrators and the Internal Revenue Service both believe that enactment of Section 721 will enable us to improve our services and simplify matters for our customers, the taxpaying public. Given that state and federal tax agencies deal with the same taxpayers, it only makes sense to explore ways of accomplishing our objectives more effectively through joint cooperative action, rather than each pursuing independent, yet similar, efforts. Enactment of section 721 will facilitate the development of such cooperative projects and should simplify the tax system for taxpayers, improve voluntary compliance with our tax laws, and reduce the burden imposed on taxpayers and others.

The most immediate benefit of section 721 will be to permit state tax agencies and the Internal Revenue Service to develop a program for joint electronic filing of income tax returns. A successful pilot program was completed in South Carolina during the 1990 return filing season. A limited number of taxpayers filed both their state and federal income tax returns electronically, sending both to the IRS on a single transmission. The IRS, acting as a conduit of data, then forwarded the state portion of the transmission to South Carolina for routine processing. This pilot will be expanded for the 1991 filing season to include projects in West Virginia, New York, Maine, North Carolina, South Carolina, Kansas and Wisconsin. Joint electronic filing cannot be expanded beyond a pilot stage, however, without the authorization of section 721. The ability to offer joint electronic filing on a national basis in future years should increase the number of taxpayers choosing to file electronically. This will, in turn, simplify matters for them, produce faster refunds, and ease the burden placed on state and federal tax agencies.

Beyond the electronic filing arena, we believe there is substantial opportunity for joint tax administration efforts in the delinquent tax collection, examination, investigation, wage and information reporting, and taxpayer service areas as well as many others. These and other joint cooperative efforts reflect the commitment of both state and federal tax authorities to simplify procedures for taxpayers and to reduce the burden they face. We as state tax administrators anticipate that this commitment toward increased standardization and reduced duplicative efforts will encourage voluntary compliance with our respective tax systems by making it as easy as possible for a taxpayer to deal with our complex tax laws.

Section 721 is necessary for the full development of this commitment toward a simpler tax system. The state tax agencies affirmed the importance of this legislation during the Federation's 1991 annual meeting, when state officials unanimously approved Resolution Fourteen, which reads in pertinent part:

> "The Internal Revenue Service and the states are increasingly benefitting from joint tax administration projects ... the rapid growth of technology has opened new vistas for joint tax administration ... the primary motivation of the federal and state governments in pursuing these projects is to improve productivity and reduce the burden on the taxpayer ... and the Federation of Tax Administrators respectfully request(s) the Congress to enact this legislation during 1991."

In accordance with Resolution Fourteen, on behalf of the state tax agencies in the 50 states, the District of Columbia and New York City, we ask that Congress grant favorable consideration of section 721 of the Tax Simplification Act of 1991.

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September 6, 1991

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
U.S. Senate
Washington, D.C. 20515-6200

Dear Chairman:

The purpose of this letter is to provide the comments of Financial Executives Institute's Committee on Taxation to the foreign provisions of S. 1394 and its companion H.R. 2777 in the U.S. House of Representatives. We appreciate this opportunity to provide our views on this vital issue.

Financial Executives Institute (FEI) is a professional association of 14,000 senior financial officers in over 7,000 major corporations. FEI's Committee on Taxation includes the senior tax officers of over 30 of the nation's largest corporations.

Financial executives responsible for collecting the data, keeping the records and doing the tax accounting for foreign source income, foreign source expenses and foreign taxes assign high priority to simplifying the foreign provisions of the Internal Revenue Code. Our members are encouraged by indications that Congress recognized that these provisions were more complicated and onerous than they needed to be to meet Congressional policy objectives. We have submitted numerous suggestions on how to reduce compliance burdens without materially affecting the amount of tax due and looked forward to seeing at least some of these ideas reflected in a tax simplification bill, along with ideas suggested by others.

Unfortunately, Title III of S. 1394 not only falls short of accomplishing meaningful simplification of U.S. multinational taxpayers, but also makes matters worse in many respects. FEI hopes that the comments set forth below will be helpful in improving the bill.

1. Anti-deferral Provisions

The several anti-deferral regimes of the Code would be consolidated into one regime, essentially by making the rules which now apply to individual investors in foreign portfolio securities apply to foreign subsidiaries of U.S. business corporations. Since many of these rules, such as the foreign personal holding company provisions and the accumulated earnings tax provisions, do not in practice apply to U.S. multinationals present law, their repeal or consolidation, however helpful this might be to individual taxpayers, would not ease compliance burdens for U.S. multinationals.

The bill would eliminate deferral in many cases where it now applies, for example by repealing the so-called "high tax" and "export trade" exceptions. The bill does not address the basic problems which taxpayers have raised regarding PFICs. It makes matters worse by reducing the income test used for defining "passive" corporations from 75% to 60%, so that companies which do not have to comply with such rules would have to do so in the future.

Some of the concepts embodied in the bill could be made to work. Relying solely upon subpart F concepts as to how income is to be included could be helpful. Eliminating overlap by exempting controlled foreign corporations already covered under subpart F from the new proposed rules for truly passive investment companies would greatly improve the bill without changing basic policy. There is also one important technical problem having to do with the foreign tax credit "baskets." The bill appears to convert "general limitation income" into "passive income" when it is included in the income of the shareholder. There is no reason to treat income which is earned in the active conduct of a business as though it were passive investment income.

2. Treatment of controlled foreign corporation earnings

FEI applauds the proposal to extend section 1248 treatment to gain on sales of stock in lower tier controlled foreign corporations. This rule requires taxpayers to treat such gains as if they had distributed the earnings of the corporation being sold as a dividend before selling the stock. The proposal would accomplish simplification by making it easier for U.S. taxpayers to restructure their foreign investments to meet changing business conditions.

The proposal would be improved and compliance problems reduced if such constructive dividends were treated the same as actual dividends for all purposes of the Code, including the "same country" exception from the subpart F rules. We do not see any tax policy reason for saying that an actual distribution of earnings from a second tier subsidiary to a first tier subsidiary should be taxed differently from a constructive distribution of the same earnings.

FEI opposes the proposal to repeal section 960(a)(3), thereby denying U.S. taxpayers credits for foreign taxes actually paid by their subsidiaries. Under present law subpart F income earned by a second tier controlled foreign corporation is included in the U.S. shareholder's income in year 1. In year 2 the subsidiary pays a dividend to its parent, which in turn pays the funds up to the U.S. shareholder. In order to avoid taxing the income twice the dividend in year 2 is treated as a distribution of the income previously taxed in year 1. In year 2, however, the first tier foreign corporation may have paid taxes on the dividend it received, thereby generating additional foreign tax credits for use by its U.S. parent. Under present law the parent may use these foreign tax credits currently. Under the bill the credits would be added to a pool and might be used in some future year, or, in some cases, never. Since the avoidance of double taxation is a key component of U.S. tax policy, present law should be retained.

3. Translation of foreign taxes

FEI recommends that foreign taxes be translated into U.S. dollars at the same rate as the underlying income is translated. This rule, which worked well for many decades, is conceptually correct

because it preserves the correct effective foreign tax rate. It is also very easy to administer. There is no revenue impact for this item.

If an average exchange rate must be used, it should be for the year in which the tax is either paid or accrued. The Code permits taxpayers to claim foreign tax credits on an accrual basis, and many taxpayers keep their books on an accrual basis. The proposal contained in the bill would be acceptable and compliance would be simplified if the proposal were amended to cover taxes "paid or accrued" instead of being limited to taxes "paid."

4. Alternative minimum tax

The proposal to use the same numerator in the foreign tax limitation for the alternative minimum tax as is used for the regular corporate tax would only slightly simplify tax calculations, but would do so in a manner which would artificially limit the foreign taxes which a U.S. taxpayer could credit. Using minimum tax numbers in the denominator while using regular corporate tax numbers in the numerator mathematically produces a smaller foreign tax credit limitation than would be produced if comparable numbers were used in both the numerator and the denominator. FEI believes that a better solution to having to reallocate and reapportion expenses for the minimum tax would be to use the earnings and profits basis of assets both for regular tax and for the alternative minimum tax.

Again, we appreciate this opportunity to comment on S. 1394 and H.R. 2777. Please ask your staff to contact Kevin Sabo, FEI's Manager of Government Relations, if you would like to discuss our views in greater detail.

Sincerely,

A.E. Germain
Chairman
COMMITTEE ON TAXATION

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September 24, 1991

The Honorable Lloyd Bentsen, Chairman
United States Senate Finance Committee
205 Dirksen Building
Washington, D.C. 20510

Re: S. 1394, "Tax Simplification Act of 1991"

Dear Senator Bentsen:

On September 10 and 12, the Subcommittee on Taxation held hearings on S. 1394. The Futures Industry Association ("FIA") respectfully requests that the following comments on S. 1394 be included in the hearing record.

The FIA is the national trade association of the commodity futures and options trading industry. Our regular membership is comprised of approximately 100 of the largest futures brokerage firms, known as "futures commission merchants" or "FCMs." These firms handle more than 80 percent of the transactions on U.S. futures exchanges. Our associate members also consist of many commodity trading advisers ("CTAs") and commodity pool operators ("CPOs"). In addition, all the U.S. futures exchanges are associate members of the FIA.

Public commodity pools which are often sponsored by futures commission merchants are organized as limited partnerships and publicly distributed pursuant to the Securities Act of 1933 and the regulations issued by the CFTC pursuant to the Commodity Exchange Act. It is estimated that at least $12.5 billion is currently invested in commodity pools subject to U.S. regulation. Many of these publicly offered pools have more than 250 participants and would, therefore, be treated as "large partnerships" under the proposed legislation.

Title II of S. 1394 contains a series of provisions that require large partnerships to compute partnership income, loss, minimum tax liability, capital gains and losses and tax credits at the partnership level and to flow through these items to individual limited partners in simpler fashion. In crafting this measure, a special rule has been provided for certain partnerships holding oil and gas properties. Because of the special tax rules applicable to the income and expenses of such partnerships, it was determined that the simplified reporting provisions should only apply on an elective basis.

In the development of the proposed simplified reporting regime for large partnerships another unique type of partnership has apparently been overlooked. Large partnerships which buy and sell futures, forwards and options with respect to commodities and which are subject to the mark-to-market rules of Section 1256 are partnerships which should similarly be subject to the simplified reporting regime on an elective basis only. Unlike other investment partnerships which acquire assets for the production of income over an extended period, a substantial portion of the income of commodity pools is derived from trading activities which generate short and long term capital gains and losses, subject to special tax rules.

Generally, large partnership investors have committed to making commodity pool investments on the premise that such investments will be countercyclical to the performance of the stock and bond markets and that gains derived from commodity pools may offset losses in the stock market and that losses from commodity pools may be available to offset gains from the sale of stocks or bonds.

Since a major portion of the income of commodity pools consists of capital gains or losses subject to the mark-to-market rules of Section 1256 rather than the very different types of income realized through other large partnerships, separate treatment under the proposed simplified reporting regime is warranted.

Indeed, under the simplified reporting rules proposed in Title II, commodity pools are quite unfairly placed in an untenable position -- required to recognize and report net unrealized gain to each limited partner and at the same time prohibited from reporting recognized net capital losses to such partners. The FIA believes this situation is entirely inappropriate.

Unlike many other large partnerships, the current reporting of commodity pool income, loss, capital gain or loss, etc. is already quite simple. Gain or loss realized on "Section 1256 contracts" held at year end are deemed to be sold for their fair market value. Gain or loss realized is treated as 60% long term capital gain or loss and 40% short term capital gain or loss. Additionally, such partnerships realize interest income on funds held in reserve.

The Form K-1 provided to each of the limited partners generally contains the following items: (1) Interest; (2) Short Term Gain or Loss; and (3) Long Term Gain or Loss. An additional item reporting gain or loss from certain foreign currency transactions may also be provided. Because commodity pools are not subject to the passive loss rules under Section 469 and are provided with simplified rules for reporting foreign currency transactions under Section 988, individual investors do not require further simplification for the reporting of income, gain or loss, etc. from these partnerships.

The FIA believes that the changes proposed in S. 1394 which require commodity partnerships to defer reporting of net capital losses to limited partners are inconsistent with the mark-to-market regime. Congress has recognized that fairness requires that taxpayers be afforded the right to offset gains and losses produced under that system to the maximum extent possible. This intent is clearly demonstrated in Section 1212(c) where a special carryback rule for offsetting current mark-to-market losses against earlier mark-to-market gains has been provided.

The FIA urges that new Section 776 be modified to provide that the term "large partnership" does not include a partnership, a principle activity of which is the buying and selling of commodities (not held as inventory), options, futures, or forwards with respect to commodities. The FIA is pleased to note that the Investment Program Association has also requested the Committee to make this important modification.

Additionally, the FIA urges that the proposed audit rules for large partnerships be modified in the case of commodity pools. Because commodity pools, unlike other large partnerships, may decrease significantly in the number of investors and in size of investment over a relatively brief period, the proposed method for the collection of deficiencies from current partners could be particularly harsh. In the case of commodity pools, we believe that the current system of adjusting the tax liability of partners for the year in which a deficiency arises continues to be the proper method for the collection of any additional taxes.

We would be pleased to meet with you and your staff to discuss this matter in greater detail and supply any additional information you may require. Thank you in advance for your consideration.

Sincerely,

John M. Damgard
President

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August 6, 1991

Mr. Wayne Hosier
Committee on Finance
United States Senate
Washington, D.C. 20510

Re: S. 1394/H.R. 2777 - Tax Simplification Bill of 1991 - S Corporation Provisions

Dear Mr. Hosier:

In reviewing Title IV of S. 1394/H.R. 2777, relating to S corporations, and in particular Section 404(b) thereof, relating to permitting S corporations to hold subsidiaries, it would be extremely useful to also permit S corporations to be eligible shareholders of an S corporation in situations where an S corporation owns 80% or more of the stock of the corporation. While permitting S corporations to have 80% or more owned subsidiaries will certainly ease some concerns over liability issues and other non-tax business reasons necessitating separate entities, not permitting the subsidiary to also be an S corporation will undoubtedly continue to hamper structuring in this area. There does not appear to be any revenue or policy reason why subsidiaries in such situations should not be permitted to also make an S election.

While I agree that affiliated S corporations and C corporations should not be able to join in filing a consolidated return, it strikes me that there would be no policy reason against permitting elective consolidated returns for S corporation groups, as is the case under present law for certain corporate groups (note Section 1504(c) permitting certain insurance companies to separately file on a consolidated basis and Section 1504(e) permitting certain tax-exempt organizations to separately file on a consolidated basis).

To summarize, if an S corporation decides to form a wholly-owned subsidiary, there would seem to be no policy reason why that subsidiary corporation could not also elect S status (this would be accomplished by permitting S corporations to be eligible shareholders and, for purposes of the number of shareholder limitation rule, the S corporation individual shareholders would be counted in making that determination). Again, from a policy perspective, there does not appear to be any reason why that subsidiary could not independently make the decision whether or not to make an S election. In addition, if such a rule were adopted, it would seem that there should also be no policy reason why S corporations, if they so elected, could not file on a consolidated basis. The rule that an S corporation and a C corporation could not file on a consolidated basis would obviously continue.

I would be pleased to discuss this further at your convenience.

Sincerely,

John P. Barrie

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August 6, 1991

Mr. Wayne Hosier
Committee on Finance
United States Senate
Washington, D.C. 20510

Re: S. 1364 - Employee Benefits and Simplification and Expansion Bill of 1991 - Modification of Leased Employee Rules (Section 301)

Dear Mr. Hosier:

We are writing to express concern over the parameters of the proposed changes to the leased employee provisions provided in Section 301 of S. 1364. There are many industries where independent contractors provide services at the place of business of the service recipient. It is very common for these individuals to be governed by the service recipient's general rules and regulations that may sometimes be imposed by industry standards which are applicable to all individuals providing services on the service recipient's premises. For example, hospitals generally have rules and regulations governing all physicians utilizing hospital facilities, regardless of whether the physician is an employee of the hospital or an outside physician.

If the "control" test proposed in Section 301 of S. 1364 is adopted, it would be very helpful to have legislative or committee report language which would indicate that general rules and regulations applicable to all service providers are not to be taken into account in determining whether or not the requisite control exists or does not exist. We have enclosed for your possible use suggested committee report language. We have also enclosed a copy of our comments submitted last year in connection with S. 2901 as it related to this same issue.

We would be pleased to discuss this with you further.

Sincerely,

John P. Barrie

Michael N. Newmark

Enclosures

LEASED EMPLOYEE CONTROL TEST
SUGGESTED STATUTORY REPORT LANGUAGE

A person should not be deemed to be under the direction or control of the service recipient solely because the person is subject to the recipient's rules and regulations which are applicable to all service providers providing similar services, such as safety and health standards, confidentiality standards or professional practice standards. Professional practice standards would include professional standards imposed by a service recipient applicable to all professional service providers. For example, this would include hospital rules and regulations governing medical practice applicable to all physicians providing medical services on hospital premises (regardless of the identity of the person or entity responsible for enforcing such rules). As a result, a physician providing medical services at the emergency facilities of a hospital would not be treated as a leased employee solely because the physician is subject to the hospital's rules and regulations governing medical practice at the facilities.

Alternative Language:

A person shall not be deemed to be under the direction or control of the service recipient solely because the nature of the services provided by the person requires the person to be subject to rules and regulations, such as safety and health standards, confidentiality standards and professional practice standards that are applicable to all service providers providing similar services.

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STATEMENT REGARDING EMPLOYEE LEASING TAX PROVISIONS IN THE "EMPLOYEE BENEFITS SIMPLIFICATION ACT" (S.2901)

We represent a number of organizations that contract with hospitals throughout the United States to provide emergency medical coverage at the hospitals' emergency departments. This statement sets forth our concerns over the potential application of existing and proposed employee leasing rules to the emergency medicine physician practice.

Emergency Medicine Practice. Emergency medicine is a medical specialty that has been recognized since the early 1970s. Many hospitals find it necessary to contract for emergency medicine coverage with outside independent emergency medicine physicians. The hospitals generally contract with independent organizations who provide for the emergency medical coverage. This coverage may be for weekends, night shifts (6:00 p.m. to 6:00 a.m.) or on a full 24-hour 7-days a week basis. This specialized practice is particularly beneficial to rural hospitals that many times are otherwise unable to obtain qualified emergency department coverage. Greater usage is also occurring in urban hospitals. Most of these hospitals are Section 501(c)(3) organizations, although some are for profit. In many instances, the hospitals' cost of retaining 24-hour emergency medical coverage through outside emergency medicine physicians, including standby costs, is reimbursable through Medicare.

After a contract with a hospital is obtained, the emergency medicine physician provider organizations will contract with qualified emergency physicians to provide the hospital with the emergency medical coverage. Many of these independent physicians provide emergency medical coverage through these organizations on a part-time basis for multiple hospitals and their availability to provide such coverage may be concentrated over a period of months, sporadically during the year, certain days during the year, etc. These physicians typically have other medical practices independent of their contractual obligations with the organization contracting with the hospital to provide emergency medical coverage. A much smaller group of independent emergency medicine physicians contract with these organizations on a full-time basis, generally providing emergency medical coverage only at one hospital.

In contracting with an emergency medicine physician provider organization, the independent emergency physicians are generally free to choose and change the number of hours they want to work and what periods of time they want to work within the times specified in the hospital contract. Emergency medicine physicians are usually paid a fee on an hourly basis because the nature of emergency medicine rests upon having qualified physicians available, rather than the number of patients seen or the amount of billings.

It is important to note that many of the organizations contracting with the hospital are not licensed to practice medicine and do not control how an emergency medicine physician practices emergency medicine at a particular hospital. The contracting hospital also does not control these physicians. At the hospitals, the physicians are subject only to the rules and regulations required of all physicians, whether hospital physicians or outside physicians providing medical services on the hospital premises. These physicians are not entitled to participate in any of the hospital employee benefit plans.

Emergency medicine physicians generally provide emergency medical coverage 12 hours at a time. On an annual basis, most of these physicians would be classified as highly compensated individuals under the tests for determining such status under the Internal Revenue Code.

Impact of Employee Leasing Rules. Because of the nature of the emergency medicine practice, the employee leasing tax rules are of concern to the hospitals, the contracting organizations, and the independent emergency medicine physicians.

Currently, Section 414(n) of the Code provides that an individual will be treated as a leased employee of the service recipient for qualified plan purposes if (1) the services are provided pursuant to an agreement between the recipient and "the leasing organization," (2) such person has performed such services on a "substantially full-time basis" for a period of at least one year, and (3) such services are of a type historically performed, in the business field of the recipient, by employees.

The potential application of the "substantially full-time basis" test and the "historically performed" test to emergency physicians is of concern. As a result of possible interpretations of these two tests, there is potentially significant uncertainty as to the treatment of emergency medicine physicians vis-a-vis the hospitals (and the organizations that contract with the hospitals to provide emergency medical coverage).

With respect to the substantially full-time basis test, given the unique nature of the emergency medicine practice and its coverage requirements, it is possible that part-time independent emergency medicine physicians will sometimes provide sufficient hours of coverage at a particular hospital to satisfy the hourly threshold set forth in Treasury's proposed regulations, and thus come within the substantially full-time basis test, although this generally can never be determined in advance. For example, an independent emergency physician who provides just three 12-hour shifts (6:00 p.m. to 6:00 a.m.) of coverage per week at a single hospital for each week during a particular year would provide 1872 hours of coverage during the year (3 x 12 x 52). We think that all would agree that these physicians on an aggregate annualized basis are highly compensated. However, because a physician may not be within the class of highly compensated at a particular hospital under the existing Code rules, we respectfully urge that this situation be addressed.

To clarify the part-time physician situation, the definition of highly compensated should include an alternative hourly compensation test. This hourly compensation test would include in the definition of highly compensated those individuals who earn in excess of a specified amount per hour. Such a test would address part-time situations that may exceed the hours of coverage threshold during a particular year. For example, if the highly compensated annual threshold is $50,000, we would propose an hourly threshold of $25 per hour ($50,000 divided by 2,000 hours). Thus, an emergency physician who provides coverage at a fee of $25 or more per hour would be highly compensated.

In addition to our concern over the "substantially full-time" component of Section 414(n), we are also concerned about the "historically performed by employees" component. While many hospitals historically have used independent contractors to provide emergency medical coverage, a small percentage of hospitals have used hospital employee physicians and the "historically performed by employees" component of Section 414(n) could be viewed as being satisfied.

The physician provider organizations, like other groups commenting on the leased employee proposal, were not initially concerned about the "historically performed" test in Section 414(n) because of the historic practice of treating emergency department physicians as independent contractors. However, in August 1987, the Internal Revenue Service issued proposed regulations providing very broad rules that go far beyond the scope and intent of Section 414(n). We understand that at the August 3, 1990, hearings on Senate Bill 2901, the Department of Treasury acknowledged that these regulations were too broad, that they would be withdrawn, and that more narrow regulations would be issued in the future specifically addressing the abusive transactions that prompted the enactment of Section 414(n).

Section 301 of Senate Bill 2901 is intended to simplify and clarify the intended scope of the employee leasing rules by substituting a "control" test (a service provider would be deemed to be a leased employee if the service provider performed services under the control of the service recipient, assuming the other requirements of Section 414(n) were satisfied) for the "historically performed by employees" test in Section 414(n) of the Code. Given the Internal Revenue Service's interpretation of the "historically performed" test set forth in its proposed regulations, the proposed control test would appear to be an improvement over the existing "historically performed" test. We are, however, concerned that the proposed "control" test is still somewhat subjective and subject to varying interpretations.

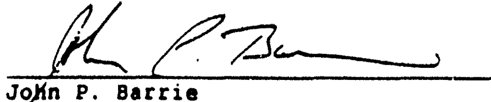
To prevent the unintended application of these rules to particular categories of service providers, we would suggest for consideration that the Internal Revenue Service be given specific regulatory authority to exclude specific categories of taxpayers from the application of Section 414(n) and that the committee report reflect a Congressional intention not to have these rules apply to emergency medicine physicians.

In addition, clarification of the control test would be helpful. In this regard, we would request consideration of statutory or committee report language along the lines of the following:

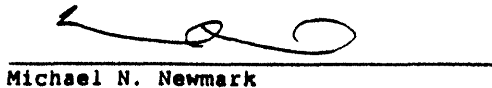
A person should not be deemed to be under the control of the service recipient solely because the person is subject to the recipient's rules and regulations which are applicable to all service providers providing similar services, such as safety and health standards, confidentiality standards or professional practice standards. Professional practice standards would include professional standards imposed by a service recipient applicable to all professional service providers. For example, this would include hospital rules and regulations governing medical practice applicable to all physicians providing medical services on hospital premises (regardless of the identity of the person or entity responsible for enforcing such rules). As a result, a physician providing medical services at the emergency facilities of a hospital would not be treated as a leased employee solely because the physician is subject to the hospital's rules and regulations governing medical practice at the facilities.

Conclusion Although the intent behind Section 414(n) was to prevent abuse, we are concerned that the purpose has been lost over time and that the rules are being interpreted to encompass situations not intended by Congress or in need of being addressed. While we believe the proposed "control" test set forth in Senate Bill 2901 represents an improvement in this complicated area, we continue to be concerned that such a test will be subject to varying interpretations. We believe our suggested clarifications would go a long way in addressing these concerns.

Date: August 30, 1990



John P. Barrie



Michael N. Newmark

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STATEMENT OF GOVERNMENT FINANCE OFFICERS ASSOCIATION; AMERICAN PUBLIC POWER ASSOCIATION; COUNCIL OF INFRASTRUCTURE FINANCE AUTHORITIES, AMERICAN PUBLIC WORKS ASSOCIATION; NATIONAL ASSOCIATION OF COUNTIES; NATIONAL CONFERENCE OF STATE LEGISLATURES; ASSOCIATION OF METROPOLITAN SEWERAGE AGENCIES; NATIONAL ASSOCIATION OF REGIONAL COUNCILS; NATIONAL LEAGUE OF CITIES; NATIONAL ASSOCIATION OF STATE TREASURERS; U.S. CONFERENCE OF MAYORS; ASSOCIATION OF LOCAL HOUSING FINANCE AGENCIES

INTRODUCTION

This statement presents the views of 12 state and local government organizations on tax simplification relating to tax-exempt bonds. These organizations greatly appreciate the Subcommittee's efforts to simplify the tax law and Chairman Bentsen and Senator Packwood are to be commended for their leadership in this area.

In June, the Subcommittee on Taxation held a hearing on several bills affecting the issuance of tax-exempt debt, including S. 913--the Tax-Exempt Bond Simplification Act of 1991. All of the organizations submitting this statement strongly support all the provisions of S. 913. This statement provides the views of these organizations on S. 1394 -- the Tax Simplification Act of 1991 -- and H.R. 2775, a bill providing additional simplification provisions.

COMMENTS ON S. 1394--THE TAX SIMPLIFICATION ACT OF 1991

The Tax Simplification Act of 1991 (S. 1394) represents a step in the right direction toward simplifying the tax-exempt bond provisions of the tax law. However, the proposed changes only represent a good beginning; there is much more that can and should be done as is discussed in the final report of the Commission on Public Finance established by Congressman Anthony and proposed in S. 913.

The bill contains five provisions related to tax-exempt bonds. The bond provisions provide for

1. deletion of the $100,000 limit on proceeds that may remain unspent after six months for certain governmental issuers and qualified 501(c)(3) bonds otherwise exempt from the rebate requirement under the six-month exception rule,

2. exemption of earnings on bond proceeds invested in bona fide debt service funds from the arbitrage rebate requirement and the spending and penalty requirements of the 24-month construction expenditure exception,

3. automatic extension of the initial three-year temporary period for certain construction bonds to four years if at least 85 percent of the available construction proceeds are spent within three years and the issuer reasonably expects to spend the remaining proceeds within the 12-month extension,

4. authority for the simultaneous issuance of governmental bonds and tax and revenue anticipation notes, and

5. authority for the Treasury Department to exempt certain taxpayers from the tax-exempt interest reporting requirement.

The overview of the tax-exempt bond provisions in S. 1394 notes that it is expected that Congress will continue to review as the subject of possible legislative projects additional simplification options in two areas affecting state and local government tax-exempt bonds. These issues are

1. possible statutory rules for use by governmental units maintaining non-arbitrage motivated commingled accounting practices in determining their arbitrage rebate liability, and

2. possible penalty alternatives to loss of tax exemption for selected violations of the rules governing qualification for tax exemption.

Finally, the bill also modifies the tax treatment of large partnerships, and in doing so, subjects the tax-exempt interest earned by certain partnerships to income taxation.

Our comments on specific provisions and issues under continuing review follow.

Arbitrage Rebate

The first two bond provisions (deletion of the $100,000 limit on unspent proceeds and the bona fide debt service fund exemption) are aimed at simplifying the arbitrage rebate requirement. While helpful, these provisions provide only a modicum of relief from a requirement that is horrendously complex and enormously burdensome. We continue to believe that the arbitrage rebate requirement should be repealed and the two areas of federal concern--earlier and larger issuance of tax-exempt bonds than is actually necessary for the accomplishment of governmental purposes--should be addressed in some other way. One option for dealing with these concerns is to permit all issuers to avail themselves of spend-out requirements similar to those found in the 24-month construction bond exception to the arbitrage rebate requirement.

The second and third provisions (bona fide debt service exemption and automatic temporary period extension) make improvements to the 24-month construction bond expenditure exception which many state and local issuers rely on to avoid having to comply with the arbitrage rebate requirement. The workability of this exception is especially important in view of the fact that the proposed and temporary arbitrage rebate regulations issued in May 1989, which were uniformly criticized, have not yet been substantially revised. Recently, IRS proposed modifications to the rebate regulations. The changes were judged to be improvements, but they are largely technical and computational and do not address many of the concerns previously expressed by commenters.

Simultaneous Issuance of Discrete Issues

The simultaneous issuance of certain discrete issues of tax and revenue anticipation notes and other governmental bonds is a practice we support, but the provision in S. 1394 dealing with this area is too limited in its applicability. We propose that the provision be broadened to permit the simultaneous issuance of all discrete issues, whether for long-term or short-term debt. Currently, an issuer cannot go to market on more than one issue at a time without negative repercussions because of IRS Ruling 81-216. This ruling states that if an issuer has multiple financings at approximately the same time, the issues would be considered as a single issue. The IRS has since defined a separate financing to be those bond sales that are held at least thirty days apart. Forcing issuers to separate their bond issues by thirty days raises borrowing costs for state and local governments and increases the total amount of tax-exempt debt sold which is not consistent with federal tax policy.

IRS Ruling 81-216 has been interpreted to apply to the simultaneous issuance of AMT and non-AMT bonds. This has created a problem for issuers in that many capital improvement programs include both projects for which bonds would be subject to the AMT, and projects for which bonds would not be subject to the AMT. Thus, an issuer is left with two relatively unattractive alternatives: to accept the higher interest rate attributable to the AMT portion of the bond issue on the entire financing, including that portion for projects the issuer knows should not be subject to the AMT, or separating the two

financings by a sufficient period of time (at least thirty days) so that bond counsel will be able to conclude that two separate financings have occurred.

Paying the higher "AMT rate" on the entire issue is obviously an unattractive option. Requiring the two issues to be separated by at least thirty days also is unattractive because it increases the issuer's costs of issuance by requiring that certain activities, such as document printing, be repeated. It also increases staff time and requires more outside legal assistance, both of which increase the cost of financing. Moreover, the thirty day minimum separation significantly increases market risk to the issuer, in that very significant interest rate movements can occur during such a period.

The provision in the simplification bill should have broader applicability to the simultaneous issuance of AMT and non-AMT bonds. It also should permit multiple short-term borrowings such as bond anticipation notes and tax and revenue anticipation notes without penalty as well as other financings that occur within 30 days of each other.

Tax-Exempt Interest Reporting Requirement

The bill contains a provision to permit the Treasury Department to exempt certain taxpayers from the tax-exempt interest reporting requirement. Presumably it has been burdensome for some taxpayers to compile and report such information and if the Secretary of the Treasury determines that such information is not useful for the administration of the tax laws, the requirement may be waived. We are fully sympathetic with the need to reduce the compliance burden. On the other hand, we believe that the data provided to the Internal Revenue Service provides the basis for more informed policy making. We question the advisability of this change when so much importance and emphasis is being placed on the revenue implications of policy changes without more information about the rationale for the change.

An example of the type of research and policy analysis that has been prepared using tax return data is the recent work by Daniel Feenberg of the National Bureau of Economic Research (NBER) and James M. Poterba of the Massachusetts Institute of Technology and NBER. For their report, Who Owns Municipal Bonds?, Feenberg and Poterba use data from 1987 tax returns to analyze the distribution of tax-exempt asset holdings across tax brackets. They found the tax return data to be superior to information provided in the Survey of Consumer Finances because it provided much better information on household marginal tax rates.

Measuring the revenue cost of tax exemption requires information not only on the holdings of municipal bonds across sectors, but also the distribution across different types of households. Prior research on household ownership of tax-exempt bonds had established that most such debt was held by relatively high-wealth, high-income households. Taking into account accuracy problems and deliberate misreporting problems, the researchers suggest that there is a possibility that the marginal investors in municipal bonds may face tax rates substantially below the top-bracket rate, which is at variance with the assumption currently used to measure the revenue cost to the federal government of tax exemption.

Commingled Accounting Practices

The development of rules relating to the allocation of investment income from commingled investment funds and the procedures to allocate project expenditures to various sources of payment for a project is a high priority. In 1990, the Government Finance Officers Association (GFOA) conducted an extensive survey of state and local government accounting practices to provide technical assistance to the Internal Revenue Service and the Treasury Department. In addition, a legislative proposal was drafted by GFOA and the National Association of Bond Lawyers at the request of the House Ways and Means Committee staff to provide for simplified accounting rules related to the rebate of arbitrage on tax-exempt bonds.

Allocation and accounting rules for arbitrage rebate purposes, including rules on commingled investments and expenditure of grant monies, are reported to be a high priority regulation project for the Internal Revenue Service. Whether guidance is provided through the regulatory process or the legislative process, state and local governments should not be required to make expensive and wholesale changes to their existing accounting systems solely for the purpose of complying with the arbitrage rebate rules. Governmental issuers employ a wide variety of methods in accounting for the receipt, expenditure and investment of bond proceeds and other funds.

The GFOA research has documented the diversity of practice and demonstrated the need to provide broad, general rules rather than narrowly drafted rules. A general recommendation is to permit governmental units to employ any and all reasonable accounting methods for allocation purposes provided that such methods are consistently applied either on a cash, accrual, or modified accrual basis.

Alternative Penalty Provisions

Bond penalties should be realistic so that where rules exist they can be enforced. In the area of tax-exempt finance the only penalty for failure to abide by the rules is the loss of tax exemption on the bonds. Under this penalty system, however, it is the private purchaser of the securities, not the issuer, who is penalized if the issuer either purposely or inadvertently acts improperly. The potential threat of taxation puts the bondholder at risk and is reflected in the interest rate paid on the bonds by the issuer.

A reexamination of this penalty provision is supported because the enforcement of tax-exempt bond provisions should take into account that making threats to take away tax exemption is not always the best public policy. Furthermore, the actual taxation of bond interest may be difficult to administer if bondholders cannot be found. While the current law loss of tax exemption penalty is not perfect, it is important to recognize the difficulties that would be confronted in establishing some alternative penalty structure. Since the circumstances surrounding noncompliance among issuers and situations vary considerably, any attempt to develop rules that fit all circumstances would be inordinately complex.

Under current law, the IRS is permitted to impose financial penalties and other restitution requirements through closing agreements. This approach does not harm innocent bondholders and resolves violations by involving all parties to the transaction--issuer, bond counsel and underwriter. In the 1989 Omnibus Budget Reconciliation Act, Congress provided clarification that penalties for promoting abusive tax shelters under Section 6700 of the Internal Revenue Code may be applied to bond counsel, investment bankers and their counsel, issuers (both governmental and conduit) financial advisors, feasibility consultants, engineers and others involved in the project. Another current law option is to "black list" issuers who violate the law -- an option, to our knowledge, that has never been employed.

There are pros and cons with the current law system that must be carefully evaluated along with the details of any alternative penalty system. The Anthony Commission on Public Finance has decided to study this issue and prepare a report with recommendations. We suggest that any decision on this subject be delayed until that report is available.

Tax Treatment of Large Partnerships

The provision in the simplification proposals affecting the tax treatment of large partnerships that requires that the tax-exempt interest earned by certain partnerships be subject to income taxation is strongly opposed by the organizations submitting this statement. Tax-exempt interest should retain its tax-exempt character no matter what percentage of the partnership's assets are tax-exempt securities. Any limitation on the value of tax exemption--no matter how large or small--affects the market for tax-exempt debt and cannot be condoned. Furthermore, any intrusion is a serious precedent and will lead to

other and more serious violations of tax exemption. The proposed change is part of a simplification bill. However, this is not simplification, but rather a significant policy change in the tax treatment of tax-exempt debt.

COMMENTS ON H.R. 2775--A BILL RELATING TO ADDITIONAL TAX SIMPLIFICATION

The tax-exempt bond provisions in H.R. 2775 provide meaningful simplification of the federal tax laws. This bill, introduced by House Ways and Means Chairman Rostenkowski, has taken an important first step to eliminate some of the overregulation of the state and local government debt issuance process and these changes are especially important now in view of the fiscal difficulties facing many state and local governments. These provisions should be included in any simplification legislation approved by the Senate.

The provisions of the bill, which we support with some suggested modifications, do the following:

1. repeal the unrelated and disproportionate use limit,
2. increase the small-issuer arbitrage rebate exception from a $5 million annual limit to $10 million,
3. repeal the 150-percent of debt service limit, and
4. permit issuers to elect to terminate the arbitrage rebate requirement after the initial temporary period and comply with a yield restriction requirement.

Our comments on these provisions follow.

Disproportionate and Unrelated Use Limit

Repeal of the five percent disproportionate and unrelated use rule would accomplish significant simplification without sacrificing significant policy objectives. We do not believe that there are any measurable revenue consequences to the repeal of this provision because there is no indication that there is significant private use financing provided with governmental bonds and three other current law tests would continue to limit private involvement.

Small-Issuer Rebate Exception

Increasing the small-issuer rebate exception helps those governments most in need of relief. The proposed increase in the annual limit to $10 million is beneficial, but we recommend a $25 million limit. In addition, we support eliminating the current law requirement that jurisdictions must have taxing authority to be eligible for this exception--a requirement that denies issuers of small water, sewer and other facility bonds rebate relief.

A large number of issues account for a small amount of total dollar volume in the municipal market, so it is possible to provide a substantial amount of simplification at little cost. In 1990, 89.5 percent of all municipal issues were less than $25 million, but these accounted for only 28.6 percent of total municipal volume. It is safe to say that the governmental bonds eligible for the small-issuer rebate exception are not arbitrage-motivated. These bonds are for core governmental facilities such as schools, streets and city halls as well as other infrastructure facilities such as water and sewer systems.

There are several other reasons to increase this exception. Small issuers go to market infrequently and when they do, they often package several projects together to reduce issuance costs. Issuers whose total annual borrowing exceeds the $5.0 million limit should not be forced into more frequent and costly borrowing practices. It has been five years since the arbitrage rebate was enacted and project costs have escalated during that time. On that basis alone, the $5.0 million limit is now less adequate than ever.

It has been argued that the existence of computer programs for calculating rebate simplifies the rebate requirement substantially and obviates the need for a higher annual limit. This is not true. The source of rebate complexity is the mind-boggling tracking of investment and expenditure transactions through the accounting system and the collection of the data that is used in the computer program. The actual calculation of rebate is not a significant compliance problem.

Another reason to expand this exception is because other options that were to be made available to issuers are not viable options. For example the Treasury Department's State and Local Government Series (SLGS) program was intended as a meaningful rebate safe harbor. Treasury has been unable to date to fulfill the intent of the law which was adopted in 1986. Rigid administrative requirements limit the utility of the program, and the Treasury has been unable to provide a reasonable return on the investment of bond proceeds.

150 Percent of Debt Service Limit

We support the repeal of the current law provision that limits the amount of proceeds that an issuer of governmental bonds and 501(c)(3) bonds can invest in nonpurpose investments at a yield above the bond yield to an amount equal to 150 percent of the current debt service. Since these bond proceeds are subject to rebate it serves no purpose to also restrict the yield on the bond proceeds.

Election to Terminate Rebate and Comply with Yield Restriction

We support the elimination of the duplicative yield restriction and arbitrage rebate requirements. Requiring the yield restriction in those cases where rebate or the construction bond exception apply is completely unnecessary. The yield restriction rules were in place prior to the enactment of arbitrage rebate. Requiring issuers to restrict the yield they earn on bond proceeds that are invested for temporary periods to eliminate the earning of arbitrage at the same time the issuer is subject to rebate or the construction bond exception can only be described as punitive.

We believe the proposal to impose rebate for some prescribed period and then to impose yield restriction thereafter is well intentioned, but it perpetuates the burdensome rebate requirement. We suggest eliminating rebate altogether, imposing spend-out requirements during the temporary period after the bond issue and then subjecting unused bond proceeds to yield restriction. Improving the SLGS program would facilitate compliance with yield restriction for those governments with unspent bond proceeds.

OTHER TAX-EXEMPT BOND SIMPLIFICATION SUGGESTIONS

At this time there are two additional simplification suggestions we want to hold out for consideration by the Subcommittee. Both are included in S. 913. They are

1. an increase in the bank interest deduction exception annual limit from $10 to $25 million, and

2. a reduction of arbitrage subject to rebate.

Bank Interest Deduction

The bank interest small-issuer exception is not an unnecessary tax subsidy to financial institutions. Many small jurisdictions do not have access to the national capital markets to finance their infra-structure and other public facilities and rely on local banks to

purchase their debt. If the local banks cannot use the bank interest deduction, borrowers have to find other purchasers, at a higher interest rate, or they may have to pay higher interest costs to the local banks, which ultimately means more tax-exempt debt is outstanding.

The availability of the interest deduction permits banks to offer lower-cost financing to governmental entities most in need. There is another advantage that should not be overlooked. Bank investments in municipal bonds are stable investments. It is in the national interest to provide banks with incentives to invest in municipal bonds rather than risky real estate and other investments that have been the focus of the recent financial crisis in the banking industry.

Reduction of Arbitrage Subject to Rebate

Permitting issuers to retain some reasonable percentage of their arbitrage rebate as an incentive for them to maximize investment return is a sound policy. Whether 10 percent is a large enough percentage is the question that must be answered. This provision should be viewed as a revenue-raising provision and any revenue raised should be used to offset the cost of other tax-exempt bond relief provisions.

CLOSING COMMENTS

S. 1394 and H.R. 2775 are important first steps and represent an important turning point in federal-state-local relations. It is apparent that Congress is listening and responding to state and local governments' financing problems. Further, Congress is now showing concern about the ability of state and local governments to undertake public projects and build necessary infrastructure facilities and is prepared to reverse some of the overly restrictive bond provisions that were enacted in the 1980s. These developments are welcomed and they set the course for the restoration of a healthy federal-state-local partnership.

Questions concerning this testimony may be directed to Catherine L. Spain, Government Finance Officers Association, 1750 K Street, N.W., Suite 200, Washington, DC 20006, (202) 429-2750.

Statement of John B. Huffaker

The purpose of this statement is to urge the inclusion in the Simplification Bill (S. 1394) of a measure to simplify the computation and forecasting of interest on estate tax that is deferred under Sec. 6163. That section allows the payment of tax imposed on remainders or reversions to be postponed until the executor is entitled to the trust assets. The correction of a needless problem in present law was the subject of H.R. 9 in the last Congress and a copy of that bill is attached. The sponsors were Congresswoman Lindy Boggs and Congressmen Anthony, Murtha and Schulze. The problem relates to only a few taxpayers so it has had great difficulty in finding the ear of either the Ways and Means or Finance Committees. However, it is a continuing problem and worthy of correction. While the problem can occur in any jurisdiction it is more likely in Louisiana than elsewhere due to the differences in property law.

To illustrate the problem, assume Father establishes a trust providing that income will be paid to his wife for life and at her death the principal is to be paid to Daughter. Daughter predeceases her mother and daughter's estate tax must be computed. The assets of the taxable estate will include the remainder interest in the trust valued under the Treasury tables that take into account the life expectancy of the income beneficiary as well as the current discount rate. Under recent legislation the discount rate adjusts periodically so it will always reflect current economic conditions. The remainder passes under her will but neither her executor nor her heir are entitled to the trust principal until the income beneficiary dies. This current value of the remainder is included in the gross estate but the tax on it is subject to being postponed under sec. 6163 until 6 months after the death of the income beneficiary. This postponement has been permitted since the modern estate tax was enacted in 1932 since the executor will not have possession of the trust principal as a source of funds until after the income beneficiary's death.

If we assume that a substantial part of the gross estate is attributable to the vested remainder and the balance is attributable to other assets, the executor must make a decision whether to use the other assets to pay not only the tax on these assets but that attributable to the remainder interest. From 1933 until 1975 his decision was a fairly straightforward one based on the tax on the remainder increased by interest at the fixed rate provided by statute. Since 1975 the interest rate has been a fluctuating one reflecting current interest rates. Thus estates that had the tax computed using a 3½% discount rate saw the current interest rate rise to 20%. The total burden of tax plus interest can easily exceed the value of the trust principal. To guard against this contingency the executor has a strong motivation to pay as much tax as possible although it defers until the death of the income beneficiary the receipt by an heir of any inheritance. The practical result is that the election is limited to instances of necessity (i.e., when the tax on the remainder will exceed the assets available to pay tax) to avoid the risk of an interest burden that is completely inequitable.

It is a major simplification to substitute a fixed rate of interest for the fluctuating one so that the executor can make informed choices about the use of assets to pay taxes caused by the inclusion of the remainder interest in the gross estate. A fixed rate will provide an equitable interest burden whenever the tax payment is postponed. A high discount rate leads to a low tax and a low discount rate produces a high tax. Appropriately, the low tax should match with a high interest rate and a high tax with a low interest rate, neither subject to market fluctuations.

H.R. 5369 provided that the interest rate would be the same as the discount rate used in computing the value of the remainder. This is a fair rule that would permit the executor to balance the potential hardship on the estate beneficiaries caused by diverting assets to pay estate tax against the potential hardship on the remainderman if the interest compounds for a long period. As difficult a decision as it might be, at least the total tax plus interest burden at a future time would be susceptible of computation. We submit that this is a very meaningful simplification and urge that the bill include a provision similar to H.R. 5369.

We shall be glad to supplement this statement in any way that the Committee may suggest.

IN THE HOUSE OF REPRESENTATIVES

JULY 25, 1990

Mr. SCHULZE (for himself, Mr. ANTHONY, Mrs. BOGGS, and Mr. MURTHA) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1986 to provide a fixed rate of interest on the postponed estate tax attributable to a reversionary or remainder interest in property included in the estate.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. RATE OF INTEREST ON ESTATE TAX ATTRIBUTA-**
4 **BLE TO REVERSIONARY OR REMAINDER INTER-**
5 **ESTS IN PROPERTY.**
6 (a) IN GENERAL.—Section 6601 of the Internal Reve-
7 nue Code of 1986 (relating to interest on underpayment, non-
8 payment, or extension of time for payment, of tax) is amend-

1 ed by redesignating subsection (k) as subsection (l) and by
2 inserting after subsection (j) the following new subsection:
3 "(k) RATE OF INTEREST ON PORTION OF ESTATE
4 TAX POSTPONED UNDER SECTION 6163(a).—
5 "(1) IN GENERAL.—If the time for payment of an
6 amount of tax imposed by chapter 11 is postponed as
7 provided in section 6163(a), interest on the amount so
8 postponed shall (in lieu of the annual rate provided by
9 subsection (a)) be paid at the discount rate (and com-
10 pounded annually) for the period of the postponement
11 under section 6163(a).
12 "(2) DISCOUNT RATE.—For purposes of para-
13 graph (1), the term 'discount rate' means the rate used
14 for purposes of chapter 11 to value the reversionary or
15 remainder interest in property included in the gross
16 estate."
17 (b) EFFECTIVE DATE.—
18 (1) IN GENERAL.—The amendment made by this
19 section shall apply to interest on taxes the payment of
20 which is postponed until after October 6, 1988, under
21 section 6163 of the Internal Revenue Code of 1986
22 but only if the value of the reversionary and remainder
23 interests in property included in the gross estate ex-
24 ceeds 45 percent of the value of the gross estate.

1 (2) EXCEPTION FOR INTEREST PAID ON OR
2 BEFORE OCTOBER 6, 1988.—The interest required to
3 be paid with respect to an estate tax postponed under
4 section 6163 of such Code after the application of the
5 amendment made by this section shall not be less than
6 the interest paid on or before October 6, 1988, with
7 respect to the estate tax so postponed.
8 (3) EXCEPTION FOR INTEREST FOR PERIOD TO
9 WHICH 4 PERCENT RATE APPLIED.—The amendment
10 made by this section shall not apply to interest for pe-
11 riods to which section 6601(b) of the Internal Revenue
12 Code of 1954 applied (as in effect before its repeal by
13 Public Law 93–625).
14 (4) STATUTE OF LIMITATIONS.—If refund or
15 credit of any overpayment of tax resulting from the ap-
16 plication of the amendment made by this section is pre-
17 vented at any time before the close of the 90-day
18 period beginning on the date of the enactment of this
19 Act by the operation of any law or rule of law (includ-
20 ing res judicata), refund or credit of such overpayment
21 (to the extent attributable to such amendment) may,
22 nevertheless, be made or allowed if claim therefor is
23 filed before the close of such 90-day period.

1 SEC. 2. LIMITATION ON ESTATES ELIGIBLE TO POSTPONE
2 PAYMENT OF TAX BY REASON OF INCLUDIBLE
3 REVERSIONARY OR REMAINDER INTEREST.
4 (a) IN GENERAL.—Subsection (a) of section 6163 of the
5 Internal Revenue Code of 1986 is amended—
6 (1) by striking "the gross estate," and inserting
7 "the gross estate and the value of such interests
8 exceed 45 percent of the value of the gross estate,",
9 and
10 (2) by striking "such interest" and inserting "such
11 interests".
12 (b) EFFECTIVE DATE.—The amendment made by this
13 section shall apply to estates with respect to which an elec-
14 tion is made under section 6163(a) of the Internal Revenue
15 Code of 1986 after the date of the enactment of this Act.

STATEMENT OF THE INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

My name is Denise Bode. I am President of the Independent Petroleum Association of America (IPAA). I welcome the opportunity to comment on the behalf of our national association which represents some 5,500 independent crude oil and natural gas explorers/producers in all 33 states with oil and natural gas production. The IPAA includes among its members a number of publicly traded master limited partnerships, besides the significant number of smaller partnerships in which our members maintain interests.

OVERVIEW

Partnerships have long been used by the oil and gas industry as a means of raising investment capital. The use of partnerships as an investment vehicle is now less attractive, due in part to the tax provisions enacted in the Tax Reform Act of 1986. However, a recent survey indicated that 21 percent of independent producers have raised venture capital through the use of limited partnerships, indicating the ongoing importance of partnerships to the industry. The Independent Petroleum Association of America (IPAA) also includes among its members a number of publicly traded master limited partnerships, besides the significant number of smaller partnerships in which our members maintain interests.

The Department of the Treasury and the Coalition of Publicly Traded Partnerships have each submitted studies to Congress on compliance and administrative

issues associated with widely held partnerships. We are concerned that these studies paid little attention to the problems and concerns that are raised by oil and gas investments held in partnership form.

IPAA does support the concept of simplified reporting to the extent that new requirements reduce the number of items required to be separately reported to partners. Yet, primarily because oil and gas partnerships that elect the simplified reporting benefits under the Act are subject to the loss of percentage depletion benefits, the Act will significantly reduce the attractiveness of oil and gas investments held in partnership form. Other changes in the Act, primarily those that relate to changes in partnership audit procedures, are also of significant concern to the industry.

MINIMUM TAX REFORM IS OF PARAMOUNT IMPORTANCE

Much of the complexity that is prevalent in oil and gas partnerships has resulted from the impact of the minimum tax laws. The oil and gas industry is perhaps the most heavily affected by the impact of the alternative minimum tax, with an estimated 75 percent of producers subject to this tax, on an annual basis. The oil and gas industry is subject to numerous adjustments for purposes of the minimum tax, resulting from the treatment of intangible drilling costs, percentage depletion, and equipment depreciation. The need to separately state these items would be eliminated for the majority of investors if the disparate treatment of these items was modified.

Domestic producers should be allowed to use their long established ordinary and business deductions such as drilling costs and the allowance for depletion of the resource. At a time when investment in domestic petroleum resources is in a perilous decline due to problems with oil and natural gas price volatility and lack of capital, current tax law only serves to exacerbate the problem.

For instance, due to price volatility and the complexities of the minimum tax, a potential investor may not know if he made a wise decision to drill until almost a full year after the drilling date. Given the risks an investor must undertake, he needs little additional aggravation in the form of punitive and regressive tax provisions. The IPAA feels that Congress would best advance the goals of tax simplification and wise energy policy by not penalizing these legitimate business deductions under the minimum tax.

SIMPLIFIED REPORTING AND PERCENTAGE DEPLETION

Act Section 210 would add a new section 775 to the Internal Revenue Code, which provides that the simplified reporting requirements would not apply to large oil and gas partnerships, unless the partnership makes an election to apply these requirements. However, a partnership electing the simplified reporting requirements must forego the benefits of percentage depletion and can only deduct cost depletion.

IPAA supports the elective treatment of oil and gas partnerships to be included within the reporting provisions. This elective treatment should be preserved in the legislation in view of the many items that are normally separately stated as a result of other oil and gas provisions in the Internal Revenue Code (especially the treatment of intangible drilling costs and percentage depletion).

However, we can see no valid reason why large partnerships should not be entitled to compute percentage depletion on behalf of their partners, if they elect to have the simplified reporting provisions apply. Although percentage depletion now must be separately reported to partners, there is little reason why this computation could not occur at the partnership level. Under the existing bill, partners with a greater than five percent capital interest in the partnership and integrated oil companies are treated as excluded partners. If there is concern that partnership level treatment would allow depletion to the companies affected by depletable quantity limitations, these concerns can be easily alleviated by requiring these partners to be treated as excluded partners. Because substantially all of the remaining partners would be individuals that likely would not be subject to the 65 percent of overall net income limitation, there would seem to be negligible revenue loss that would result from the allowance of percentage depletion computed at the partnership level.

Denial of percentage depletion benefits as a condition of obtaining simplified reporting runs counter to the tax policy decisions made in enacting the oil and gas provisions in the Revenue Reconciliation Act of 1990, which expanded the availability of percentage depletion benefits in order to improve the economic viability of production from marginal properties. Percentage depletion remains an important deduction to investors in oil and gas partnerships, as it acts to "level the playing field" with investments in nondepletable assets by recognizing that oil and gas

assets have no residual value, and that replacement costs for oil and gas assets is significantly greater than assets in nondepleting industries.

The IPAA recommends that there should be no limitations on the allowance of percentage depletion deductions by large partnerships, if the partnership elects to apply the simplified reporting provisions. In order to advance the goals of simplified reporting, depletion could be computed at the partnership level, except for those partners otherwise excluded from the simplified provisions.

We also note that a clarification needs to be made to the exclusion for oil and gas partnerships from the definition of a "large partnership." Many oil and gas partnerships do not directly hold working interests in oil and gas properties, and often hold these interests through other operating partnerships. The Act should be clarified to provided that the exclusion applies if 50 percent or more (by value) of the assets of the partnership (including assets held indirectly thorough other pass- through entities) are oil and gas properties.

MAGNETIC MEDIA FILING AND OIL AND GAS PARTNERSHIPS

Act section 203 amends section 6011(e)(2) of the Internal Revenue Code to provide that the I.R.S. may require large partnerships with more than 250 partners to file their tax returns and copies of the schedules sent to each partner on magnetic media. However, oil and gas partnerships that are not subject to simplified reporting may pass out as many as twenty different items to partners. Often, these items do not fit into any kind of standardized category and are simply listed separately and referred to in the line items described as "other items of income or loss" on the I.R.S. form K-1, reporting the partner's distributive share of the partnership's taxable items. It would be extremely difficult to fit these items into the simplified reporting categories that would be necessary for magnetic media reporting.

It appears that the purpose of the magnetic media filing requirements is to facilitate matching of the information reported by a large partnership to its partnership returns. Matching requires consistent treatment of partnership items on both the partnership and partner's returns. However, it is unlikely that items that do not fit into a standardized reporting category (e.g. those items described as other deductions on form K-1) would be correctly picked up correctly and accounted for through any kind of mechanized procedure. In addition, correct matching could not occur relative to those items for which the partner may make a separate election (e.g. the section 59(e) election, relating to an optional election to capitalize and amortize intangible drilling costs), or that are subject to partner level limitations (e.g. percentage depletion, pursuant to section 613A(d)(1)). Thus, comparison of the magnetic media filing would be difficult, if not impossible, and would most likely require partners to spend a large amount of time and money to reconcile differences if matching was attempted. For these reasons, the IPAA feels that only those oil and gas partnerships that have elected simplified reporting should be subject to magnetic media reporting.

PROPOSALS AFFECTING ASSESSMENT OF DEFICIENCIES WITH RESPECT TO WIDELY HELD PARTNERSHIPS

Act section 202 provides for a number of changes in the audit procedures of widely held partnerships, apparently arising out of the Treasury study's recommendation that audit procedures should be changed. However, we question the need for changes in this area based upon the Treasury Department's conclusion that a significant amount of unreported partnership income exists from widely held partnerships. The Treasury study is notable in that it offers no factual evidence to back up this conclusion. However, the approach adopted in Act section 202 would severely damage the ability of partners to resell partnership interests and would impose an unfair burden on partners by subjecting them to tax on income they may have never received.

Certainly the Treasury study is correct in noting that the current TEFRA audit system is not ideal for large partnerships. For instance, giving each individual partner the right to participate in negotiations with the Service and in court proceedings may result in a cumbersome process. In addition, the requirement that the I.R.S. must give notice of the beginning of partnership-level administrative proceedings and the resulting administrative adjustments is also cumbersome. However, the proposed system represents a radical departure form existing partnership tax principles, and would appear to violate the principles and stated criteria on which the simplification bill is based.

We note that most large partnerships and all publicly traded partnerships are subject to independent audits by certified public accountants. In addition, the Serv-

ice has audited many "tax-shelter" type nonpublicly traded partnerships. Yet, despite the fact that these partnerships are routinely audited, the Treasury study suggests that the Service is unable to audit these partnerships under current law. We are not aware of any circumstances where the Service has even attempted to audit a large publicly traded partnership in the oil and gas industry. However, if relatively minor changes in the notification requirements are made, the Service should be able to audit most large partnerships using the system that is generally applicable under current law.

We also believe that most partners report the taxable income that is passed through to them by the partnership, and that most partnerships take reasonable positions based on existing tax law in preparing partnership returns. Most partnerships have little reason to take aggressive positions on their returns, as a public relations debacle would result with investor partners if significant changes were made arising out of a partnership audit.

Act section 202 specifically adopts the approach recommended by the Treasury Department study that would provide that an item of a partnership shortfall in a prior year would be treated as a current item of income in the year in which a final determination of the adjustment is made, and would provide for the collection of interest and penalties with respect to the shortfall directly from the partnership. This approach represents a significant departure from usual partnership principles. The Treasury department proposal acknowledges that the approach would give a "windfall" to the partner in the year income was understated and would impose an unfair burden on the partner buying into the tax liability. The Treasury report minimizes this problem, stating that the "detriment to a partner who buys into a tax liability of a widely held partnership under the current assessment approach would be less than the detriment to a shareholder who buys into a corporation with a similar tax liability."

This statement is erroneous as to its application to the approach adopted in the Act. For example, a partner that becomes subject to a partnership adjustment may have reportable income on which he must pay tax. But yet, the partnership may have otherwise have incurred a loss for the year such that the partner receives no cash with which to pay the tax. This is different from the corporate situation, where the corporation (and not the partner) is liable to pay the tax. However, we are not advocating that the partnership pay (on a nonelective basis) the tax liability on behalf of the partner. We feel, consistent with current law, that the tax liability is best collected from the partner that was in the partnership at the time the underpayment of tax arose.

The new audit provisions would have the effect of severely decreasing the marketability and resale of partnership interests. Few partners would wish to purchase partnership interests with respect to which they could be purchasing contingent tax liabilities. The problem is especially acute in those partnerships that were formed for a singular purpose (i.e. an exploratory well drilling program), rather than those partnerships which operate ongoing businesses. For example, those partnerships formed for a single business venture often incur losses in the early years of partnership formation and realize income in later years. The earlier loss years are most susceptible to change upon partnership audit. Few investors would be willing to purchase partnership interests knowing that audit adjustments arising out of the loss years would be passed through to them.

The Treasury study also indicates that this approach may present serious liquidity problems for existing partnerships. This is a valid concern. In many audits, by the time the audit is settled, the collection of interest and penalties associated with a tax deficiency may be as large as the deficiency itself. Collection of interest and penalties from the partnership itself could easily cause partnerships with insufficient cash reserves to sell assets or liquidate in order to satisfy the interest and penalties. Such a threat would further depress the value of partnership interests.

Again, we believe that the proposed changes in the partnership audit provisions are unwarranted. If significant changes must be made, we recommend that the changes apply to publicly traded partnerships only and those partnerships that are not publicly traded and were formed for purposes of conducting a single business venture be exempted from the new rules.

ADVANCE OF DUE DATE FOR FURNISHING INFORMATION TO PARTNERS

Section 107 of the Act would amend section 6031(b) of the Internal Revenue Code to provide that a partnership must supply information returns to partners by the 15th date of the third month following a close of a partnership's taxable year, in order to better facilitate the partner's return preparation. Most partnerships are sensitive to the needs of their investor partners to file their returns, and most part-

nerships work extremely diligently in getting this information out to partners on a timely basis. Indeed, many partnership agreements provide that this information must be furnished to partners by March 15 after the end of the calendar year.

It is important that legislators understand the amount of work that must be accomplished within an extremely small window of time after the end of a partnership's taxable year. The partnership must first close its books and records for the taxable year. After the books and records are closed, the partnerships are often audited by independent certified public accountants. Partnerships that have units held by brokers in street name must collect and process the information necessary pertaining to the beneficial owners of these interests. After the audit (if one occurs), the income tax workpapers are prepared and are often reviewed by independent tax counsel. After the workpapers have been prepared, the return is usually completed with the assistance of an outside computer services and processing company. The completion of the finished return requires a tremendous amount of coordination between staff of the partnership, independent auditors, tax counsel, and computer services personnel. This work must be completed at a time of year when the workloads of all parties involved are exceptionally heavy, placing them under significant pressure.

A few of the largest partnerships, because of their size and complexity, are unable to get information returns to partners by the 15th day of the third month following the close of their taxable year. This partnerships may not be able to meet the new information reporting requirement in any event. Given the choice of mandatory compliance with the new due date, the partnerships may have to either close their books one month earlier in order to have adequate time to prepare the return, or may take "shortcuts" that would minimize proper review of the return and would increase the chance for errors. In any event, the chances for an incorrect filing would be dramatically increased.

In addition, many partnerships that are experiencing financial difficulties are not able to file their returns on a timely basis. These partnerships may not be able to afford to hire in-house personnel that are usually necessary to prepare such returns. In addition, the costs of hiring outside personnel to prepare the returns (usually from C.P.A. firms) is often prohibitive during the initial months of the year because of their significant workloads and higher fees during the tax season. These partnerships will often file their returns during the summer months in order to save money on preparation fees. Although inconvenient for partners, the burden of waiting until the summer months for return preparation may be preferable to the loss in their investment from the payment of increased fees.

We believe that partnerships should be allowed to extend the due date for filing their partnership returns (and sending information returns to partners) if reasonable cause for the extension exists. Accordingly, if a due date of two and a half months after year end is used for partner information returns, we believe that this date should be allowed to be extended if reasonable cause for a later filing exists. If it is important that the information returns be provided to partners by an earlier due date, we recommend that the partnerships be given the opportunity to elect instead to have an earlier year end (such as a November 30 year end). This year end would allow more time for return preparation, but would minimize any opportunity for deferral of partnership income.

Statement Individual Members of the Real Property Probate and Trust Law Section of the American Bar Association

Mr. Chairman and Members of the Committee: Each of the undersigned holds officer, council or committee positions with the Real Property Probate and Trust Law Section of the American Bar Association. The following comments have been prepared in connection with that Section but are being submitted only on behalf of the undersigned as individuals.

I. TITLE IV OF H.R. 2775: SUPPORT THE OVERRULING OF ALEXANDER V. COMMISSIONER

Title IV of H.R. 2775 would overrule *Alexander* v. *Commr.*, 82 T.C. 34 (1984), *aff'd* 760 F.2d 264 (4th Cir. 1985). The Council of the Real Property, Probate and Trust Law Section of the American Bar Association voted unanimously to support this provision to the extent it would prevent a "specific portion" as that term is used in Section 2056(b)(5) from being interpreted to include a fixed dollar amount (determined as of the surviving spouse's death). However, there is concern that this provision would inadvertently disqualify for the marital deduction pecuniary formula marital deduction clauses (calling for a fixed dollar amount determined as of the

estate tax valuation date of the transferor's spouse) that meet the requirements of Rev. Proc. 64-19, 1964-1 C.B. 682. Pecuniary formula clauses are easier to administer and more commonly used then fractional share formula clauses. As a result, we believe that the suggested language of Title IV should be clarified, if necessary, to avoid the possibility of such an interpretation.

II. H.R. 2645: NOTIFICATION OF CHARITABLE BENEFICIARIES OF CHARITABLE REMAINDER TRUSTS

It has been suggested that H.R. 2645, which was introduced by Congressman Gibbons on June 13, 1991, be included in any simplification legislation. This bill contains certain requirements to insure that the charitable beneficiaries of a charitable remainder trust for which a tax deduction is allowed are in a position to enforce their state law rights under such trusts. While we recognize the appropriateness of a notice requirement and support that concept, we believe generally that the entire area of protection of trust beneficiaries is more appropriately left to the states. Thus we urge that some means be found to foster enactment of notice requirements by the states, rather than adding this complication to the Internal Revenue Code.

If, however, it is determined to accomplish this with a new tax rule, we are concerned that the specific requirements of H.R. 2645 are so invasive that if enacted they would discourage individuals from creating such trusts or, more likely, from naming specific charitable beneficiaries, leaving the choice of specific charitable beneficiary up to the trustees or others. Specifically, we urge you to consider the following changes to the legislation contained in H.R. 2645, if this approach is adopted:

(1) Increase the time period for giving notice in order to reduce the administrative burden imposed on fiduciaries by this legislation and the likelihood of inadvertent errors;

(2) Delete the requirement that the charitable beneficiary of a charitable remainder trust be given a copy of the federal estate tax return (particularly if the trust is to be funded with a fixed dollar amount) in order to address the privacy concerns of the individual donors; and

(3) Delete the requirement that the charitable remainder beneficiary receive a copy of the trust's income tax return in order to address the privacy concerns of individual donors.

III. JOINDER IN COMMENTS OF LLOYD LEVA PLAINE

Oral and written testimony was given to this Committee on September 10, 1991 by Lloyd Leva Plaine, Secretary of the Real Property Probate and Trust Law Section (and Chair of the Estate and Gift Tax Committee of the Tax Section) of the American Bar Association, in her individual capacity. Several of the undersigned worked with her on those comments. The undersigned agree with those comments, and hereby join in them.

MAX GUTIERREZ, JR.
PAM H. SCHNEIDER
LLOYD LEVA PLAINE
JERRY J. MCCOY
DAVE L. CORNFELD
FREDERICK R. KEYDEL

INDIVIDUAL MEMBERS OF THE
ESTATE AND GIFT TAXES COMMITTEE
OF THE SECTION OF TAXATION
AND
OF THE SECTION OF REAL PROPERTY,
PROBATE AND TRUST LAW

AMERICAN BAR ASSOCIATION

TAX SIMPLIFICATION PROPOSAL NO. 1

Internal Revenue Code References: § § 642(c), 645(a), 663(b) and (c), 469(i)(4), 267, 1239, 1244, 1361, 1361(d)(3), 2035, 2038(a)(1), 2056(b)(5), 2523(e), and 2652(b)(1)

Subject Area: Equal tax treatment for individuals who utilize revocable trusts.

Summary of Problem: Under current law, individuals who take advantage of a funded revocable trust are taxed differently in a number of circumstances from those who do not. These differences in tax treatment have no justifiable basis, other than an historical one.

Discussion: In recent years, there has been an increasing estate planning use of revocable trusts holding assets during the settlor's lifetime. Use of a funded revocable trust offers significant non-tax advantages over a traditional estate plan, in that it provides (1) a convenient vehicle for managing the property of the settlor, particularly in the event of illness or incapacity, and (2) a means of reducing or eliminating the delay, expense and potential lack of privacy associated with probate at death. Revocable trusts avoid no taxes; the income continues to be taxable to the settlor during life, and the trust property is includible in the settlor's estate for estate tax purposes at death. Under current law, however, individuals who take advantage of a funded revocable trust are taxed differently in a number of circumstances than those who do not. We recommend that those differences, which fall into the following six categories, be eliminated.

1. Tax Treatment of Estates and Revocable Trusts Following Death of Decedent/Settlor

The tax treatment accorded estates and revocable trusts following the death of the decedent/settlor differs in a number of respects. A suggested correction for each of those differences is set forth below.

2. Revocable Trust Ownership of Section 1244 Stock

Small business stock that is owned by a revocable trust is not entitled to ordinary loss treatment under section 1244. Such treatment is available only in the case of an "individual."[1] Section 1244 stock appears to be the only kind of property, the ownership of which by a revocable trust will disqualify the settlor from a tax benefit to which he or she would be entitled if he or she owned that property individually. We recommend that section 1244 be broadened to permit stock owned by a revocable trust to be taxed as though it were owned by the trust's settlor.

3. QSST Income Distributions to Beneficiary's Revocable Trust

In PLR 9014008 (Dec. 27, 1989), the Service concluded that if the income of a "qualified subchapter S trust" ("QSST") is distributed to the income beneficiary's revocable trust, rather than to the individual beneficiary himself, the trust will no longer be a QSST. This conclusion was apparently based on a literal reading of section 1361(d)(3) which states that the term "qualified subchapter S trust" means a trust --

> "(A) the terms of which require that -
>
> > (i) during the life of the current income beneficiary, there shall be only 1 income beneficiary of the trust,...and
>
> (B) all of the income...of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States."

This recent ruling appears to require that the income beneficiary of a QSST who has a revocable trust as a will substi-

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[1] Section 1244(d)(4) provides that:

> "For purposes of this section, the term 'individual' does not include a trust or estate."

tute first receive the income and then subsequently transfer it to the revocable living trust to prevent termination of the corporation's S status. This may be difficult or impossible if the beneficiary becomes incapacitated during his or her lifetime. Furthermore, to avoid guardianship/conservatorship problems should a trust beneficiary become incapacitated, many trusts (including QSSTs) include boiler plate "facility of payment" clauses permitting the trustee to make distributions other than only to the beneficiary individually -- for instance, by direct payment of the beneficiary's expenses or by payment to "the trustee or trustees of any trust all the assets of which are then fully and unqualifiedly withdrawable by" the beneficiary (i.e., the beneficiary's revocable trust). The holding in this recent ruling makes such a facility of payment clause a trap for the unwary -- a trap that is contrary to the income tax laws' almost universal treatment of transactions involving a revocable trust during the settlor's lifetime as though the trust did not exist and the transactions involved only the settlor individually (e.g., Rev. Rul. 74-613, 1974-2 C.B. 153).

We therefore recommend that section 1361(d)(3) be amended to make it possible for a QSST to make distributions to the income beneficiary's revocable trust without jeopardizing the trust's QSST status.

4. Gifts Made Within Three Years of Death From Revocable Trusts

Except in certain narrowly defined circumstances,[2] the Internal Revenue Service has taken the position that gifts made directly from a donor's revocable trust within three years of death, including gifts of $10,000 or less which are covered by the annual exclusion, are included in the donor's gross estate for federal estate tax purposes. In order to avoid this trap, individuals with revocable trusts are often put to the inconvenience of first transferring the property to be gifted out of their trusts and into their individual names before making the transfer to the donee (e.g., by writing the trust owned bank

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[2] See, e.g., (i) Rev. Rul. 75-553, 1975-2 C.B. 477 and TAM 8940003 (June 30, 1989) (where the trust instrument directs that the trust property be distributed to the settlor's estate on the settlor's death) and (ii) TAMs 9010004 (Nov. 17, 1989), 9010005 (Nov. 17, 1989), 9017002 (Jan. 5, 1990), and 9018004 (Jan. 24, 1990) (where the trust instrument treats the settlor as the only permissible distributee and does not confer on anyone, even the settlor himself, the power to direct distributions to individuals other than the settlor) -- but note the recent holding in Perkins Estate v. U.S., 90-2 USTC ¶ 60,042 (N.D. Ohio 1990) that the three-year rule applies notwithstanding such trust instrument provisions.

account check to the settlor who then endorses the check on the back to the donee). In the case of an individual who wishes his trustee to continue his gift program in the event he becomes incapacitated, the problem becomes more acute. In order to avoid this trap for the unwary, section 2035 should be amended so that the transfer tax consequences of making a gift from a revocable trust are no different than if such gift were made directly by the donor.

5. Marital Deduction Qualification for Gifts and Bequests to a Spouse's Revocable Trust

With the advent of the unlimited marital deduction, interspousal gifts, whether intended or inadvertent, will occur more frequently than in the past and with less attention given to the tax niceties. Where the spouses have revocable trusts, transfers between them are likely to be, in fact, transfers between their revocable trusts. However, the marital deduction, which would seem to most to be so obviously applicable, may turn out to be technically not available.

Often a typical revocable trust may neither contain a general power of appointment exercisable by the settlor in all events nor require distribution of all income to the settlor at least annually. See Treas. Reg. § 20.2056(b)-5(f)(6). In addition, it will probably not contain typical marital deduction savings clauses (e.g., with respect to unproductive property) and it may not prohibit the trustee from making distributions to persons other than the settlor (e.g., gifts in the event of the settlor's incapacity).

We therefore recommend that language be added to section 2056 to allow transfers directly between typical revocable trusts without requiring the draftsman of a revocable trust to insert a detailed savings provision qualifying for the marital deduction additions to the trust made by the settlor's spouse during the settlor's lifetime.

6. Equal Generation Skipping Tax Treatment of Estates and Revocable Trusts Following Death of Settlor (Section 2652(b)(1))

For Chapter 13 purposes, a revocable trust that is a will substitute should be treated the same as an estate.

Suggested Corrections: The following proposals are intended to provide equal and fair treatment for taxpayers who should not logically be taxed differently. They will affect an increasing number of taxpayers as the use of revocable trusts continues to grow. No taxpayers will be adversely affected, and there should not be significant revenue consequences.

1. Equal Income Tax Treatment of Estates and Revocable Trusts Following Death of Settlor [Sections 642(c), 663(b) and (c), 469(i)(4), 267, 1239, 1361, and 645(a)]

For a limited period following the death of the settlor, revocable trusts and probate estates should be treated as nearly as practicable in the same manner for tax purposes. We suggest that the period for such similar treatment be taxable years commencing within two years of the year of death if no federal estate tax return is filed. If a federal estate tax return is filed, then the period should be extended to include taxable years commencing no later than six months after the final determination of the federal estate tax. The treatment should be applicable to only one such revocable trust. The suggested wording of such a provision [patterned after section 6654(1)(2)(B)] is set forth in paragraph 6 below. The following are provisions which should be adopted to accomplish such simplification:

a. Section 642(c): Section 642(c) should be revised to allow revocable trusts a charitable deduction for amounts permanently set aside for charitable purposes as in the case of an estate. This proposal has been adopted in a resolution by the House of Delegates of the American Bar Association in 1989, a copy of which is attached as Exhibit A.

b. Section 663(b) and (c): The deduction for distributions in the first 65 days of the taxable year under section 663(b) should be allowed to estates as well as trusts. Likewise, the separate share rule under section 663(c) should apply to estates in the same manner as it now applies to decedents' revocable trusts.

c. Section 469(i)(4): Section 469(i)(4) [and section 502(d)(2) of the Tax Reform Act of 1986] should be amended to allow a decedent's revocable trust, during the extended period for similar tax treatment described above, the same passive loss exemptions as are available to a decedent's estate under those sections.

d. Sections 267 and 1239: Section 267 (and section 1239) should be amended to provide that, during the extended period for similar tax treatment described above, a beneficiary of a decedent's revocable trust will be treated as

unrelated to the trust in the same manner as the beneficiary of an estate is treated as unrelated to the estate. Such a provision would eliminate income tax differences in the funding of bequests, which presently exist, depending on whether the beneficiary received the distribution from an estate or from a revocable trust.

e. Section 1361: Section 1361 should be amended to provide that a decedent's revocable trust, during the extended period for similar tax treatment described above, can qualify to be a shareholder of an "S" corporation in the same manner as an estate can during such extended period.

f. Section 645(a): Section 645(a) should be amended to exempt a decedent's revocable trust, during the extended period for similar tax treatment described above, from the requirement that its taxable year be the calendar year, thereby permitting the decedent's revocable trust, like an estate, to initially choose any fiscal year as its taxable year. If the decedent has an estate that is required to file an income tax return, the taxable years of the estate and the revocable trust should be required to close at the end of the same month. Upon close of the extended period, the trust would be required to convert to the calendar year.

2. Revocable Trust Ownership of Section 1244 Small Business Stock [Section 1244]

We recommend that section 1244(d)(4) be amended to read as follows:

> "(4) Individual defined. For purposes of this section, the term 'individual' does not include a trust or estate (other than a revocable trust which is treated as owned by its grantor under subpart E of part I of subchapter J of this chapter)."

3. QSST Income Distributions to Beneficiary's Revocable Trust [Section 1361(d)(3)]

We recommend that the following sentence be added at the end of section 1361(d)(3):

> "Distributions to a revocable trust described in (c)(2)(A)(i) [a grantor trust] shall be treated as distributions to the grantor individually."

4. Gifts Made Within Three Years of Death From Revocable Trust [Sections 2035 and 2038(a)(1)]

As suggested by Janice A. Mays, Chief Tax Counsel of the Committee on Ways and Means,[1] (i) section 2035 should be amended so that the transfer tax consequences of making a gift from a revocable trust are no different than if such gift were made directly by the donor and (ii) section 2035 should be redrafted to make the current rules more comprehensible. See also Proposal No. 5 below, and proposed revision at Exhibit B.

5. Marital Deduction Qualification for Gifts and Bequests to a Spouse's Revocable Trust [Sections 2056(b)(5) and 2523(e)]

We recommend that section 2056(b)(5) [and section 2523(e)] should be amended so that the last part of that section would read as follows:

> "This paragraph shall apply only if such power in the surviving spouse to appoint the entire interest, or such specific portion thereof, whether exercisable by will or during life, is exercisable by such spouse alone and in all events. Where such power in the surviving spouse is exercisable with respect to any interest in property and the income therefrom in favor of the surviving spouse during the remainder of his or her lifetime, this paragraph shall apply to such interest notwithstanding that:
>
> (i) The surviving spouse is not otherwise entitled to the income therefrom,
>
> (ii) The property produces no income,
>
> (iii) There are restrictions on the exercise of such power in the event of the surviving spouse's alleged mental incapacity, and
>
> (iv) There is a power in any other person acting on behalf of the surviving spouse to appoint any part of such interest to persons other than the surviving spouse,
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> and, for the purposes of sections 2041 and 2514, notwithstanding the existence of the circumstances described in clauses (iii) and (iv) above.

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[1] Committee on Ways and Means, U.S. House of Representatives, "Written Proposals on Tax Simplification," May 25, 1990, (hereinafter "Ways and Means Committee Print") at 69.

such power shall be treated as though it were exercisable by such spouse alone and in all events."

6. Equal Generation Skipping Tax Treatment of Estates and Revocable Trusts Following Death of Settlor [Section 2652(b)(1)]

We suggest that, at the end of section 2652(b)(1), the following sentence [patterned after section 6654(l)(2)(B)] be added:

"Any trust -

(A) all of which was treated (under subpart E of part I of subchapter J of chapter 1) as owned by the settlor and

(B) to which the residue of the settlor's estate will pass under his will (or, if no will is admitted to probate, which is the trust primarily responsible for paying debts, taxes and expenses of administration)

shall be treated as an estate during taxable years of the trust commencing (i) within 2 years of the settlor's death or (ii) if a federal estate tax return is required and filed within that 2 year period, within 6 months of the final determination of the settlor's federal estate tax liability."

Contact Person: Lloyd Leva Plaine (202-383-0155) or Carol A. Rhees (202-429-6220).

Statement of the International Association of Fire Fighters

Mr. Chairman, my name is Al Whitehead, and I am the President of the International Association of Fire Fighters. I appear before you today not only on behalf of the more than 180,000 professional fire fighters across the nation, but also on behalf of public pension and deferred compensation plan administrators. This statement has been expressly endorsed by the National Conference on Public Employee Retirement Systems, which represents some 300 state and local government pension plans, 5 million employees and $600 billion in assets, and the National Association of Government Deferred Compensation Administrators, which speaks for the hundreds of public sector deferred compensation plans around the nation.

As you are aware, Mr. Chairman, state and local governments are treated separate and apart from the private sector in many parts of the tax code. Consequently, our pension simplification needs are somewhat different than our private sector counterparts. I would like to focus today on two sections of the Internal Revenue Code which are currently posing problems for public sector workers and officials: Section 415, which caps benefits that may be paid by a qualified pension plan, and Section 457, which governs state and local government deferred compensation arrangements. I will discuss each in turn.

Section 415

Section 415 of the Internal Revenue Code was created in 1974 as part of ERISA. The goal was to prevent taxpayer subsidies of exorbitant pension benefits sometimes paid to corporate executives. The law posed a two-pronged test to determine a maximum benefit that may be paid by a qualified, or tax exempt, pension plan: 1) the benefit may not exceed a specific dollar amount set forth in regulation, and 2) the benefit may not exceed 100% of annual compensation, a limit determined by averaging the employees' three highest earnings years.

Although the law generally works well in the private sector, several problems arise when it is applied to public sector pensions. The entire compensation structure of state and municipal government employees, as well as the federal tax treatment of such compensation, differs significantly from the private sector. Unfortunately, Section 415 failed to take into account these differences. The law attempts to apply uniform rules to very different circumstances.

This problem first came to light several years ago, when local governments—much to their surprise—found themselves in non-compliance with a law that was

supposed to restrict the compensation packages of corporate executives. Congress responded in 1988 with legislation intended to correct the problem. The new law allowed states to exempt current employees from Section 415 limits if it created a new pension benefit system that would comply with Section 415 for all new hires.

Although well intentioned, the 1988 amendment proved to be inadequate because it failed to acknowledge the inherent differences between public and private sector work. Simply giving states and municipalities additional time to comply with Section 415 did nothing to address the underlying cause of the law's inequity.

Congress now has before it an opportunity to resolve this issue once and for all. It is both imperative and urgent that it does so because, even as we speak, state and local government pension plans are in technical violation of the law. The IRS could tomorrow disqualify an entire state pension system based on a payment to a single participant that exceeds the 415 limit. And let us be clear about who disqualification hurts. First, it hurts fire fighters and other public employees who will be taxed on the accrued benefits of their pension plan during the year they are earned. But it also hurts local governments. Governmental agencies are ultimately responsible for the obligations of their pension system. If the earnings of the pension fund are taxed, government may need to contribute funding in order to cover the money paid to the federal government in taxes. In the end, every American will be affected by this law as states and local governments find themselves forced to either curtail services or raise taxes in order to pay their federal taxes.

We are pleased to note that the legislation pending before this committee, S. 1364, would correct the inequities currently embodied in the law. I would like to take this opportunity to extend our appreciation to Senator David Pryor for including amendments to Section 415 in his omnibus pension simplification proposal. I would like to take a few moments to discuss how S. 1364 will address the problems associated with Section 415.

- *Definition of Compensation*

The most egregious problem in Section 415 is the use of an inequitable definition of compensation. The definition utilized by the IRS for purposes of applying the 100% of compensation rule discriminates against public sector employees by failing to take into account certain features unique to public sector compensation.

For example, employer pension contributions made through the employer pick-up option (Section 414 (h)) and voluntary contributions made to deferred compensation plans (Section 457) are not counted as income by the IRS for determining the maximum allowable benefit, but they are counted as income by pension plans determining the actual benefit. Consequently, someone whose pension pays only 75% of annual compensation can still exceed the 100% rule simply because they utilized these two benefit options.

S. 1364 resolves this inequity by establishing a uniform definition of compensation which counts employer pick-ups and deferred compensation contributions as income for purposes of determining Section 415 limitations.

- *Survivor and Disability Benefits*

As the nation's most dangerous profession, fire fighters see more than their share of service-connected disability retirements. The application of Section 415 to disability and survivor compensation virtually guarantees that fire fighter pension plans will run afoul of Section 415. Currently, Section 415 requires benefits to be actuarially reduced from age 62 to the present age of the recipient at the time of injury or death. Because many fire fighters are injured at relatively young ages, the 415 limitation will often be lower than the disability benefit. We therefore support S. 1364's exemption for survivor and disability benefits from Section 415 limits.

- *Excess Plans*

The way many private sector pensions avoid disqualification under Section 415 is through the use of excess plans. These plans are non-qualified adjuncts to qualified plans through which pension benefits in excess of the 415 limitations can be paid. We recognize that private sector practices are not always the best model for the public sector, and we therefore are not seeking to replicate private sector excess plans. We do, however, believe that government entities should be given some flexibility when it comes to establishing a supplemental, non-qualified plan.

Under S. 1364, public agencies could establish excess plans, but those plans would be subject to severe limitations. Benefits paid by these plans could only be those benefits which have been earned under the established pension benefit structure. Unlike the private sector, individual employees would not be able to use the excess plan as a way to defer compensation. In this sense, the excess plan proposed by Senator Pryor could be more accurately described as an "overflow" plan since it would

be used only to pay normal retirement benefits which—through some fluke—happen to exceed the 415 limits. The creation of this excess plan would allow state and local governments to pay legitimate, earned benefits to a few employees without jeopardizing the tax-exempt status of the entire pension plan.

- *100% of Compensation Test*

Section 415's 100% of compensation test was established to curb abuses of the tax-exempt treatment of pensions by prohibiting corporations from creating compensation packages that hide wages in the pension fund. The goal is laudable, but is generally inapplicable to the public sector.

State and local governments, which are watched closely by the press and ultimately accountable to the people, rarely engage in this type of fancy footwork. On the other hand, public sector pensions sometimes violate Section 415's 100% rule simply because of the low pay and long tenure common in public service. For example, a city hall janitor whose pension benefit is 2.6% of salary multiplied by the number of years of service will receive a relatively small pension in terms of the dollar amount, but would exceed the 100% of compensation rule if he or she works for 40 years (2.6% x 40 years=104%). Surely, Congress never intended Section 415 to restrict the pension paid to a city hall janitor who is guilty of nothing more than spending 40 years in public service.

Simply put, Section 415's 100% of compensation rule is not needed and is a severe detriment to state and local workers. S. 1364 resolves this inequity by exempting the public sector from the 100% of compensation rule.

Before leaving the subject of Section 415, I would like to take a moment to answer a question many people have posed to us. If the basic problem is a conflict between federal law and state pension plans, why not change the pension plans rather than amending the tax code? The question overlooks one important aspect of state and local government pension plans. Many of the pensions—especially those established for disability—are bound by statutory or constitutional strictures against reducing benefits. Thus pension plans are legally prohibited from reducing benefits so as to comply with Section 415. The only viable solution is to change the tax code.

Finally, I wish to address the important and valid question of germaneness. Do the Section 415 provisions of S. 1364 fit the definition of pension simplification? We believe the answer is an emphatic "yes."

From our understanding, the test of what constitutes simplification has three components: is the change non-controversial? will the change have a budgetary impact? and, is the change technical rather than substantive? I shall address each point.

First, the proposed Section 415 reforms are entirely non-controversial, as demonstrated by the broad bipartisan support S. 1364 enjoys. S. 1364 is cosponsored by more than a third of the entire Senate, including both the Chair and the Ranking Minority Members of the Senate Finance Committee. Second, the proposal will have a "negligible" impact on federal budget revenues, according to the Joint Tax Committee. JTC issued that opinion in a June 6 letter. And third, these proposed changes are certainly technical in nature for it was certainly never the intent of Congress to create a pension benefit cap which unfairly disqualifies the pension plan of virtually every state and local government in the country.

SECTION 457

Mr. Chairman, I would now like to turn your attention to a different section of the Internal Revenue Code. Section 457 was enacted in 1978 when Congress opted to provide state and local governments the opportunity to offer deferred compensation arrangements.

As Section 457 plans evolved, we believe there have been some oversights as well as areas which need some technical correction that we now respectfully request this Committee to address. These amendments have been incorporated into legislation introduced in the other chamber: H.R. 2906, authored by Representative Jim Moody.

First is the absence of a provision allowing for inflationary adjustments in the maximum contribution an employee may make annually. All other contributory plans—including 401(k)—are indexed to the rate of inflation. We have been unable to find any legislative history to suggest that this was an intentional distinction. Rather, we believe the absence of the indexing provision extending to 457 plans was an accidental oversight which can be easily corrected. There is simply no tax policy which supports excluding these programs from others as it relates to indexation.

The second technical change we believe should be made to Section 457 is allowing for a one-time change in the date selected by the employee to begin receiving payments from the plan. Currently, workers who have participated in a Section 457

plan must make an irrevocable election upon separation from service as to the exact date when payments begin. This may present little problem for many workers, but creates a hardship for those individuals that have changing retirement requirements. It is simply not reasonable to expect someone leaving employment at age 45 to be able to predict whether he or she will want to receive these funds as part of their retirement in 15 years versus 20 years.

The result is that workers choose the earliest reasonable dates only to find they may still be gainfully employed when the deferred distributions commence. The irrevocable election, therefore, can hinder Section 457's intent which is to provide retirement income for public sector workers.

We believe the solution is to allow a one-time change in the date previously selected. Importantly, such a change to IRC Section 457 need not violate the "made available" rule since it is only necessary to allow workers to change to a later date. In this way, plan participants would be prohibited from withdrawing funds on command by changing to an earlier date.

The final technical correction we recommend for Section 457 is allowing for the cancellation of a small inactive account. Too often a young person in their first real job will sign up for a deferred compensation plan only to find that he or she cannot afford to continue making payments. Lifestyle changes, such as marriage, buying a first home or having children alter disposable income in such a way that future contributions to the fund become impossible.

These small, inactive accounts are a significant burden to plan administrators. The funds must be maintained and regular statements must be issued to the beneficiary even though the amount of money in question does not justify the expense and work involved over a period of years.

We suggest this problem be addressed by allowing individuals to withdraw their money or the plan to dissolve the account and distribute the funds to the participant of a 457 plan without penalty if the account contains less than $3,500 and has been inactive (no contributions made) for two years. The recipient of the money would, of course, be taxed on the income.

As with our Section 415 proposal, it is fair to ask, do these provisions meet the definition of simplification? I'm sure you'll agree, Mr. Chairman, that they do.

First, the proposals are relatively non-controversial, and are supported by both the administrators and beneficiaries of 457 plans, as well as state and local governments and the employee unions. Additionally, we have received no indication that the Administration would object to these issues. Indeed, we believe that these provisions are a necessary correction now that the law has had time to mature.

Second, we believe the proposals will have little, if any, budgetary impact. Although the Joint Tax Committee has not yet prepared a revenue estimate, the fact that one of the three proposed changes will be a revenue raiser (and therefore offset any potential revenue losses in the other two) virtually guarantees a negligible net effect on revenue. An indication of the budgetary impact of this proposal can be gained from a recent survey from the Ohio Public Employees Deferred Compensation Program. Currently, there are 87,716 participants in the program. Of 65,101 currently deferring, 2,693 are deferring the maximum of $7,500 per year. If each one of them increased to the maximum deferral as provided H.R. 2906 to $8,475 per year, their taxable income would *decrease* by $2,625,675. Of the 15,442 inactive participants, 5,565 have account values less than $3,500 and have not deferred for more than two years. If these individuals were given lump sum distributions under the proposed deminimus provision, approximately $11,000,000 would become immediate taxable income. Assuming other state and municipal government plans are similar (and we have no reason to believe Ohio is in any way exceptional), the data clearly indicates that this three-part proposal would be revenue neutral.

Finally, the proposals are certainly technical in nature; none of the amendments fundamentally alters the program or changes congressional policy or intent.

CONCLUSION

In conclusion, Mr. Chairman, we urge this committee to consider the pension simplification needs of the public sector in putting together this omnibus legislation. The changes we are recommending to Sections 415 and 457 of the Internal Revenue Code (as embodied in S. 1364 and H.R. 2906, respectively) are reasonable and just, and we hope you agree that they belong in any comprehensive pension simplification measure.

As always, Mr. Chairman, the International Association of Fire Fighters appreciates the opportunity to appear before you, and we look forward to working with you on this and other issues affecting the nation's fire service.

STATEMENT OF THE JAMES FINLAY INTERNATIONAL, INC.

Introduction

These comments are respectfully submitted by James Finlay International, Inc. to the Senate Finance Committee on Taxation with regard to its hearings on September 10 and 12, 1991. The comments specifically relate to S. 1364, the pension simplification bill introduced by Senator David Pryor and Finance Committee Chairman Lloyd Bentsen.

Background

James Finlay P.L.C., a U.K. public company based in Glasgow, Scotland ("Finlay U.K."), began investing in the United States in 1973 through a newly formed New Jersey corporation, James Finlay & Co. (U.S.), Inc. ("Finlay U.S."). Finlay U.S. was created to engage in tea trading. Consistent with the employee benefits philosophy of Finlay U.K., a defined benefit plan, qualified under the Internal Revenue Code of 1954, as amended (the "Code") was implemented for the employees of Finlay U.S. and was named the James Finlay & Co. (U.S.), Inc. Pension Plan (the "Plan").

During the period extending from the formation of Finlay U.S. until 1987, Finlay U.K. made additional investments in the U.S. In 1980, Finlay U.K. reorganized its U.S. operations and formed James Finlay International, Inc., a Delaware corporation ("Finlay International") to be the parent of all its acquired U.S. operations. Finlay U.S. became a subsidiary of Finlay International and remained involved in tea trading. Finlay Energy, Inc., a Texas corporation ("Finlay Energy") was formed, to consolidate and manage oil and gas investments. The Plan was amended and restated to be the James Finlay International, Inc. Employees' Retirement Plan ("Finlay International Pension Plan"). All employees of Finlay International, Finlay U.S. and Finlay Energy who meet the minimum service requirement participate in the Finlay International Pension Plan.

In 1981, Finlay International purchased Finlay-Cargen International, Inc., a Wisconsin corporation ("Finlay-Cargen") (formerly Sajac Company), an inventory management and storage business. Finlay-Cargen, prior to acquisition, maintained a qualified retirement plan under Section 401(k) of the Code for its employees (the "Finlay-Cargen 401(k) Plan or 401(k) Plan"). Because the employees of Finlay-Cargen were young and had accumulated significant account balances against which they could and had borrowed, as part of the negotiations for the purchase of Finlay-Cargen, it was agreed that the Finlay-Cargen 401(k) Plan would be maintained. All of the approximately 150 employees of Finlay-Cargen who meet the minimum service requirement participate in the 401(k) Plan.

Employees of Finlay International, Finlay U.S. and Finlay Energy do not participate in the Finlay-Cargen 401(k) Plan, and employees of Finlay-Cargen do not participate in the Finlay International Pension Plan. Because of the parent/subsidiary relationship of Finlay International and Finlay-Cargen, they are in the same "control group" under Section 414(c) of the Code. Code Section 401(a)(26) (which

was adopted under the Tax Reform Act of 1986), contains a minimum participation rule which requires, in subparagraph (A), that any qualified plan benefit the lesser of 50 employees of a common control group or 40% of all employees of the common control group. After the effective date of Section 401(a)(26) and up until 1987, the Finlay International Pension Plan had at least 50 participants.

Because of the depressed market in the oil and gas industry, which began in the middle 1980s and which is continuing, Finlay Energy lost several employees, to the point that, currently, less than 50 employees of Finlay International, Finlay U.S. and Finlay Energy participate in the Finlay International Pension Plan. The loss of employees has jeopardized the qualification of the Finlay International Pension Plan under Code Section 401(a)(26) due to the fact that 33 employees currently participate in the Finlay International Pension Plan which is only about 20% of the total employees of the Finlay International/Finlay-Cargen control group.

Code Section 401(a)(26)(G) provides that, at the election of the employer and with the consent of the Secretary, the minimum participation test of subparagraph (A) may be applied separately with respect to each separate line of business of the employer. The term "separate line of business" for purposes of paragraph (26) generally has the meaning given such term by Code Section 414(r).

Until Proposed Regulations defining qualified separate lines of business under Code Section 414(r) were published by Treasury on February 1, 1991, Finlay International had in good faith viewed Finlay-Cargen as its only separate line of business and thus determined that Finlay-Cargen could be excluded as a member of the control group when applying the 401(a)(26)(A) test. This allowed Finlay International to be the sole "employer" under Code Section 401(a)(26) because at least 40% of the Finlay International, Finlay U.S. and Finlay Energy employees (although less than 50 in number) are participants in the Finlay International Pension Plan.

The Proposed Regulations on separate lines of business, however, state that once an entity elects one separate line of business it effectively has created at least two separate lines and each separate line must independently meet the requirements of Code Section 414(r)(2). Under Code Section 414(r)(2) each separate line must have at least 50 employees. Because, as set forth in the Proposed Regulations, the Finlay International/Finlay-Cargen control group is deemed to have at least two separate lines, and Finlay International, Finlay U.S. and Finlay Energy do not have a total of at least 50 employees, the Proposed Regulations cause Finlay International to fail the minimum participation test of Section 401(a)(26). Thus a pension plan which has benefited employees of Finlay International for approximately 20 years will lose its qualification unless proposed simplification measures are adopted.

<u>Reasons for Change</u>
Congress enacted the Section 401(a)(26) minimum participation rule in order to deal with the abusive situation of an employer who maintained multiple discriminatory plans within an existing business. Under that scheme, highly compensated employees could participate in a plan offering generous

benefits while lower-paid employees would have no plan or would be in a plan with minimal benefits. In such cases, it was often difficult for the IRS to uncover such arrangements and, if uncovered, to establish discrimination. However, the rule which was adopted -- to aggregate the employees of the employer and to apply an arbitrary 50 employee/40% minimum participation requirement -- creates complexity and operates inequitably.

The minimum participation rule is a potential source of complexity because, under Section 401(a)(26), a trust must satisfy an arbitrary participation requirement during each day of the plan year. Thus, for example, in the case of an employer with two qualified plans (similar to Finlay International) employee attrition can reduce the employment level to below 50 in one year (or in one day during the year) and new hiring can increase it above 50 in the following year resulting in the disqualification of the plan in the first year and leaving its status uncertain in the next. Such disqualification would be in no way attributable to an effort on the part of the employer to favor highly-compensated employees over other employees. Yet the use of an arbitrary bright line test creates the anomalous situation of a trust falling within and out of qualification each year depending upon the need of a business for employees.

The minimum participation rule also operates inequitably in that, by applying arbitrary standards which by themselves do not reveal whether an employer's plan is discriminatory, they force employers such as Finlay International to discontinue one or the other of two bona fide plans adopted for good business reasons and in good faith for the benefit of their employees.

Simplification Proposals

S. 1364 was introduced by Finance Committee Chairman Lloyd Bentsen on behalf of Senator David Pryor and others. It contains amendments designed to simplify various provisions of the pension law, including, in Section 104 of the bill, amendment of the minimum participation rule of Section 401(a)(26)(A) by substituting 25 employees for the present law 50 employees. The provision may be applied retroactively at the election of the taxpayer to the date of enactment of Section 401(a)(26).

Ways and Means Committee Chairman Dan Rostenkowski has introduced H.R. 2730 to simplify the pension law. However, H.R. 2730 does not contain a provision amending the minimum participation rule. H.R. 2641, a bill introduced by Congressman Chandler, does incorporate the minimum participation rule change of S. 1364. H.R. 2742, a bill introduced by Congressman Cardin, also incorporates the minimum participation rule change of S. 1364.

Discussion

James Finlay International, Inc. supports adoption of Section 104 of S. 1364. However, while lowering the 50-employee limit to 25 employees would solve James Finlay's problem for the current year and achieve some simplification by reducing the number of employers who may need to restructure their pension plans, it does not address the fundamental problem posed by Finlay International in cases where the employee count for economic or other reasons drops below 25.

It is submitted that where a company is conducting two or more bona fide separate lines of business it should not be required to penalize its employees by discontinuing their pension plan merely because the employee size of the line of business has been reduced below an arbitrary number. What this suggests is the adoption of an amendment which provides that the test for determining separate lines of business for purposes of Section 401(a)(26) should not require that a line of business employ any minimum number of employees. Such a provision would simplify the operation of Section 401(a)(26) by eliminating the potential for confusion which may be created by annual fluctuations in the number of employees. It would also avert the application of an inequitable rule which forces employers similarly situated to Finlay International to make the disagreeable decision of having to discontinue one or the other of two plans which are not discriminatory and which their employees want to retain.

Absent adoption of these amendments, it is recommended that consideration be given to granting discretion to the Internal Revenue Service to issue exemptions from the minimum participation rules in cases where it can be established that failure to meet the numerical limits is attributable to the operation of separate lines of business and for good business reasons and not to efforts to discriminate among employees.

James Finlay International appreciates the opportunity to present its views to the Subcommittee.

MANAGED FUTURES ASSOCIATION

September 10, 1991

The Honorable David L. Boren
United States Senate
Committee on Finance
205 Dirksen Senate Office Building
Washington, DC 20510-6200

Dear Senator Boren:

The Managed Futures Association ("MFA") respectfully requests that the following comments on Title II of S. 1394, the "Tax Simplification Act of 1991", be included in the record.

The MFA is a nationwide trade association representing all segments of the managed futures industry, including commodity pool operators, commodity trading advisors, futures commission merchants, introducing brokers, exchanges, and associated persons. MFA has approximately 350 members who manage in excess of $16 billion in customer funds.

Commodity pools are partnerships that combine investment funds of the partners to trade futures and other commodity-related financial instruments. It is estimated that at least $12.5 billion is currently invested in commodity pools subject to U.S. regulation. While many commodity pools are formed with a small number of institutional or accredited investors making substantial investments in the pool, others are publicly distributed pursuant to an effective registration statement filed under the Securities Act of 1933 and applicable regulations issued by the CFTC pursuant to the Commodity Exchange Act. The majority of investors investing in a publicly offered commodity pool make an investment of less than $10,000. Through the pool, individuals can obtain access to trading strategies and expertise that would otherwise be unavailable to investors having relatively small amounts to invest in the commodities markets. Although futures, forwards and options are viewed as speculative investments, trading of such contracts may actually reduce risk and increase overall return when combined in a portfolio with other investments such as stocks and bonds. Commodity pools, therefore, permit smaller investors to diversify their portfolio investments, thereby reducing portfolio risk and/or increasing return.

Many of these publicly offered pools have more than 250 participants and would, therefore, be treated as "large partnerships" under the proposed legislation. We are concerned that the tax proposals, in the name of simplification, would impose major substantive tax disadvantages on the pools and their investors.

Title II of S. 1394 contains a series of provisions that require large partnerships to compute partnership income, loss minimum tax liability, capital gains and losses and tax credits at the partnership level and to simplify flow-through of these items to individual limited partners. The main problem is with the proposed new Code Section 772 under which capital gains and losses would be netted at the partnership level but capital loss flow-through would be denied. If the result of netting were a net capital gain, that amount would be flowed-through to individual partners in computing their taxable incomes; if the netting results in a net capital loss, however, it would be carried forward for offset against subsequent capital gains in the partnership and would have no current effect on the individual partners.

For most partnerships in general, the denial of capital loss flow-through may be acceptable because they have relatively few capital gain or loss transactions and would be largely unaffected by it. For commodity pools, however, the negative impact would be substantial since the bulk of income or loss produced by most commodity pools is capital gain or loss resulting from the trading activities.

Moreover, most taxpayers, including securities investment partnerships and regulated investment companies, can control the timing and amount of recognized capital gains and losses from trading stock and securities. In contrast, commodity pools cannot elect to defer recognition of capital gain or loss due to the mark-to-market rules of Section 1256. Capital loss realized by a commodity pool therefore reflects an actual economic loss in the entire investment. Investors

would be forced to liquidate their investments in the commodity pool in order to recognize the tax loss associated with their investment. This is especially likely since these partnership interests are acquired in part because the investments tend to run counter cyclical to returns on stocks and bonds. Further, commodity pools tend to have bad years interspersed with profitable years, which makes the failure to match one year's gains with another years's losses disturbing. Thus, an investor with a commodity pool loss and gain from other sources (stocks/bonds) in the same year would have his tax results distorted to his disadvantage by the proposed capital loss disallowance rule. The investor would be taxed on the gain but not be allowed to offset it by the commodity pool loss.

Especially affected would be small investors. Wealthy individuals who invest directly in commodities would be subject to the normal netting rules that appropriately permit gains and losses from different investments to be offset against each other and provide capital loss carryback relief with respect to mark-to-market items. By contrast, the middle-class investor in a commodity pool would be denied this ability to offset losses against gains.

Under the simplified reporting rules proposed in Title II, commodity pools are placed in an untenable position -- required to recognize and report net unrealized gain to each limited partner and at the same time prohibited from reporting recognized net capital losses to such partners. The MFA believes this situation is inappropriate and not the intention of the legislation.

The requirement that commodity partnerships defer reporting of net capital losses to limited partners is inconsistent with the mark-to-market regime which does not permit gains to be deferred until they can be matched with losses. Congress has recognized that fairness requires that taxpayers be afforded the right to offset gains and losses produced under that regime to the maximum extent possible. This intent is clearly demonstrated in Section 1212(c) which provides a special carryback rule for offsetting current mark-to-market losses against earlier mark-to-market gains.

Additionally, the MFA urges that the proposed audit rules for large partnerships be modified in the case of commodity pools. Unlike other large partnerships, commodity pools may decrease significantly in the number of investors and in size of investment over a relatively brief period. At present, there is no mechanism that would allow the remaining investors to seek a contribution from those investors who had previously redeemed their units. Therefore, the proposed method for the collection of deficiencies from current partners could be particularly harsh. In the case of commodity pools, we believe that the current system of adjusting the tax liability of partners for the year in which a deficiency arises continues to be the proper method for the collection of any additional taxes.

The tax items generated by commodity pools are already very simple. The Form K-1 provided to each of the limited partners generally contains only three items: (1) Interest, (2) Short Term Gain or Loss, and (3) Long Term Gain or Loss. An additional item reporting gain or loss form certain foreign currency transactions may also be provided. Commodity pools are not subject to the passive loss rules under Section 469 and are provided with simplified rules for reporting foreign currency transactions under Section 988.

In developing this bill, a special rule has been provided for certain partnerships holding oil and gas properties. Because of the special tax rules applicable to the income and expenses of such partnerships, it was determined that the simplified reporting provisions should only apply on an elective basis. Likewise, since a major portion of the income of commodity pools consists of capital gains or losses subject to the mark-to-market rules of Section 1256 rather than the very different types of income realized through other large partnerships, separate treatment under the proposed simplified reporting regime is warranted.

The MFA urges that new Section 776 be modified to provide that the term "large partnership" does not include a partnership, a principle activity of which is the buying and selling of commodities (not held as inventory), options, futures, or forwards with respect to commodities.

We would be pleased to meet with you and your staff to discuss this matter in greater detail and supply any additional information you may require. Thank you for your consideration.

Sincerely,

William E. Seale, Ph.D.
Director
Government Relations

Statement of the National Association of Bond Lawyers

Mr. Chairman, thank you for the opportunity to testify before the Committee. My comments are submitted on behalf of the National Association of Bond Lawyers regarding certain provisions of the Tax Simplification Act of 1991 (S. 1394, H.R. 2777) and H.R. 2775 containing additional tax simplification proposals. I am Richard Chirls, President of the Association and a partner at the law firm of Orrick, Herrington & Sutcliffe. The National Association of Bond Lawyers consists of approximately 2,800 lawyers who practice the law of public finance in all 50 states, the District of Columbia and Puerto Rico. The Association's members represent state and local governments that issue debt obligations subject to the restrictions of sections 103 and 141 through 150 of the Internal Revenue Code of 1986. Accordingly, our comments address the tax-exempt bond provisions of the proposed legislation.

Overview

The Association applauds the efforts by the Committee to provide meaningful simplification of the tax law and thanks Chairmen Rostenkowski and Rangel for their personal interest and commitment to tax law simplification. In his remarks introducing the legislation, Chairman Rostenkowski stated that "the Ways and Means Committee and Congress have a responsibility to pursue meaningful simplification." We believe that the need for simplification should not be underestimated. In our view, the tax simplification legislation continues a recent, positive trend in Congress toward recognizing the difficult restrictions imposed on state and local governments. There are few, if any, areas of the Code where simplification is needed more than the tax-exempt bond area, both because of the degree of complexity and, more importantly, because of who the beneficiaries of such simplification are--state and local governments and their taxpayers. We appreciate that Chairman Rostenkowski has already supported and enacted meaningful simplification in the bond area by passing the two-year expenditure exception to the rebate requirement.

Nevertheless, we believe that the tax-exempt bond provisions of S. 1394/H.R. 2777 and H.R. 2775, in several respects, reflect a lost opportunity to pursue meaningful simplification. As Chairman Rostenkowski has stated, "simplification does not create headlines," and we fear that if this simplification effort does not address many of the problems of state and local governments, those problems may not be addressed for a long time. Given the degree of complexity of the Code's tax-exempt bond provisions and the extent to which these limitations provide overlapping restrictions, we hoped for greater simplification in an area that has been widely identified and criticized as placing substantial administrative and financial burdens on state and local governments with little or no furtherance of federal tax policy. Another problem is that the technical explanations accompanying the bills appear to be based, in certain respects, on a lack of understanding of the actual procedures and financial considerations relating to the issuance of tax-exempt bonds with which issuers are faced. Finally, certain of the provisions of the bills seem to be based on a misunderstanding

of current law and, rather than simplifying the law, those provisions may further complicate the law and potentially create a problem where none existed.

While we recognize the constraints under which tax legislation is being considered this year, the Association is particularly disheartened by the narrowness of the tax-exempt bond provisions of these simplification proposals given the breadth of the suggestions made to the Ways and Means Committee. On June 18, 1990, the Committee on Ways and Means released a report entitled "Written Proposals on Tax Simplification" which included recommendations by the staff of the Ways and Means Committee and the staff of the Joint Committee on Taxation. The simplification recommendations set forth in that Report have generally been recognized by the public finance community, issuers and lawyers alike, as being thoughtful and helpful proposals that would significantly address many of the unnecessary complexities of the Code. Congressman Anthony and Senator Baucus have also introduced tax simplification legislation relating to tax-exempt bonds (H.R. 710 and S. 913, respectively) which have been the subject of very favorable testimony, comment, and support by municipal bond issuers. On April 20, 1990, the National Association of Bond Lawyers also submitted to the Committee on Ways and Means suggestions for the simplification of the tax-exempt bond provisions of the Code (copy attached).

The Association recognizes that not everything that is on someone's "wish list" can be accomplished and that the impact on federal revenues of tax law changes must be considered. Chairman Rostenkowski set out explicit criteria for inclusion of provisions in the simplification package, and we believe that the suggestions made to the Ways and Means Committee fall within his criteria of protecting the stability of the tax system while not being violative of the Budget Agreement. We hold out the hope that you will consider the recommendations described below during this legislative session so that state and local governments, already swamped by the effect of reduced revenues due to the recession, massive cuts by the federal government and the increased need for services as a result of the recession, can be freed of some of the burdens created by the current state of the tax laws.

Specific Comments on S. 1394 and H.R. 2777

1. **Issues Under Continuing Review.** The technical explanation accompanying this bill states that it is expected that Congress will continue to review as the subject of possible legislative projects two areas: (i) rules for use by governmental units maintaining commingled accounting practices for arbitrage rebate purposes and (ii) possible alternate penalties to the loss of tax-exemption for tax law violations.

It is very discouraging to find that Congress will merely be continuing the study of rebate accounting rules for commingled accounts and that the current legislative proposals do not address this problem when nearly five years have passed and the Treasury Department has not provided guidance in this area. We understand that the Treasury Department expects to issue regulations on this subject in the very near future and we hope that it is this factor which has led to continuing study rather than the inclusion in the bill of substantive rules.

We also hope that, as part of this process, the Treasury Department and the Ways and Means Committee will consider the legislative proposal for simplified accounting rules prepared by the Government Finance Officers Association (assisted by members of the National Association of Bond Lawyers) and submitted to the Ways and Means Committee in September 1990

(copy attached). In addition to setting forth proposed rules, this submission emphasized the need for prompt guidance in this area. Now that we are nearing the five-year anniversary of the Tax Reform Act of 1986, many state and local government issuers soon must deal with the practical realities of rebate for the first time. The GFOA proposal for simplified accounting rules would permit issuers of bonds (other than private activity bonds) to use any "reasonable, consistently applied accounting method" to determine rebate. This proposal recognizes that governmental issuers employ a wide variety of accounting methods to deal with the receipt, expenditure and investment of bond proceeds and is intended to allow issuers to continue to rely on existing practices, including existing methods of accounting for proceeds that are commingled with other amounts, and investments acquired with commingled amounts.

We have no desire to see a delay in the publication of regulations on simplified accounting or for Congress to become involved in matters that are more properly dealt with by regulation and with respect to which the Treasury Department has dedicated substantial amounts of time. We do hope, however, that the Treasury Department will follow the previously expressed directives of Congress that Treasury promptly promulgate rebate regulations that are workable and understandable, and that the continuing review of these matters means that the Ways and Means Committee wishes to make sure that any such rules are promulgated expeditiously and follow its directives and are in keeping with the spirit of the simplification legislation. On the other hand, we also hope that the announcement of this study will not delay or derail the continuing efforts by the Treasury.

In connection with the proposal to continue to study an alternative tax penalty system, regardless of the outcome of such a study, we wish to reiterate the long-standing position of the National Association of Bond Lawyers supporting evenhanded and vigorous enforcement of existing federal tax laws relating to state and local government finance and urging prompt adoption of clear, understandable and unambiguous amplifying regulations. The Association has urged Congress to appropriate sufficient funds to the Internal Revenue Service for such purposes.

2. **Simplification of Arbitrage Rebate Requirement for Governmental Bonds Regarding the $100,000 Limit on Unspent Proceeds Under the Six-Month Exception.** The tax simplification legislation contains several provisions aimed at easing compliance with the arbitrage rebate requirement of the Code, a requirement that is extremely burdensome to issuers. Of all the restrictions imposed on issuers of tax-exempt bonds since 1984, none has proven more burdensome than the arbitrage rebate requirement. The Association recognizes that, prior to 1986, there were occasions on which bonds were issued in large part to earn arbitrage and that, in order to prevent continued abuse, some response was required. The most effective responses were the enactment of narrowly targeted provisions aimed at specific abuses, such as Code section 149(d), eliminating abusive refunding transactions, and sections 148(c)(2) and 149(f), limiting pooled financings. In retrospect, imposition of the arbitrage rebate requirement was more severe than required. We believe that in attempting to eliminate any residual opportunities for arbitrage motivated financings, the cost of compliance with the arbitrage rebate requirement outweighs the marginal federal benefit. After enactment of the effectively targeted responses to abuse, most of the remaining arbitrage opportunities could be eliminated with less administrative cost by vigorous enforcement of the Code by the IRS and the prompt promulgation of Treasury regulations. We believe that placing this burden on state and local governments is excessive and inappropriate and that

insufficient attention has been paid to the cost imposed on these municipalities. For these reasons, we continue to support additional exceptions to the rebate requirement and the expansion of existing exceptions.

The repeal of the $100,000 limit on proceeds that may remain unspent after six months for certain governmental and qualified 501(c)(3) bonds otherwise exempt from the rebate requirement under the six-month exception rule will provide some relief for issuers who choose to avail themselves of this exception. Clearly, for such issuers, the administrative complexity of calculating rebate liability on $100,000 of proceeds outweighs any opportunity for arbitrage abuse from eliminating the rebate requirement. The requirement of spending ninety-five percent of the proceeds within six months after issuance, and the remainder within one year, provides ample limitation on the opportunities for arbitrage profit. The Association supports this provision of the bill.

3. **Simplification of Compliance with 24-Month Arbitrage Exception Regarding Exemption for Earnings on Bond Proceeds Invested in Bona Fide Debt Service Funds.** Although the Association supports this provision of the bill, we believe that more can be done. While this proposal obviously improves the 24-month construction bond expenditure exception, the addition of a third exception to rebate for bona fide debt service funds is not genuine simplification. Moreover, where a bond issue is bifurcated for purposes of the 24-month rule, this provision will necessitate complicated allocations.

The short-term nature of investments in bona fide debt service funds results in very limited potential for generating arbitrage profits. In fact, more often than not, including these funds in the rebate computation lowers the rebate amount owed by an issuer. In light of this, the simplest approach would be to exempt all earnings in a bona fide debt service fund from rebate in all cases. The complexity of calculating rebate liability on such small amounts outweighs the other federal policy concerns advanced by the rebate requirement.

4. **Automatic Extension of Initial Temporary Period for Certain Construction Bonds.** We believe this proposal misses an opportunity to address the real burden and problem created by the current law. The Association strongly believes that the appropriate simplification solution is to eliminate any arbitrage yield restrictions with respect to bond proceeds (other than advance refunding bond proceeds) which are subject to the arbitrage rebate requirement or the alternative penalty for certain construction issues. Even if adopted, this provision is another example of simplicity through complexity; that is, the elimination of the application of one restriction only if several new tests (in addition to the tests under existing law) are satisfied.

It appears that this proposal in S. 1394/H.R. 2777 is based on a misunderstanding of the economics of tax-exempt financing. The technical explanation accompanying the bill states as follows: "Notwithstanding the arbitrage rebate requirement, requiring yield restriction following initial temporary periods is an important factor in curbing earlier issuance of bonds than otherwise would occur." We believe that this simply is not correct, and, more importantly, that this statement appears to serve as a justification for not providing greater simplification. There is no reason to accelerate an issue of bonds to earn arbitrage profits where those profits will be expropriated in full by the federal government. On the other hand, there are many reasons to delay a financing until the money is needed (e.g., reducing negative carrying costs, qualification for exceptions to the rebate requirement). The yield restriction requirement together with the temporary

period rules did not adequately prevent early issuance during the many years prior to the 1986 tax law changes, especially when coupled with a lack of enforcement. Yield restriction does not supplement the effectiveness of the rebate requirement, it only adds to the difficulty of tax law compliance.

Accordingly, as long as the arbitrage rebate requirement applies, yield restriction furthers no federal purpose but merely creates difficult and unnecessary financial and administrative burdens and costs for issuers of tax-exempt bonds. The present proposal does not solve a problem; rather, it merely perpetuates the problem in a slightly different form.

If Congress is unwilling to eliminate entirely the yield restriction requirements where the rebate requirement also applies, as proposed by Congressman Anthony and others in H.R. 710, we recommend that there be included as a provision of H.R. 2777 a rule recognizing that it should be sufficient to justify continued investment at an unrestricted yield if an issuer expected to spend its funds in accordance with the temporary period requirements as long as the issuer must still rebate or pay a penalty. It is unclear what is gained by requiring that issuers yield restrict at the end of the temporary period. In fact, given the limitations of the Treasury's state and local government securities ("SLGS") program, yield restricting an ongoing construction fund without taking other actions that the Treasury Department finds objectionable (e.g., so-called "yield-burning" transactions) is costly to local governments and practically impossible.

5. **Simultaneous Issuance of Certain Discrete Issues Not Aggregated.** The Association objects to this proposal because it may create a new problem by attempting to address a problem that, in fact, does not exist.

The problem with this provision of the bill appears to stem from an inaccurate characterization of existing law. The technical explanation accompanying the bill states that, under present law, multiple issues of bonds are treated as a single issue if: (i) paid from substantially the same source of funds, (ii) issued within a relatively short period of time, and (iii) issued pursuant to a common plan of marketing. The bill provides that tax and revenue anticipation notes ("TRANs") and another governmental bond would not be treated as a single issue under this rule.

Under existing law, an issue of TRANs and an issue of other governmental bonds are not treated as a single issue. The technical explanation of the bill has not properly set forth current law. Treasury Regulation section 1.103-13(b)(10) provides that one of the required elements of the definition of a single issue is that the obligations be issued pursuant to a common plan of financing -- not a common plan of marketing, as stated in the technical explanation. This regulation has been widely interpreted and applied to the effect that TRANs, which finance temporary working capital shortfalls of state and local governments, and other bonds financing the cost of long-lived capital assets, are not issued pursuant to a common plan of financing. There has never been any indication to the contrary from the IRS. Accordingly, such issues are not a single issue under current law as implied by this provision.

This provision of the bill, by attempting to solve a nonexistent problem with a provision having a prospective effective date, creates a cloud for numerous existing and pending financings that have been based upon the analysis of the existing law as correctly set forth above, rather than as inaccurately described in the technical explanation of the bill.

In addition, the explanation of the bill, in its misguided attempt to benefit issuers, has created more uncertainty. In order for separate obligations to be part of a single issue, the obligations must be issued at "substantially the same time." The IRS has issued a number of private rulings to the effect that bonds issued more than 30 days apart are not issued at "substantially the same time," while the Treasury regulations provide that bonds issued within 7 days of each other are issued at "substantially the same time." For obligations issued more than 7 days apart but less than 31 days apart, it has been an open question whether such obligations are part of a single issue. For no apparent reason and without elaboration, the technical explanation of the bill attempts to set 31 days as a bright line test for this requirement. We are aware that the IRS is working on a new definition of the term "issue" and we believe that it is more appropriate to allow the IRS to complete those efforts without Congressional intervention through comments in legislative reports. In addition to throwing a cloud on existing and pending financings, this provision may also restrict the IRS in its ongoing attempt to create a uniform and more workable definition of the term "issue."

Specific Comments on H.R. 2775

1. **Repeal of Unrelated and Disproportionate Use Limit.** The Association supports this provision of the bill. Elimination of this unnecessarily complicated test is welcome. This requirement has been difficult for issuers and the IRS to understand and apply. Given that current law provides three other tests for determining whether to classify a bond as governmental or private-activity (including the very restrictive 10 percent private use test), its repeal will not subvert the federal policy of limiting private involvement in tax-exempt financing.

2. **Simplification of Arbitrage Rebate Requirement for Small Issuers: Increase of the Small Issuer Rebate Exception from $5 to $10 million.** This provision is the single most important and effective simplification initiative contained in either of the two bills. Issuers will not be forced to consider any of the other rebate areas that require simplification if they are eligible for this rebate exception. This increase is important both for consistency with the bank deductibility provision and because the needs of local government continue to expand and inflation continues to drive their costs higher and higher. This is genuine relief from the burdens of rebate compliance and we express our strong support for the Chairman for including this provision in the bill.

3. **Repeal of 150% of Debt Service Limit.** The Association supports this provision of the bill. As discussed above and further below, we recommend the elimination of all yield restriction rules in light of the restrictions already imposed by the arbitrage rebate requirement.

4. **Election to Terminate Most Post-Initial Temporary Period Rebate Liability for Certain Bonds.** This provision of the bill is properly based on the premise that the yield restriction and rebate requirements are duplicative and, therefore, unnecessary. However, the provision takes the wrong approach to simplification by eliminating the rebate requirement in very limited circumstances, while perpetuating the yield restriction requirement and adding significantly to the complexity of the applicable tax provisions through election procedures and complicated timing requirements. Furthermore, the provision only provides the illusion of simplification in that, for the most part, issuers can obtain all of the benefits of this rule under current law.

The technical explanation to the bill is incorrect in its stated premise that familiarity with the yield restriction requirement by bond issuers makes compliance with that requirement easier than the rebate requirement. Yield restriction is generally extremely difficult for issuers to comply with and is likely to lead to abuse (through non-market price investments) or ignoring the law. The short temporary periods for mortgage revenue bonds, student loan bonds and pooled transactions are particularly troublesome for issuers. An analysis of any variable rate bond financing will readily show that compliance with yield restriction is much more difficult than the rebate requirement.

As stated previously, the proper approach to simplification is to eliminate the yield restriction requirement for bonds that are subject to rebate.

OTHER TAX SIMPLIFICATION SUGGESTIONS

Despite their omission from the bills, the continued importance of the following suggestions, as well as their relationship to the simplification provisions which are being advanced, merit their inclusion in the bills if meaningful progress is to be made towards easing the burdens imposed on state and local governments.

1. **Permit Issuers to Retain Small Amounts of Arbitrage.** In H.R. 710, Congressman Anthony has proposed that issuers subject to rebate be permitted to retain a relatively small percentage of the arbitrage earned. We believe that this suggestion should be adopted for several reasons. First, for many years, the Treasury Department has been concerned with the investment of bond proceeds in non-arm's-length transactions. This concern has led to the issuance of the market price rules which, in many instances, has led to investment practices with respect to investment contracts that the Treasury views as objectionable. In fact, these practices result from a lack of the ability or the incentive to make market rate investments that comply with the yield restriction requirement or that enable the issuer to avoid earning rebatable arbitrage. The failure by the Treasury to respond to Congress' legislative directives to make the SLGS program more workable also contributes to the difficulties that issuers have in complying with the current law rebate requirement.

Second, as we have already stated, the cost imposed on state and local governments in complying with the rebate requirement is significant. There have, in fact, been published reports of instances where these costs far exceeded the amount of rebate owed. Although the Treasury Department allows issuers a credit against the rebate that is intended to compensate issuers for their compliance costs, this $3,000 credit is wholly inadequate. Allowing issuers to retain a small percentage of the arbitrage would alleviate this situation. It should be remembered that the rebate requirement was intended to prevent issuers from issuing bonds in order to make large profits. It was never intended that issuers should have to expend large amounts of money to comply with these requirements.

Allowing issuers to keep a percentage of their arbitrage earnings would solve both of these problems. Issuers would be better able to cover the costs of complying with rebate. At the same time, issuers would, once again, be investing their own money at least partially for their own benefit. An issuer would have every incentive to invest in an arm's-length manner since, if it failed to do so, it would be throwing away its own money. If the issuer chose to invest in another manner, such as in a low-yield savings account or a checking account, no concern would be raised about the issuer's motivations since it

would be giving up not just the federal government's earnings, but its own.

Finally, we strongly believe that allowing issuers to retain even some amount of arbitrage profit will increase the degree of compliance with rebate and thereby enhance, rather than detract from, federal revenues through more effective implementation of the rebate rules.

We recommend, however, that before adopting this proposal, Congress carefully consider the appropriate percentage of arbitrage that issuers be permitted to retain. Allowing ten percent of the arbitrage to be retained, as some have suggested, may not be sufficient to achieve the above mentioned goals, especially for small issues or in an interest rate environment like the present where issuers are generally unable to earn any arbitrage. It is important to strike the correct balance between the interests and incentives of state and local governments on the one hand and the federal government on the other.

2. **SLGS Program.** Given the continued complexity of complying with the arbitrage rebate requirement and the application of yield restrictions, the need for more flexibility in the SLGS program remains apparent. The demand deposit SLGS program needs to be modified to fully implement Congress' existing directive that the SLGS program allow more flexible investment of bond proceeds in a manner eliminating the need for rebating arbitrage profits on tax-exempt bonds. Recommended changes should include the offering of variable rate demand deposits, with the option of specifying a cap on the interest rate, next-day settlement arrangements, and the option to invest all or just a portion of the proceeds of an issue in demand deposit SLGS. Expansion of the zero percent SLGS program to permit issuers to invest any bond proceeds in such securities without limitation, is also recommended as a means of simplifying both yield restriction and rebate compliance for many issuers and reducing the incidence of market price violations and "yield burning" transactions.

Congress has, in prior legislation, directed that the Treasury Department make these types of changes to the SLGS program, to little effect. Mandating changes to the SLGS program would appear to benefit the simplification process both by providing real simplification and by increasing the use of the SLGS program, thus enabling the Treasury to borrow greater amounts at less expensive tax-exempt rates from state and local governments. If the Treasury Department cannot make the SLGS program work effectively, Congress should not be encouraging yield restriction in lieu of rebate.

3. **Replacement of the Two-Year Rebate Exception With a Safe Harbor Rule for Long-Term Fixed Debt.** We wish to repeat our April 1990 recommendation that the two-year rebate exception be replaced with a safe harbor rule for long-term, fixed rate debt. Such an approach would benefit more issuers than the current two-year rebate exception and would greatly simplify the compliance burden on state and local government borrowers, without providing opportunities for abusive arbitrage transactions.

The goal should be to establish a simple safe harbor rule that defines when an issuer of long-term, fixed-rate debt is not deemed to have earned arbitrage subject to the rebate requirement. Permitting an issuer to easily determine at the time of issuance that no substantial arbitrage profit is to be earned will eliminate the substantial tracking, allocation and calculation costs associated with complying with the rebate requirement.

4. **Delete the General Taxing Power Requirement for the Small Issuer Exception to Rebate.** We recommend that the small governmental issuer exception to rebate be amended by deleting the provision that requires that an issuer possess "general taxing power" in order to be eligible for this exception. This would make this exception more parallel to the bank deductibility provisions of section 265 of the Code. It would also eliminate the current distinction in the treatment of different types of governmental issuers (for example, between bonds for water and sewers often issued by special districts without taxing powers and bonds for schools).

5. **Elimination of Restrictions on Private Activity Bonds.** Like the arbitrage restrictions, the history of the enactment of restrictions on private activity bonds is that prior to 1986 a number of individual restrictions were adopted which generally either attempted to prevent private activity bonds being used for undesirable projects (e.g., restaurants, to buy land) or to channel private activity bonds toward federally approved purposes (e.g., acquiring used property only where there is substantial rehabilitation). Then in 1986, the most significant and all-encompassing restriction was adopted: the subjecting of virtually all private activity bonds to a state-by-state volume cap.

In the past, we and others have urged that, given the volume cap, most of the other limitations on private activity bonds are unnecessary. We continue to be of this view, but we recognize that Congress may not be ready to adopt this approach on a wholesale basis. However, given the effectiveness of the volume cap, there are a number of limitations that can be removed, including the limitation on acquiring land, the limitation on acquiring existing facilities, certain of the requirements applicable to specific exempt facilities (e.g., the two-county rule applicable to the local furnishing of electricity, the limits on office space applicable to governmentally owned airports, docks and wharves) and the public approval requirement, all of which complicate the ability of issuers to pursue private activity bond projects in a cost-effective manner. Our suggestion is that Congress let the cities and states which allocate the volume cap use their judgment as to whether it is more effective to use their limited volume cap for the acquisition of an existing facility or to build a new one.

6. **Other Proposals.** In the Association's April, 1990 tax simplification submission, we made a number of other suggestions for simplification. We continue to believe that each of those suggestions would provide additional simplification without creating the potential for significant abuse. In addition, there are other proposals in the Report prepared by the staff of the Ways & Means Committee and the Joint Committee on Taxation that merit further consideration.

We urge the Committee to consider that state and local governments are bearing enormous costs as the result of federally mandated requirements. Paying significant amounts of money to lawyers, accountants, financial advisors and rebate analysts in order to avoid running afoul of arbitrage and other tax law restrictions is not a good use of the limited resources of state and local governments and, as the Treasury Department has regularly testified, makes the tax-exemption less efficient. The projects that must be financed could be built more quickly and at a reduced cost if Congress would reconsider the approach that it has used in increasing the complexity of tax-exempt financing and, instead, focus on means of increasing the IRS' enforcement actions and encouraging the productive investment of public funds in infrastructure to promote competitiveness. The tax simplification process is an excellent opportunity to remove some of the layers of overlapping requirements and make tax-exempt financing more efficient.

N · A · W

Mary T. Tavenner
Senior Director-Government Relations

September 24, 1991

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
SD-205 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

In conjunction with your recent hearings on S. 1394, the Tax Simplification Act of 1991, I would like to submit the following comments on behalf of the National Association of Wholesaler-Distributors (NAW).

NAW is a federation of 113 national wholesale distribution trade associations, 54 state and regional trade associations and 2,000 individual wholesale distribution firms, representing over 40,000 companies nationwide. (A list of NAW member associations is attached.)

Over one year ago, the Chairman of the House Ways and Means Committee requested comments from the public on ways to simplify the Tax Code. After surveying our members, NAW submitted its "top three" simplification proposals on April 20, 1990.

We are pleased that two out of NAW's three proposals are addressed in S. 1394, namely simplification of the Uniform Capitalization Rules and Depreciation under the Corporate Alternative Minimum Tax. Additionally, we commend you for including changes in Subchapter S rules, which has been of major concern to our members.

The following are our comments on S. 1394 as its provisions apply to those three major issues.

As you know, S. 1394 authorizes, but does not require, the issuance of Treasury regulations for a simplified method of applying uniform cost capitalization rules. Although NAW strongly supported the Tax Reform Act of 1986, we actively opposed this particular provision. During Senate consideration of the 1988 Tax Technical Corrections Act we received some modification of the rules as they apply to the allocation ratio for storage and handling costs,but the Uniform Cost Capitalization rules continue to be an administrative burden for our members. At the very least, NAW urges the Committee to require the Treasury Department to issue simplification regulations.

The depreciation calculations under the corporate Alternative Minimum Tax have also presented an unnecessary burden to wholesaler-distributors. Under current law, taxpayers are generally required to use the 150 percent declining balance depreciation method over the ADR life of property. In computing adjusted current earnings (ACE), corporate taxpayers are generally required to compute the ACE depreciation deduction using the straight-line method over the ADR life. Thus, almost all of our members must attempt the AMT

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calculations regardless of whether they are actually subject to the AMT. This requirement has forced wholesaler-distributors and others to maintain depreciation records under two, and sometimes three, systems. Your bill's simplification of the current system by requiring taxpayers to use the 120 percent declining balance depreciation method in computing both the AMT and ACE depreciation deductions is, in our view, a very positive step forward.

Finally, your bill's clarification of the one-class-of-stock requirement of Subchapter S corporations is also a positive step forward. As you know, the Treasury Department's proposed regulations on Subchapter S rules were unacceptable and eventually replaced with another proposal. Although we are pleased with your efforts to clarify these rules, NAW hopes that the Committee will further specify the requirements for and circumstances under which the one-class-of-stock rule applies. This will not only provide guidance for future Treasury regulations, but will provide relief for thousands of legitimate S corporations.

Thank you for this opportunity to comment on your legislation. NAW looks forward to working with the Committee as the process moves forward.

Sincerely,

Mary T. Tavenner
Senior Director-Government Relations

STATEMENT OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES

The National Conference of State Legislatures (NCSL) commends the committee for addressing the issue of pension simplification. Simplifying the tax code with regard to public and private pensions will assist both employers and employees to better comply with the laws governing their benefit plans. Specifically, NCSL supports the inclusion of clarifying language regarding the application of Section 415 of the Internal Revenue Code to state and local government benefit plans.

During the past five years, Congress has attempted to define the application of Section 415 to public pension plans through the 1986 Tax Reform Act and the 1988 Technical and Miscellaneous Revenue Act. These efforts, however, have either failed to recognize the unique characteristics of public plans or have been constructed in such a way that implementation would pose an economic burden on public employees. In far too many cases, Congress has not realized the inherent difficulties in applying pension-related tax provisions, which are designed to address abuses in the private sector, to public plans. Section 415 is an example of applying limits that work in the private sector but do not work in the public sector.

Section 415 places limits on the amount of pension benefits that an individual can receive annually in both public and private qualified retirement plans. A public qualified plan is a pension plan that complies with the requirements of Section 401(a), is eligible for favorable tax treatment, and is exempt from certain qualification requirements that are applicable to private sector plans.

The 1986 Tax Reform Act limited the annual benefit that can be paid by public qualified defined benefit plans to the lesser of $90,000 or 100 percent of an employee's average compensation based on a three-year final average pay. The $90,000 limitation is increased annually based on a cost of living adjustment. The limit for 1991 is $108,963. For qualified defined contribution plans, the limit is the lesser of $30,000 or 25 percent of the pay limit. The Tax Reform Act also provided special rules for police and firefighters who are qualified participants. These rules state that pension benefits cannot be reduced to less than $50,000 a year regardless of retirement age.

By not adjusting for these limits, state benefits that previously satisfied Section 415 limits may exceed the new limits. This will cause the plan to violate Section 415 and to cease being a qualified benefit. Disqualification means that the earnings on a pension plan's assets would lose their tax-exempt status. In addition, each plan participant's vested interest in such assets would lose its tax-deferred status, and would have to be taken into the participant's income in one lump sum in the year in which the plan was disqualified.

A grandfather rule was added to the tax code for government plans in order to prevent the taxation of certain benefits that could exceed the new limits. The Tech-

nical and Miscellaneous Revenue Act of 1988 added Section 415(b)(10) which provides that the limitation, for all participants before January 1, 1990, will not be less than their accrued benefits under the plan. Thus, the benefits for such participants will not violate Section 415 even if they exceed the adjusted dollar limitation or the compensation limitation.

In order to qualify for this grandfather provision, a government employer must apply the private sector rules of Section 415 to employees hired after December 31, 1989. These new employees will have their benefits limited by Section 415, including the private sector early retirement adjustments which are lower than the limits presently available for the public sector. Unfortunately, the grandfather provision did not solve the problem of exceeding the 415 limits and it created additional complications for employees and employers. Many public sector employees tend to be longer-tenured and lower-salaried than their private sector counterparts. Because public plan benefit formulas reward such service, the consequence can be a pension benefit that can exceed 100 percent of the individual's final three year average compensation. Furthermore, many employers were reluctant to adopt the grandfather provision because this two-tiered system would allow discrimination against newly hired employees.

NCSL believes the best way to resolve these issues would be to again amend Section 415 to assist states in complying with the law. S. 1364 provides for simplification and clarification of Section 415. The bill includes the following provisions which will facilitate state and local government compliance with Section 415.

Establish a Uniform Definition of Compensation—this change will establish parity between state and local government compensation definitions and the federal compensation definition used to determine retirement benefits by allowing deferrals, such as 457 plans, to be included in compensation for Section 415 testing purposes.

Exempt Governmental Plans from the 100 Percent Test of Compensation — this exemption will assist lower-paid, long-term employees that exceed 100 percent of final pay at retirement due to step-rate formulas or after retirement due to benefit increases that exceed the cost-of-living index.

Exempt Survivor and Disability Benefits—this inclusion is necessary because unlike the private sector, state and local governments typically provide these benefits through the retirement system thereby making them subject to the Section 415 limits. Under Section 415, benefits must be actuarially reduced from age 62 to the present age of the beneficiary at the time of injury or death. In the case of younger workers or their survivors, the resulting benefit allowed under Section 415 is often considerably below the amount authorized under the public plan.

Authorize Excess Plans—this provision allows state and local governments to establish excess plans, which are used in the private sector, to pay amounts in "excess" of the dollar limits. These plans will enable public plans to pay the benefits guaranteed under the plan without violating Section 415. Plans that decide to fund these plans would be required to tax vested participants on a current basis for future benefits.

NCSL applauds the Senate Finance Committee in its efforts to simplify pension provisions in the tax code. Within any final pension simplification legislation, we hope the committee will include language from S. 1364 which clarifies the requirements of Section 415 for state and local government benefit plans.

Statement of the National Council of Farmer Cooperatives

Introduction

The National Council of Farmer Cooperatives is a nationwide association of cooperative businesses which are owned and controlled by farmers. Its membership includes over 100 agricultural marketing, supply and credit cooperatives, plus 32 state councils. National Council members handle practically every type of agricultural commodity produced in the U.S., market these commodities domestically and around the world, and furnish production supplies and credit to their farmer members and patrons. The National Council represents about 90 percent of the nearly 5,100 local farmer cooperatives in the nation, with a combined membership of nearly 2 million farmers.

Overview

In recent years, there have been an increasing number of disputes between farmer cooperatives and the Internal Revenue Service over the proper Federal income tax treatment of gain or loss resulting from the sale of assets used by cooperatives in their patronage operations. The issue in controversy is whether gains or losses from such dispositions should be considered to be derived from "patronage" or "nonpatronage" sources. This distinction is important because gain from patronage sources is eligible to be distributed to patrons as a patronage dividend which is deductible to a cooperative (and taxable to the patron). Nonpatronage sourced income is taxable to a nonexempt agricultural cooperative whether or not it is distributed to the farmer patrons.

Over the years, agricultural cooperatives have taken different approaches toward the classification of gain or loss from the sale of assets used in the patronage operation. Some cooperatives, relying on a general standard that has been adopted by both the IRS and the courts, have treated this gain or loss as patronage sourced on the ground that the assets sold were "directly related to" or "actually facilitated" the marketing, purchasing, or service activities of the cooperative. Other cooperatives have treated gain or loss from the sale of assets used in the patronage operation as nonpatronage sourced in reliance on an example in Treasury Regulation Section 1.1382-3(c)(2) and the IRS's administrative position that capital gain (or gain treated as capital gain under section 1231) is automatically nonpatronage sourced.

Recent court decisions have consistently applied a "directly related/actually facilitates" test in distinguishing between patronage and nonpatronage income, finding in one case that gain from the disposition of a capital asset used in the patronage operation was "directly related" to the patronage operation and thus patronage sourced. Notwithstanding these decisions, the IRS has continued to assert deficiencies in such cases based on its administrative position or an overly narrow interpretation of the "directly related/actually facilitates" standard.

S.1522 is intended to put an end to this controversy and avoid continuing audit disputes and court proceedings that are burdensome for farmer cooperatives and consume U.S. tax dollars in enforcement activity.

Problems With Existing Law

Generally speaking, a cooperative is a corporation which is required, under its governing corporate documents or by contract, to return its net earnings from patronage sources to its members

and other participating patrons on an annual basis. Farmer cooperatives market the production of agricultural producers or purchase supplies and equipment for producers to use in their businesses (e.g., feed, fertilizer, petroleum products).

For federal income tax purposes, so-called "non-exempt cooperatives" are allowed to deduct patronage dividend distributions under subchapter T of the Internal Revenue Code and are thus treated as a "conduit" with respect to patronage operations and earnings. The result of such treatment is that patronage earnings paid out or allocated to members and other participating patrons as "patronage dividends" are not taxed at the cooperative level (but are taxable to the patrons).

Section 1388(a) of the Code provides that patronage dividends can be paid only out of cooperative net earnings "from business done with or for its patrons." If a non-exempt cooperative has patronage earnings which are not paid out, or which it is not obligated to pay out, as patronage dividends, it is taxable on such earnings at applicable corporate rates. It similarly is taxable with respect to income from nonpatronage sources.

The term "net earnings from business done with or for its patrons" (i.e., "patronage sourced income") is not defined in the Code. However, the converse term -- "income from sources other than patronage" (i.e., "nonpatronage income") -- is defined by Treasury regulation as follows:

> "[I]ncome 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. Section 1.1382-3(c)(2) (emphasis added).]

This regulation applies specifically to "exempt" cooperatives, which are described in section 521 of the Code and are permitted to deduct distributions from patronage and nonpatronage sources. Nevertheless, the courts and the IRS considered this regulation in developing the basic test for a nonexempt cooperative.

Under the basic test, if the source of the income in question is directly related to or actually facilitates the marketing, purchasing, or service activities of the cooperative, the income is patronage sourced. In a 1969 revenue ruling involving a non-exempt cooperative, the IRS stated the basic test for distinguishing between patronage and nonpatronage income as follows:

> The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income of the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources. [Rev. Rul 69-576, 1969-2 C.B. 166 (emphasis added).]

The courts have consistently applied this basic test, and in particular factual contexts, items of income in the nature of interest, dividends, rentals and capital gains -- i.e., the "examples" of nonpatronage income items listed in Reg. Section 1.1382-3(c)(2) -- have all been held to constitute patronage sourced income. See, e.g., Illinois Grain Corp. v. Comm'r, 87 T.C. 435 (1986) (interest); Cotter & Co. v. United States, 765 F.2d 1102 (Fed. Cir. 1985) (interest; rent); St. Louis Bank for Cooperatives v. United States, 624 F.2d 1041 (Ct. Cl. 1980) (interest; section 1231 asset); Astoria Plywood Corp. v. United States, 79-1 USTC Para. 9197 (D. Ore. 1979) (capital gain); Linnton Plywood Assoc. v. United States, 410 F. Supp. 1100 (D. Ore. 1976) (dividend). Thus, the courts have not viewed any of the "examples" in Reg. Section 1.1382-3(c)(2) as automatically requiring nonpatronage treatment for the types of income items therein described.

Nonpatronage Treatment of Gain on Sale of Assets Used in Patronage Operation. The IRS has taken the position that, with the exception of depreciation recapture income, gain on the sale of a capital asset (or gain treated as gain from the sale of a capital asset under section 1231) is nonpatronage sourced based on Regulation Section 1.1382-3(c)(2). See Rev. Rul 74-160, 1974-1 C.B. 245; Rev. Rul. 74-84, 1974-1 C.B. 244. This position reflects a literal reading of the regulation and has been followed by a number of cooperatives in reporting sales of non-inventory assets. There are practical non-tax reasons why these cooperatives have adopted and need to continue this practice. The proceeds from sales of non-inventory assets are often reinvested in replacement assets with expectation of indefinite retention in the business. In other cases, such proceeds are retained in the business as an important source of equity capital which is used to reduce indebtedness. Allocating gains to patrons in such a case may create an expectation of redemption inconsistent with the need to retain the proceeds in the business. To these cooperatives, the treatment of the gains as nonpatronage income and payment of tax by the cooperative is consistent with the intent to retain the after-tax proceeds in order to continue the operation of the business.

Patronage Treatment of Gain on Sale of Assets Used in Patronage Operation. Other cooperatives have viewed gain on the sale of assets used in the patronage operation as distributable or allocable to members and other participating patrons based on the court decisions applying the basic test (in particular, Astoria Plywood and St. Louis Bank) and Rev. Rul. 69-576.

Many of these cooperatives customarily pay out only a portion of their patronage refunds in cash, issuing "notices of allocation" to patrons for up to 80 percent of the total patronage refund distribution. The non-cash portion is retained by the cooperative to finance capital expansion or for working capital. However, these allocations cannot be viewed as permanent capital since they are subject to a reasonable expectation of redemption on the part of the patrons. Sales of non-inventory assets provide additional internal funds for these cooperatives, but they generally are required by their governing instrument as well as long-standing custom and practice to treat such sales as patronage sourced.

Apart from its inflexible reliance on the nonpatronage examples in the Treasury regulation, the IRS otherwise tends to take an overly restrictive view of the factors to be considered in determining whether a particular item of income meets the "directly related/actually facilitates" test. In this regard, it often focuses on the particular "transaction" or type of "transaction" that gave rise to the income in question rather than on all facts and circumstances that demonstrate the historical relationship between the source of the income or loss to the overall conduct of the cooperative's patronage business.

The controversies that continue to surface in this area are especially troublesome because of the fact that cooperatives are required by subchapter T of the Code to make patronage dividend distributions within 8-1/2 months of the close of the taxable year. Even though the cooperative may pay a patronage dividend based on a good faith determination of its patronage sourced income under the "actually facilitates" test, an examining IRS agent may attempt to recharacterize part of the income as non-patronage sourced and to tax the cooperative accordingly. If the agent ultimately prevails, the nonpatronage income thus created cannot be offset by the "excess" patronage dividend paid; and no part of that dividend can be recouped by the cooperative in order to fund payment of the increased tax liability. Even where the cooperative ultimately does prevail, the financial and other costs of contesting and perhaps having to litigate the issue can become extremely burdensome.

Explanation of S.1522

S. 1522 would provide cooperatives with a mechanism for avoiding the serious administrative uncertainties that continue to exist in connection with the determination of whether gain or loss from the disposition of cooperative assets should be classified as patronage or nonpatronage sourced. Specifically, cooperatives would be able to elect patronage sourced treatment for gain or loss from the sale or other disposition of any asset, provided that the asset in question "was used by the organization to facilitate the conduct of business done with or for patrons." This approach comes directly from the test used by the IRS and the courts for distinguishing between patronage and nonpatronage sourced income generally. As the IRS stated in Rev. Rul 69-576:

> [t]he classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. [Emphasis added].

Thus, in the case of an electing cooperative, the IRS could not deny patronage sourced treatment solely on the basis that the asset in question was held, or treated, as a capital asset for federal income tax purposes. The question of whether an asset is a "capital asset" would not be an issue.

For example, under the election the entire gain on the sale of a depreciable "section 1231 asset" that had been used to facilitate the conduct of patronage activities -- including any gain over and above depreciation recapture -- would qualify as patronage income. Furthermore, the proposed statutory language makes clear that gain from a sale of stock or securities held by an electing cooperative might also qualify as patronage income. That result could follow, for example, where a cooperative sells the stock of a controlled subsidiary corporation the operations and activities of which related and contributed to the cooperative's overall conduct of business with or for the benefit of its member-patrons. In such a case, it is contemplated that the factual determination of whether the subsidiary's stock "was used... to facilitate the conduct of business done with or for patrons" would be made with reference to the totality of all facts and circumstances relevant to the historical relationship between the cooperative and the subsidiary -- and not solely with reference to the stock sale transaction itself, viewed in isolation.

In general, gain or loss treated as patronage sourced pursuant to the statutory election would be characterized for all purposes of the Internal Revenue Code as ordinary income or loss, notwithstanding the fact that the asset disposed of might otherwise constitute or be treated as a capital asset. Thus, if the amount of patronage income eligible for payment or allocation as a patronage dividend was to exceed for any reason the patronage dividend ultimately paid or allocated for the applicable period, the excess would be taxable at the cooperative level at whatever ordinary corporate rates might then be in effect. Moreover, qualifying patronage sourced losses would fully offset qualifying patronage income items irrespective of the nature or character of the assets from which such income or losses were derived -- i.e., the use of such losses against current or future income would not be subject to the capital loss deductibility or carryover limitations of the Code.

S.1522 would not affect the treatment of nonpatronage sourced capital gains and losses (e.g., from sales of portfolio securities), which are not subject to the special rules governing patronage sourced income. These items would continue to be taxable at the cooperative level as under existing law.

Where an asset has been used for both patronage and nonpatronage purposes, the election to treat gain or loss from the sale of that asset as patronage sourced applies only to the amount of the gain or loss allocable to the patronage use. A cooperative may use any reasonable method for making allocations of income or expenses between patronage and nonpatronage operations.

The statutory election would be available generally with respect to taxable years beginning after 1990 and, unless revoked by the cooperative, for all taxable years subsequent to the first taxable year for which the election is made. However, an election which is made with respect to a taxable year beginning before 1992 would, if the election so provided, apply also to prior taxable years of the electing cooperative. Any such retroactive election could not be selective -- i.e., it would have to apply to all prior years or to none, as well as to all asset dispositions within a particular year.

An electing cooperative could at any time revoke its election effective for taxable years beginning after the date on which the revocation notice was duly filed with the IRS. Upon revoking an election, however, the cooperative would have to wait at least three (3) taxable years before making another election. It is contemplated that procedural rules relating to the content and filing of revocation notices would be provided by Treasury regulation.

Non-electing cooperatives (including cooperatives which have revoked a prior election) would continue to determine the patronage v. nonpatronage classification of income or loss from asset dispositions as they have under existing law. H.R. 2361/ S.1522 expressly provides that no inference could be drawn therefrom regarding the proper application of existing law to non-electing cooperatives in particular factual contexts. Existing law similarly would apply with respect to prior years of cooperatives in particular factual contexts. Existing law similarly would apply with respect to prior years of cooperatives that make the election for a taxable year beginning before 1992, but which choose not to have such election apply retroactively.

Compelling Reasons For
Proposed Legislative Relief

S.1522 represents a reasonable approach toward resolving a very significant problem for the cooperative industry. Given the fundamental role of the patronage v. nonpatronage determination in

the scheme of cooperative taxation, it is essential that cooperatives be able to know with reasonable certainty the tax consequences of the disposition of assets used in the patronage operation. This simply has not been the case under the conflicting interpretations that now exist.

The electivity feature of S.1522 will permit cooperatives to gain assurance that the "actually facilitates" test will govern their determination of patronage sourced gain or loss from the disposition of any asset. In order not to disturb legitimate industry practices, cooperatives that wish to continue relying on the capital gain example in the Treasury regulation will be able to do so by not making an election, as will electing cooperatives whose mode of operations or other business circumstances might change. The proposed 3-year waiting period for re-elections should provide an adequate safeguard against potentially abusive situations.

The retroactivity feature of the election is essential to protect from IRS challenge good-faith determinations of patronage income that cooperatives have made as a basis for paying patronage dividends to member-patrons for which the cooperative is unable to require repayment. This determination is the cornerstone of the special "conduit/single tax" regime to which non-exempt cooperatives and their member-patrons are subject. The absence of consistent administrative guidance on such a fundamental issue is both unfortunate and unfair. If a cooperative can demonstrate that assets disposed of in earlier tax years satisfied the factual criteria of the "actually facilitates" test, it should be spared the threat of double taxation and the very significant costs and uncertainties attendant to prolonged disputes with the IRS.

The ultimate losers in these disputes, of course, are the millions of American farmers who belong to cooperatives. Their livelihoods and ability to operate effectively are inextricably linked to the unique role that cooperatives play in helping to serve the enormous agricultural demands of the country. The proposed legislation will remove a major impediment that cooperatives now face in carrying out this important role. It will do so, moreover, without in any way frustrating the Government's legitimate interest in assuring that the statutory tax benefits enjoyed by cooperatives are not abused. In that regard, it is important to keep in mind that cooperatives will not be relieved from having to establish, on a factual level, a clear "facilitative" relationship between the historical use of the assets sold and the conduct of the cooperative's activities with or for the benefit of its member-patrons. Thus, in appropriate cases the IRS could, and no doubt would, continue to challenge patronage sourced income determinations believed to be erroneous.

Conclusion

Legislation is needed to clarify the tax treatment of gains and losses on the sale of assets by farmer cooperatives, eliminate existing uncertainty, and better target the limited resources of the IRS. S.1522 will provide such relief in a fair and reasonable manner, and will enable the farmer cooperatives of this nation to continue their critical work more effectively. For these reasons, we strongly support S.1522 and urge its enactment.

STATEMENT OF THE NATIONAL EMPLOYEE BENEFITS INSTITUTE

INTRODUCTION

The National Employee Benefits Institute ("NEBI") is an organization composed of Fortune 1000 companies. NEBI members have a great interest in the proposed pension simplification bill introduced by Senator Bentsen. NEBI is aware of the difficulty in drafting legislation to reduce the complex regulatory and administrative burdens on employers who sponsor private pension plans and commends Senator Bentsen for his efforts. However, NEBI, like many other organizations, is concerned with several provisions of Senator Bentsen's proposed bill.

NEBI is pleased that the Senate Finance Subcommittee on Taxation is permitting organizations to submit written statements regarding Senator Bentsen's pension simplification bill. Following are NEBI's written comments regarding the proposed pension simplification bill.

I. PROPOSALS WHICH NEBI SUPPORTS.

NEBI generally favors the following proposals contained in the bill:

- NEBI supports Senator Bentsen's proposal regarding the historically performed test for leased employees.
- NEBI favors extending IRA rollover eligibility by simplifying the tax rules to encourage employees to roll over distributions to IRAs.
- NEBI supports the proposal simplifying the definition of highly compensated employee to include those who are 5% owners or who receive compensation in excess of $50,000 (as adjusted for cost of living).
- NEBI favors amending the full funding limitation to allow better funding of pension plans.
- NEBI supports continuing the current preferential treatment of net unrealized appreciation on employer stock.
- NEBI favors supplementing the current ADP test with safe harbors.
- NEBI favors rounding amounts adjusted yearly for cost of living changes to the nearest $1,000 (or to $100 in the case of 401(k) elective deferrals and elective contributions to SEPs).

II. ELIMINATION OF FIVE-YEAR AVERAGING.

A. Proposed Legislation. Currently, lump sum distributions from qualified plans are eligible for five-year averaging. The bill introduced by Senator Bentsen would repeal five-year averaging for lump sum distributions.

B. Position. NEBI objects to the elimination of five-year averaging. Instead NEBI recommends preserving five-year averaging for all employees. At the very least, participants with current account balances should be permitted to use five-year averaging with respect to those balances. Alternatively, the use of five-year averaging could be limited to distributions that occur after early retirement age.

C. Discussion. Many employees have accumulated funds in retirement plans for years with the expectation that the distributions would be eligible for five-year averaging. These employees will not have the benefit of the averaging rule. By eliminating five-year averaging, the Bentsen proposal may encourage employees to remove funds from retirement plans now before the repeal of the five-year averaging takes effect.

III. TRUSTEE TO TRUSTEE TRANSFERS.

A. Proposed Legislation. The Bentsen bill would require that distributions from a pension plan be transferred to an IRA or a qualified plan. The plan trustee would be required to notify employees of the requirements of the transfer rules and of the amount of any transfer. The participant would be given the opportunity to designate the transferee plan and the trustee would honor, if practical.

B. Position. NEBI supports permitting participants to roll over their plan benefits to an IRA or qualified plan. However, NEBI objects to requiring plans to accept direct trustee-to-trustee transfers from other employers' plans. Rollovers to IRAs should be sufficient.

C. Discussion. NEBI believes that employers presently have more than enough administrative responsibilities regarding pension plans and this provision would add to those responsibilities. If acceptance of transfers is mandated, the recipient plan should not be required to distribute benefits in the forms allowed by the transferring plan.

IV. LARGE EMPLOYERS SHOULD ALSO BENEFIT FROM PENSION SIMPLIFICATION LEGISLATION.

A. Proposed Legislation. A major purpose behind the pension simplification bills is to expand the number of employees covered by retirement plans, especially employees of small businesses. Senator Bentsen's bill introduces a proposal which would increase the use of simplified employee pensions by small businesses.

B. Position. NEBI believes Congress should encourage small businesses to provide retirement arrangements. However, NEBI believes that pension rules should be simplified for all employers, both large and small.

C. Discussion. The new rules regarding SARSEPS would introduce new complications and complexities because different rules or different types of benefit programs would apply to small employers that currently would not apply to large employers. In addition, one of the goals of pension simplification legislation is to preserve retirement savings by improving pension portability. However, SARSEPS would, presumably, allow employees to withdraw funds from their accounts at any time. The ability of employees to withdraw funds at any time does not appear to further the goal of the pension simplification legislation. Rather, it appears to permit employees to use SARSEPS as savings vehicles. NEBI asserts that larger employers are not on equal footing with smaller employers if large employers may offer only retirement-oriented pension plans and small employers may offer either retirement-oriented plans or savings-oriented SARSEPS.

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	CURRENT LAW	ROSTENKOWSKI	CHANDLER	"POWER"	CARDIN-HOUSE BENTSEN/PRYOR-SENATE	NEBI'S POSITION
ELIMINATION OF FIVE-YEAR AVERAGING	Lump sum distributions from qualified plans are eligible for special five-year averaging or, in certain circumstances, ten-year averaging. Also, a portion of the distribution may qualify for capital gains treatment.	Repeals five-year averaging and ten-year averaging after 1992 for lump sum distributions. Also, repeals favorable capital gains treatment.	Repeals five-year averaging of lump sum distributions effective January 1, 1997. Preserves grandfather provision for ten-year averaging.	Repeals five-year averaging, ten-year averaging and favorable capital gains treatment for lump-sum distributions that are not rolled over into another retirement account.	Repeals five-year averaging for lump-sum distributions.	NEBI recommends preserving five-year, ten-year averaging and capital gains treatment for all employees.
ELIMINATION OF UNREALIZED APPRECIATION OF EMPLOYER STOCK	When a distribution from a qualified plan includes securities of the employer, the recipient may exclude from gross income the amount attributable to the net unrealized appreciation.	Repeals exclusion for net unrealized appreciation and treats the distribution of employer securities the same as other distributions.	Continues the current preferential treatment of net unrealized appreciation.	Repeals exclusion for net unrealized appreciation and treats the distribution of employer securities the same as other distributions.	Continues the current preferential treatment of net unrealized appreciation.	NEBI objects to repealing the exclusion for net unrealized appreciation.
SIMPLIFICATION OF ADP TESTS UNDER 401(k) PLANS	Under a 401(k) plan, a special nondiscrimination test (the ADP test) applies to elective deferrals to ensure that the tax benefits of 401(k) plans are not used disproportionately by highly compensated employees. The ADP test is applied at year-end and there are two alternative tests. In applying the tests, the highly compensated employee limits apply to the average of the group of highly compensated employees' contributions.	Replaces the present two alternative ADP tests with a single test that is applied at the beginning of the plan year. Each highly compensated employee could defer up to 200% of ADP of non-highly compensated employees for preceding year. ADP restriction would apply separately to each highly compensated employee, not to the highly compensated employees as a group.	Would provide for the use of safe harbors as in Cardin/Pryor/Bentsen. Also, would allow plans that do not have step-rate matching contributions to meet safe harbors.	Addresses the need to make 401(k) plans easier to administer, but does not present specific methods.	Supplements the ADP test with safe harbors. Could disregard ADP test if plan designed in accordance with the safe harbor. First safe harbor satisfied if plan provides that non-highly compensated employees receive at least a 100% matching contribution on elective deferrals up to 3% contribution, and at least a 50% match on elective deferrals of 3% to 5% of compensation. Second safe harbor is satisfied if the plan provides a non-elective employer contribution of at least 3% of compensation.	NEBI supports allowing employers to use one or more of the proposals as an alternative to the current rules. However, NEBI objects to limiting each employee to a percentage of the average deferrals by nonhighly compensated employees.

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	CURRENT LAW	ROSTENKOWSKI	CHANDLER	"POWER"	CARDIN-HOUSE BENTSEN/PRYOR-SENATE	NEBI'S POSITION
MINIMUM PARTICIPATION REQUIREMENTS UNDER CODE SECTION 401(a)(26)	A retirement plan is not qualified unless it benefits at least 50 employees, or, if less, 40% of all employees of the employer.	Does not address this issue.	Lowers 50-employee requirement to 25 for defined benefit plans. Requires that employers with two employees cover both.	Does not address this issue.	Lowers 50-employee requirement to 25 for defined benefit plans. Requires that employers with two employees cover both.	Repeal Code section 401(a)(26). Alternatively, reduce the requirement to 25 for all plans.
SEPARATE LINE OF BUSINESS ("SLOB")	Employers who maintain two or more separate lines of business, with substantially separate employees, locations, assets and management may elect to satisfy various qualification rules separately for plans maintained for employees of respective lines of business.	Does not address this issue.	An employer would no longer need to test each plan on an employer-wide basis under the reasonable classification test. Rules for allocating headquarter employees to SLOBS would also be revised. Also, an employer would be allowed to aggregate union and nonunion employees covered under same plan in nondiscrimination testing.	Does not address this issue.	Does not address this issue.	NEBI supports proposals in Rep. Chandler's bill.
EMPLOYEE LEASING	An individual who historically performs services for another party may be treated as an employee of the recipient for various pension and employee benefit purposes.	Replaces historically performed test with a control test. Under the historically performed test, a person could be considered a leased employee if it is not unusual for the recipient organization to have an employee working in the same position as the leased employee. Under the proposal, an individual would not be considered a leased employee unless the services were performed under any significant direction or control of the service recipient.	Replaces historically performed test with a control test. Would apply the change retroactively to 1984 (the adoption of the leased employee rules).	Does not address this issue.	Replaces historically performed test with a control test. Would apply the change retroactively to 1984 (the adoption of the leased employee rules).	NEBI supports all proposals with regard to leased employees, particularly the explanation accompanying Rep. Rostenkowski's bill and the statutory language of Rep. Chandler's and Cardin/Bentsen/Pryor's bill.

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	CURRENT LAW	ROSTENKOWSKI	CHANDLER	"POWER"	CARDIN-HOUSE BENTSEN/PRYOR-SENATE	NEBI'S POSITION
TRUSTEE-TO-TRUSTEE TRANSFERS	A qualified plan may, but is not required to, permit participants to elect to have a distribution transferred directly from the trustee of one qualified plan to the trustee of another qualified plan.	Requires the trustee of a qualified plan to provide the participant with written notice that before making a distribution eligible for a rollover, the participant could direct the trustee to transfer the distribution directly to a specified eligible transferee plan.	Would not require direct transfers.	Like Rep. Rostenkowski's bill, provides a mechanism for employees to direct the trustee to transfer funds directly to an IRA or a new employer's plan.	Requires distributions from the plan be made as a direct transfer to another plan or an IRA. Exceptions would include distributions after age 55, death benefits payable to a beneficiary other than a surviving spouse, and hardship distributions. Participant would be given the opportunity to designate the transferee plan and trustee would honor if practical.	NEBI objects to requiring plan to accept direct trustee-to-trustee transfers from other employers' plans. Rollovers to IRAs should be sufficient. If acceptance of transfers is mandated, the recipient plan should not be required to distribute benefits in the forms allowed by the transferring plan.
DEFINITION OF HIGHLY COMPENSATED EMPLOYEES	An employee is treated as a highly compensated employee if he or she (during the current or previous year) (1) is a 5% owner, (2) receives more than $90,893 (as indexed) in annual compensation, (3) receives more than $60,535 (as indexed) in annual compensation and is one of the top-paid 20% of employees, or (4) is an officer of the employer receiving more than $54,482 (as indexed) in annual compensation.	Highly Compensated Employee is one who is a 5% owner during the current or previous year, who has earned $65,000 the previous year (as indexed), or earned $65,000 in the current year and one of the 100 most highly compensated employees. If no employee is highly compensated, the highest paid employee is considered highly compensated.	Redefines definition of highly compensated employees similar to Cardin/Bentsen/Pryor.	Does not address this issue.	Highly compensated employee is one who is a 5% owner during current or previous year and who has earned compensation in excess of $60,535 (for 1991 as indexed) in the previous year. If no employee is highly compensated, the highest paid officer is considered highly compensated.	NEBI supports simplifying the definition of highly compensated employee.
ELIMINATION OF HALF-YEAR REQUIREMENTS	A number of rules, primarily related to distributions from retirement plans, are based on the attainment of age 59-1/2 or age 70-1/2	The bill changes age 70-1/2 to age 70 and age 59-1/2 to age 59.	Does not address this issue.	Does not address this issue.	The bill changes age 70-1/2 to age 70 and age 59-1/2 to age 59.	NEBI does not object.

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	CURRENT LAW	ROSTENKOWSKI	CHANDLER	"POWER"	CARDIN-HOUSE BENTSEN/PRYOR-SENATE	NEBI'S POSITION
ROLLOVERS	There are a number of rules which restrict the ability to make a rollover. The distribution must qualify as either a total distribution of the entire amount credited or as a partial distribution. A partial distribution may be rolled over only to an IRA and not to another qualified plan or annuity.	Extends rollover eligibility to any distribution to an employee or employee's surviving spouse into an IRA or other qualified retirement plan or annuity, with three exceptions. These exceptions are (1) minimum required distributions (at age 70½), (2) employee contributions, and (3) distributions that are part of a stream of annuity payments.	Extends rollover eligibility to any portion of a retirement distribution as long as accomplished within 60 days from the date of the distribution.	Will allow employers to directly transfer a departing employee's distributions into a new employer's retirement plan or IRA by simplifying the tax rules. As yet, the proposal does not specify how the tax rules would be simplified.	Extend rollover eligibility to any distribution with two exceptions. These exceptions are (1) after-tax employee contributions, or (2) minimum required distributions (at age 70½).	NEBI favors extending IRA rollover eligibility by simplifying the tax rules to encourage employees to roll over distributions to IRAs.
SMALL BUSINESS PLANS	Currently, the election to have amounts contributed under a SARSEP is available only if at least 50% of the employees so elect, and only if the employer maintaining the plan had 25 or fewer employees at all times during the prior taxable year. Elective deferrals are limited to $8,475 (as indexed) and subject to nondiscrimination testing under the ADP test. The ADP test limits the percentage of compensation which can be contributed by highly compensated employees to 125% of the average percentage of compensation deferred by other, non-highly compensated employees.	Increases to 100 the number of allowable participants in a small business plan. -Plan would satisfy nondiscrimination rules if the employer makes contributions of an amount equal to at least 3% of each eligible employee's annual compensation (up to $100,000). The minimum contribution would be 5% if the employer maintained another qualified plan within last two years. Eligible employees would be allowed to defer up to $5,000 each year. The employer could match deferral up to 50%.	-Increases to 100 the number of allowable participants in a SARSEP. -Plan would satisfy nondiscrimination rules if employer provides 100% match for the first 3% of compensation deferred or a 50% match for the first 6% of compensation deferred.	-Increases to 100 the number of allowable participants in a small business plan. -Plan would satisfy nondiscrimination rules if employer contributes at least 2% of compensation. Allows elective deferrals of up to $4,238 (as indexed), and permits employers to match 50% of the elective deferrals. -The requirement under current law that 50% of employees elect to participate in a SARSEP would not apply.	-Increases to 100 the number of allowable participants in a SARSEP. -Plan would consider the nondiscrimination requirement as satisfied if the plan met the safe-harbors established for 401(k) and 401(m) plans. Eligibility requirement simplified to include all employees with at least one year of service. -The requirement that 50% of employees elect to participate would not apply.	NEBI believes Congress should encourage small businesses to provide retirement arrangements. However, NEBI believes that pension rules should be simplified for all employers, both large and small. Special rules create new complexities.

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	CURRENT LAW	ROSTENKOWSKI	CHANDLER	"POWER"	CARDIN-HOUSE BENTSEN/PRYOR-SENATE	NEBI'S POSITION
FULL FUNDING	Employers who sponsor defined benefit plans may be subject to certain limitations (full funding limitations) applicable to deductible contributions.	Allows certain employers to elect to disregard the 150% of current liability limitation and direct IRS to provide a means for other plans to adjust their full funding limitations. An electing plan cannot be top-heavy, and at least 90% of the plan's accrued liability must be for active participants.	Would eliminate the 150% of current liability restriction for multiemployer plans.	Does not address this issue.	Would eliminate the 150% of current liability restriction for multiemployer plans.	NEBI favors amending the full funding limitation to allow better funding of pension plans.
NORMAL RETIREMENT AGE	Normal retirement age is defined by reference to age 65.	Replaces age 65 with the social security retirement age for purposes of the commencement of benefits.	Not changed.	Not changed.	Not changed.	NEBI does not view changing the age to social security retirement age as necessary to simplification.
MULTIEMPLOYER PLAN VESTING	Multiemployer plans may provide that benefits for an individual covered by the plan under a collective bargaining agreement will be fully vested after ten years of service rather than five.	Eliminates special ten-year vesting schedule currently allowed for multiemployer plans. Multiemployer plans must adopt same vesting schedules as all other qualified plans.	Does not address this issue.	Eliminates special ten-year vesting schedule currently allowed for multiemployer plans. Multiemployer plans must adopt same vesting schedules as all other qualified plans.	Does not address this issue.	NEBI does not object.
COST OF LIVING ADJUSTMENTS	Various dollar amounts are adjusted each year to reflect increases in the cost of living. Adjusted numbers are effective each January based upon the previous year's inflation.	Adjusted amount rounded to nearest $1,000, except amounts related to 401(k) elective deferrals and elective contributions to SEPs adjusted to nearest $100. Would base annual adjustments on the changes to applicable index as of calendar quarter ending September 30 of preceding year.	Would base annual adjustments on the changes to applicable index as of calendar quarter ending September 30 of preceding year.	Does not address this issue.	Adjusted amount rounded to nearest $1,000, except amounts related to 401(k) elective deferrals and elective contributions to SEPs adjusted to nearest $100. Would base annual adjustments on the changes to applicable index as of calendar quarter ending September 30 of preceding year.	NEBI favors this change.

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	CURRENT LAW	ROSTENKOWSKI	CHANDLER	"POWER"	CARDIN-HOUSE BENTSEN/PRYOR-SENATE	NEBI'S POSITION
TAX-EXEMPT 401(k) PLAN	Tax-exempt organizations and state and local governments cannot sponsor 401(k) plans but can sponsor 403(b) and 457 plans.	Would allow state and local governments to adopt 401(k) plans in 1995. Would allow tax-exempt organizations to adopt 401(k) plans.	Would not allow state and local governments and non-profit entities to adopt 401(k) plans.	Would allow state and local governments to adopt 401(k) plans. Would allow tax-exempt organizations to adopt 401(k) plans.	Would not allow state and local governments to adopt 401(k) plans. Would allow tax-exempt organizations to adopt 401(k).	NEBI has no objection to extending 401(k) plans to state and local governments and tax-exempt employers.
VEBA	Unrelated employers engaged in same line of business in the same geographic locale may establish voluntary employees' beneficiary association.	Does not address this issue.	Does not address this issue.	Does not address this issue.	Unrelated employers may establish common voluntary employees' beneficiary association, if in same line of business, or act jointly on tasks integral to their activities.	NEBI does not object.
AGGREGATION RULES FOR KEOGH PLAN CONTRIBUTIONS	Plans maintained by owner-employees are subject to special aggregation rules where the owner-employee also controls another unincorporated trade or business.	Does not address this issue.	Eliminate the specific aggregation rules that apply to plans maintained by owner-employers, which do not apply to other qualified plans.	Does not address this issue.	Eliminate the specific aggregation rules that apply to plans maintained by owner-employers, which do not apply to other qualified plans.	NEBI does not object.
DISTRIBUTIONS FROM RURAL COOPERATIVES	A 401(k) plan may permit distributions upon hardship or attaining age 59-1/2. However, a rural cooperative money purchase pension plan which contains a cash or deferral arrangement may not allow withdrawals upon hardship or attaining age 59-1/2.	Allow 401(k) plans maintained by rural cooperatives to make distributions to participants who have attained age 59.	Allow 401(k) plans maintained by rural cooperatives to make distributions to participants who have attained age 59.	Does not address this issue.	Allow 401(k) plans maintained by rural cooperatives to make distributions to participants who have attained age 59.	NEBI does not object.

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	CURRENT LAW	ROSTENKOWSKI	CHANDLER	"POWER"	CARDIN-HOUSE BENTSEN/PRYOR-SENATE	NEBI'S POSITION
MASTER AND PROTOTYPE PLANS	Under the IRS master and prototype program, trade and professional associations, banks and other financial institutions may obtain IRS approval of model plan documents and make those pre-approved plans available for adoption by employers.	Authorizes IRS to prescribe duties for sponsors of master prototype plans, and require timely communication to employers of amendments and other notices that may be required. Employers who adopt these plans would also have to be informed of the need to arrange for appropriate administrative services to manage the day-to-day affairs of the plan.	Does not address this issue.	Enhances the IRS Master and Prototype Program, but does not provide details.	Does not address this issue.	NEBI does not object.

Statement of the National Rural Electric Cooperative Association

On behalf of the membership of the National Rural Electric Cooperative Association, we are pleased to have this opportunity to comment on a vital piece of the infrastructure puzzle, the ability to raise capital, as contained in the tax-exempt bond provisions of S. 1394.

NRECA is the national service organization of the nation's 1,000 not-for-profit, consumer-owned rural electric systems, which provide electric service to more than 25 million rural Americans in 46 states. Rural electric lines span some 75 percent of the nation's land mass. However, rural electric systems continue to operate under the same disadvantages that have traditionally existed in rural areas. Rural electric systems now serve an average of 5.2 consumers per mile of line compared with 32 customers per mile of line for investor-owned electric systems and 41 per mile for municipally-owned electric systems.

Further, rural electric systems serve relatively few commercial and industrial loads compared to other utilities. During the past year, only about one-third of rural electric power sales went to commercial and industrial consumers, compared to two-thirds for both municipal and investor-owned utilities. The relative lack of significant commercial load on co-op lines serves to decrease load factor and increase overall costs to the predominantly residential rural electric consumer-members.

NRECA applauds the judicious approach taken by these bills in eliminating overlapping and duplicative restrictions on tax-exempt bonds. Congress has instituted demanding requirements on how tax-exempt bonds are issued and the purposes for which the proceeds of such bonds are used. The proposals embedded in S. 1394 which would relax current restrictions on arbitrage proceeds of tax-exempt bonds are a cause of concern to our members. We do not believe that a public purpose is served when tax-exempt bonds and arbitrage proceeds are available for use in the <u>acquisition</u> of <u>existing</u> electric utility facilities such as poles, lines and meters and, therefore, consumers, by municipal electric systems.

Whenever a rural electric system loses consumers, power costs increase for the system's remaining consumer-owners. Rural electric systems simply have fewer ratepayers per mile of line over which to spread fixed costs than do investor-owned and municipal electric systems. Therefore, we are concerned that a relaxation of arbitrage rebate requirements will allow the use, by municipal electric systems, of arbitrage proceeds generated by tax exempt bonds to acquire electric utility facilities. The use of tax exempt bond proceeds or arbitrage proceeds to acquire existing facilities could exacerbate a difficult situation faced by this country's rural electric systems and lead to higher rates for rural consumers remaining with rural electric systems when the facilities of the most densely-populated or fastest-growing portions of a cooperative's service territory are acquired by municipal electric utilities. In addition, rural electric systems' ability to repay the federal debt that financed the original construction of the facilities would be jeopardized by the loss of the ability to serve such areas. Such actions amount to "cream skimming" and endanger the remaining "skim milk" territory.

Most of the 46 states in which rural electric systems operate have some kind of territorial integrity statute, usually administered by a state's public service commission. Those laws generally govern service territory boundaries between electric utilities covered by the statute, setting out the rules by which service territory is determined and what compensation is due for the taking of facilities. Unfortunately, in some states, municipal electric utilities, those that are owned and/or operated by municipal governments, are <u>not</u> subject to the provisions of state territorial integrity laws.

NRECA is not advocating a reduction in the municipal governments' power to annex territory for general government purposes. We fully realize that the power to annex is embedded in state law and that the power to issue tax exempt bonds to pay for some capital investments made by local governments is extremely important.

However, we do object to the use by municipal electric systems of federally tax-exempt bonds or arbitrage proceeds to acquire facilities already put in place by rural electric systems simply by using annexation and condemnation powers. Most often, such acquisition of facilities occurs where population and economic growth have crept out to what once were isolated rural areas. Population and economic growth have occurred in many rural areas precisely because the local rural electric system helped initiate and foster that growth through its involvement in rural economic development.

In some cases, territory served by rural electric systems, that was once rural or farmland, has slowly been converted into housing subdivisions. With the subdivisions come development and increasing numbers of people, all of whom want electricity. Most often, these residents take service from the local power provider, the rural electric system. These are the areas that for the past 50 years no utility -- except the rural electric cooperative -- was willing to serve.

When these areas reach a critical mass, the local town government sometimes annexes the territory to improve its tax base and extends municipal services. However, a few municipal governments which also provide electric service acquire by condemnation procedures the facilities of rural electric systems in those areas. This acquisition often occurs with less than advantageous terms of compensation for the rural electric systems because the municipal electric systems might not be governed by adequate state law or state public service commission rules. When a municipal electric system acquires rural electric facilities without providing just and reasonable compensation (determined either by state law or through litigation), it increases the burden shared by the remaining consumer-members of the rural electric system. Further, two-thirds of rural electric systems' load is residential in nature.

An important factor to consider in this discussion is where the capital comes from to build or acquire rural electric facilities. Most rural electric systems are permitted to borrow up to 70 percent of their outside credit needs (to provide poles, lines, meters and people) from the Rural Electrification Administration (REA) of the U.S. Department of Agriculture. However, only 33 percent of facilities added by rural electric systems in 1990 were funded by REA borrowings. The remainder was financed by internally generated funds or with privately obtained capital. Rural electric systems have borrowed from REA for over 50 years, and in that time, all but approximately $42,000 has been paid back.

The proceeds of tax exempt bonds which are used by municipal electric utilities to acquire rural electric facilities stem from securities issued by governments, the interest on which is not taxable by the Federal government. The federal tax exemption on such bonds allows them to be issued at a lower cost than other debt instruments because, while their return may be lower for investors, the investors do not pay taxes on those returns.

The federal government has a strong interest in seeing that money it lends is paid back. In the case of rural electric systems, the REA carefully oversees the loans it makes; however, the security of those loans is based on the rural electric systems' ability to continue providing service to consumers. If the facilities needed to provide that service are taken away without sufficient compensation, the federal investment is threatened.

Restrictions on arbitrage go a long way to keeping the playing field among electric utilities level by ensuring that tax-exempt bond proceeds, direct or arbitrage, are not invested to build up a "war chest" for the purpose of taking over electric utility facilities. After all, rural electric systems cannot obtain government financing in order to take over municipal facilities to improve their load factor. They are also prohibited from using REA loans to serve consumers already receiving service from another utility. Rural electric systems across the country wonder why similar rules do not already apply to municipal electric systems.

In conclusion, we ask that the committee thoroughly review the relaxation of arbitrage rebate restrictions embodied in Title IV of H.R. 2777 and Title II of H.R. 2775 and curb the ability of municipal electric systems to use arbitrage proceeds to acquire electric utility facilities. We would further recommend that the Committee consider limiting the ability of municipal electric systems to use the proceeds of tax-exempt bond issues to acquire rural electric system facilities, property and service territory without just compensation.

STATEMENT OF THE NATIONAL RURAL LETTER CARRIERS ASSOCIATION

Mr. Chairman and members of the committee, my name is William R. "Bill" Brown and I am the president of 80,000 member National Rural Letter Carriers' Association. Rural letter carriers daily drive 2.5 million miles to deliver mail on 47,000 rural routes to approximately 20.1 million rural American families. On behalf of our members we strongly support the efforts, particularly of Chairman Bentsen and Senator Packwood, of the Finance Committee, to simplify the country's tax laws.

As the budget deficit escalated over the last decade, your committee has been forced to meet revenue goals principally in relation to the budget deficit. We applaud the committee for now focusing on taxpayers and attempting to make some of the laws simpler for taxpayers' to deal with.

We have a particular interest in section 110 of your bill. That section, when enacted, will greatly ease and simplify the tax filing burden for vehicle expenses incurred by our members. Rural letter carriers are employees of the U.S. Postal Service who drive their own vehicle to deliver the mail. In 1990, rural letter carriers drove their own cars 780 million miles to collect and deliver mail to their patrons. Rural letter carriers' performance is unique in the Postal Service; we perform all of the services of a Post Office for our customers. We sell stamps, money orders, express mail supplies and collect parcels, thereby providing a connection to the outside world for people who live on rural routes.

Currently, the tax treatment of our vehicle expenses and of the reimbursements from the Postal Service is unnecessarily complicated. Rural carriers across the country wring their hands every April 15 to figure the rules out. Our national association has to figure out all of the possible ways that carriers could file. The NRLCA works out with our accountants how to fill out the necessary forms for each method of filing and we publish those detailed forms and instructions in our national magazine so that rural carriers who do their own taxes, as well as accountants and tax preparation services have a place for easy reference on how to fill out the tax forms.

Even when individual carriers do figure the rules out regarding the best technique to use for filing with each individual taxpayer, the current rules and statute produce uneven results by any measure. The basic problem is that the Postal Service has, for over 30 years, used a reimbursement system approved by Congress in 1958, that is based not only on the mileage we drive, but on the stops we make. The system is sensible: a carrier who drives, for example, 40 miles but has 500 stops incurs vehicle expenses equal to the carrier who drives a much greater distance but has fewer stops. The present reimbursement system provides that both the carrier who drives 40 miles, a relatively short distance, and the carrier who drives a greater distance with fewer stops should receive comparable expense reimbursements; by contrast the tax law and related regulations are written to recognize vehicle expenses related only to mileage or to a fixed period of time (ie: for such expenses as insurance and licenses).

A special provision was enacted in 1988 to authorize a 150% standard mileage deduction for rural letter carriers, in recognition of the expense of operating a vehicle over a rural mail route. However, the provision was drafted only in terms of mile-

age, so that the basic incompatibility between the tax law and the Postal Service reimbursement system remains. The incompatibility of the two systems means that rural carriers, unlike almost everyone else who receives a reimbursement for business expenses, cannot just treat the expenses and the reimbursement as a wash and not report them on the tax return.

When a normal business employee is reimbursed for travel expenses, that employee neither deducts the expenses nor reports the reimbursement as income and that employee does not have to fill out a single tax form for those expenses or the reimbursement. A majority of rural letter carriers, by contrast, do have to fill out tax forms, because the allowable tax deduction does not exactly match the amount of the reimbursement. For some carriers the reimbursement exceeds the deduction; for others, the deduction exceeds the reimbursement. The discrepancies are small for most carriers, but they do exist and they cause complexity in computation and filing. If the reimbursement exceeds the deduction, the excess must be reported on the Form 1040 as income. If the deductible expenses exceed the reimbursement then the carrier must fill out a form 2106, Employee Business Expenses, to be able to deduct the excess. Many carriers must keep detailed records to complete Form 2106.

Section 110 of the Tax Simplification Bill would end this complexity by treating the vehicle expenses and reimbursements of rural letter carriers as a wash. In other words, the provision would allow rural letter carriers to have a tax result comparable to that of any other employee who is reimbursed for business expenses. Rural letter carriers would no longer have to worry about reporting and paying taxes on excess reimbursements; and they would not have to deal with filing out forms for deducting excess expenses. They would simply complete a Form 1040.

We believe that Section 110 represents a giant step forward in simplifying the tax laws for our members. We fully support the provision and we fully support the bill in general. Again we applaud Chairman Bentsen and Senator Packwood and the other members of the committee for undertaking the simplification projects. We are prepared to assist the committee in any way we can in seeing that the bill moves through the Congress quickly, and we appreciate the opportunity to present our views.

STATEMENT OF THE ORYX ENERGY COMPANY

Oryx Energy Company ("Oryx") appears today before the U.S. Senate Finance Subcommittee on Taxation to express its opposition to certain provisions in the proposed Tax Simplification Act of 1991 (S. 1394/H.R. 2777) (the "Act") that affect large partnerships. Oryx is the Managing General Partner of Sun Energy Partners, Ltd., a Delaware master limited partnership ("Sun Energy"). Sun Energy is an oil and gas partnership which has approximately 13,000 public unitholders and therefore would be treated as a "large partnership" as that term is defined in the Act for purposes of the proposed audit rules. The Act would also permit Sun Energy to elect to be treated as a large partnership for purposes of the proposed reporting requirements. Act §§ 201-02, proposed I.R.C. §§ 776(a)(1),(b)(2),(c)(1)(a), 6255 (a)(1).

Oryx also appears before you today to propose an additional simplification measure related to the definition of an integrated oil company.

LARGE PARTNERSHIP REPORTING REQUIREMENTS

- ELECTIVE TREATMENT FOR OIL AND GAS PARTNERSHIPS (Act § 201)

The Act proposes several changes to the reporting requirements for large partnerships. Act § 201. However, large oil and gas partnerships, such as Sun Energy, are not included within the definition of "large partnership" unless they elect to be so treated. Id.; proposed I.R.C. § 776. Oryx supports this elective treatment. It is essential and should be preserved in the legislation in view of the many items that must be separately stated for oil and gas partnerships to comply with other provisions of the Code (e.g., intangible drilling and development costs and depletion). Requiring oil and gas partnerships to be subject to the proposed reporting requirements would not result in simplification because many partners would be "excluded partners" under the proposal, thus requiring different reporting for different partners. Removing the exclusion for certain partners from application of the reporting requirements would also be objectionable because it would require changes of substantive oil and gas tax law that would go far beyond simplification.

Oryx submits that one clarification should be made to the exclusion for oil and gas partnerships from the definition of "large partnership." Sun Energy, as a master limited partnership, does not directly hold oil and gas properties. Its properties are held indirectly through operating partnerships of which Sun Energy is the sole limited partner and Oryx or an Oryx affiliate is the sole general partner. In addition, oil and gas properties are often held by industry participants through joint ventures, partnerships, or tax partnerships. The Act should make it clear that the exclusion applies if 50 percent or more (by value) of the assets of the partnership (including assets held indirectly through other partnerships) are oil and gas properties.

- CONTRIBUTED PROPERTY RULE (Act § 201, Proposed I.R.C. § 774(b))

Oryx opposes the proposed reporting requirement that would treat the contribution of property to a large partnership as a deferred sale of the property because it would add needless complexity to an already complex area by creating a different method of treating pre-contribution gain for large partnerships. In addition, the proposal does not apply to the contribution of cash to an existing partnership. There is no apparent reason for this distinction. If a new partner contributes cash to an existing partnership, the rationale for the proposal would suggest that the partnership be given an increased basis in its property. Any gain would be taken into account by the old partners on a deferred basis in the same way as pre-contribution gain is taken into account by a property contributor under the proposal.

Perhaps the same result could be obtained in a simpler manner by retaining current provisions under section 704(c) and eliminating the ceiling rule.

LARGE PARTNERSHIP AUDIT PROPOSALS

- **MANDATORY CONSISTENCY REQUIREMENT FOR LARGE PARTNERSHIPS (Act § 202)**

Under current law, a partner may either report all partnership items consistently with the partnership return or notify the IRS of any inconsistency by filing Form 8082 with his tax return. S. Rep. No. 1394/H.R. Rep. No. 2777, 101st Cong., 1st Sess., Technical Explanation of the Bill at 27, reprinted in Standard Federal Tax Reports (CCH), Technical Explanation of the Bill at 27 (June 29, 1991) (hereinafter referred to as "Committee Explanation"). The Act proposes that a partner of a large partnership, as defined for audit purposes, be required to treat partnership items on its tax return consistently with the treatment of such items on the partnership's tax return, even if such partner has knowledge of an error in the partnership's return or in the information return (Form K-1) furnished to such partner. Act § 202, proposed I.R.C. § 6241(a).

Oryx opposes the proposed mandatory consistency requirement, particularly as applied to large oil and gas partnerships. The sole purpose of the consistency requirement is to permit matching of the items on the partnership's return to the items on the partners' returns. In the case of oil and gas partnerships, the proposed consistency requirement would not achieve the desired result. The Code permits, and in some cases requires, items attributable to oil and gas activities to be reported differently by a partnership and its partners. For example, an oil and gas partnership that does not elect to be treated as a large partnership for reporting purposes will separately state intangible drilling and development costs on its tax return. A partner that is an integrated oil company is permitted to deduct only 70% of the intangible drilling costs passed through to it. Other partners may elect to amortize intangible drilling and development costs over a 10-year period. I.R.C. § 59(e). In these situations, the deduction for intangible drilling and development costs as stated on the partnership's return would not match the deduction reported on the partners' returns. Furthermore, a partner's entitlement to depletion is reported at the partner level and is not even included on the partnership's return. Thus, the returns of the partnership and the partner would not match. Similar discrepancies may exist as a result of basis adjustments permitted under Section 743 of the Code and as a result of the passive loss limitation rules. Therefore, it can be expected that some partners would treat certain items differently than the partnership. A great deal of time and resources would be spent to reconcile inconsistencies that are mandated or permitted by law and yet very little revenue would be generated by such efforts.

Oryx also opposes this provision as applied to all large partnerships on fairness grounds. This provision would require a partner to choose between (i) filing an incorrect return if he knows that the reporting information he received from the partnership is erroneous or (ii) incurring a penalty for failure to file consistently with the partnership return. Errors on partnership returns are not uncommon and often occur due to late or inaccurate reports of changes in the ownership of partnership interests. Errors, of course, can occur for other reasons. Partners should not be forced to file consistently with the partnership return if they are aware of errors for whatever reason.

The current requirement that a partner notify the IRS of any inconsistency between its return and the partnership tax return is sufficient to monitor compliance and to ensure matching between the tax returns of a partnership and its partners to the greatest extent possible. Mandatory consistency would not be equitable or cost effective and is unnecessary.

- **AUDIT PROVISIONS FOR LARGE PARTNERSHIPS (Act § 202, Proposed I.R.C. §§ 6242 and 6255)**

Under current rules, the IRS must assess any deficiency arising from a partnership audit against the persons who were partners during the taxable year related to the adjustment. The Act proposes that an adjustment for partnership items be reflected on the partnership's tax return for the year in which the adjustment becomes final, rather than the year related to the adjustment. This provision would cause current year, rather than prior year, partners to bear the burden of the adjustment. The Act provides that the partnership may elect to pay

the tax on the adjustment, rather than flowing through the adjustment to its current year partners, but in all cases, the partnership would be required to pay any penalties and interest assessed in connection with a partnership adjustment. These rules would apply to all large partnerships, including oil and gas partnerships.

The above changes are proposed to make the audit system simpler and more efficient and to cause the audit process of large partnerships to parallel more closely the audit process of other large entities. Committee Explanation at 28.

Oryx opposes the proposed audit rules because, in the interest of simplicity, the rules violate the fairness and neutrality principles on which our tax laws are based. The proposed rules are unfair because they directly shift tax burdens between partners. For example, if a partnership's 1985 tax return is audited and an adjustment is made in 1992, the proposed rules would require the partnership to reflect the adjustment related to the 1985 tax year on its 1992 tax return. The 1992 partners would bear the increased tax liability for the 1985 tax year, while persons who were partners in 1985 but who have since sold their partnership interests would not bear any of the increased tax liability. The provisions thus violate a stated criteria for including proposals in the Act: "whether the proposal would cause significant shifts of tax burdens among taxpayers." H.R. Rep. No. 2777, 101st Cong., 1st Sess., Statement of Chairman Dan Rostenkowski, <u>reprinted in</u> Standard Federal Tax Reports (CCH), Statement of Chairman Dan Rostenkowski at 1 (June 29, 1991). These rules would be particularly unfair for persons who were not partners in the prior tax year or for partners who subsequently increased their ownership interests in the partnership, while the rules unjustifiably would provide a windfall for persons who sold their partnership interests prior to the year the adjustment takes effect.

The proposals purport to make the audit rules for large partnerships similar to those for large corporations. This is neither equitable nor logical. A corporation is a taxpayer, while a partnership is not. The corporation's payment of prior year tax in a current year is equitable because the corporation received the benefit of the tax treatment in the prior year. A current year partner very well may not have received such benefit in a prior year - he may not have been a partner at that time or, even if he was a partner, he may have been unaffected by the tax treatment being adjusted.

The Code imposes a much different burden on shareholders and partners. Shareholders pay corporate taxes only indirectly through the corporate entity, while partners directly pay taxes on partnership income. Shareholders may indirectly bear increased tax liability associated with a prior year in which they were not shareholders, but are not required to come out of pocket with the cash to pay the tax. In contrast, the Act proposes that partners directly bear any increased tax liability associated with a prior year in which they were not partners. In some cases, the tax liability caused by the audit adjustment may exceed the cash distribution from the partnership for the year, causing the partners to lack the wherewithal to pay the increased tax liability.

As an alternative, the Act provides that a partnership may elect to pay the tax itself. However, this election serves only to impose on the partnership the tax cost properly attributable to persons who were partners during the tax year related to the adjustment. It is merely a disguised tax on the current partners. The fundamental unfairness of shifting the tax liability between taxpayers is not avoided with this election.

If the IRS concern relates to the collection of tax from multiple partners, Oryx suggests that a more equitable way of solving the problem would be to permit the IRS to assess and bill partners of large partnerships once an adjustment is finally determined at the partnership level. This would avoid the necessity of seeking payment of the tax deficiency from the current partners who may not have had any interest in the partnership during the year being adjusted.

Apart from fairness concerns, the proposed audit rules also violate the neutrality principle on which our tax laws are grounded. The provisions may well cause demand for interests in large partnerships to decrease. Under the proposed rules, a potential buyer of an interest in a large partnership could be purchasing a large, but unknown, tax liability for which he would be directly liable. This would

cause potential partners to shy away from purchasing interests in large partnerships and to consider other investments in which they can quantify the risk. A decrease in the number of willing purchasers of interests in large partnership units would reduce the marketability and liquidity of publicly traded units. A decrease in the demand for publicly traded units also would cause the price of the units to decrease, adversely affecting all unitholders, but particularly those unitholders at the time the Act is passed.

The proposed audit provisions are objectionable even on simplification grounds. The proposal creates different audit procedures for large partnerships, but retains the current audit procedures for all other partnerships. Multiple procedures mean greater complexity. The proposed audit rules further increase complexity because they establish different audit procedures for different partners. Certain partners are fully or partially excluded from the large partnership audit rules. Act § 202, proposed I.R.C. § 6256. Therefore, different audit procedures would apply to different partners in the same partnership and, in some cases, the same partner would be subject to two different sets of audit rules. That is not likely to be a simple procedure for the IRS or taxpayers to administer.

In the interests of fairness, neutrality, and simplicity, we believe the current audit rules should be retained for all partnerships.

- REPORTING ON MAGNETIC MEDIA BY LARGE PARTNERSHIPS (Act § 203)

The Act authorizes the IRS to require large partnerships, including large oil and gas partnerships, to provide the tax return of the partnership (Form 1065) and copies of the schedules sent to each partner (Form K-1) to the IRS on magnetic media. Act § 203, proposed I.R.C. § 6011(e)(2). The sole reason stated in the Committee Explanation for this requirement is to "facilitate integration of partnership information into already existing data systems." Committee Explanation at 31. This reason does not justify the additional administrative burden that would be placed on large partnerships required to file by magnetic media.

Mr. Abraham N.M. Shashy, Jr., Chief Counsel of the Internal Revenue testified before this Subcommittee that filing by magnetic media, in conjunction with the simplified reporting rules and the mandatory consistency requirement, would "facilitate the Service's matching of the information reported by a large partnership to its partners' returns." Tax Simplification Proposals: Hearings on H.R. 2777 Before the Select Revenues Subcommittee of the House and Ways Committee, 101st Cong., 1st Sess. (1991) (Statement of Abraham N.M. Shashy, Jr., Chief Counsel, Internal Revenue). If matching is indeed the purpose of the magnetic filing requirement, the provision, as currently drafted, is too broad. As advocated by Mr. Shashy, this provision should be limited to partnerships that are treated as large partnerships for reporting purposes. Id. Oil and gas partnerships that do not elect to be treated as large partnerships should not be subject to magnetic media reporting.

Oryx opposes this provision generally, and especially as it relates to large oil and gas partnerships. Matching requires consistent treatment of partnership items on both the partnership and the partners' returns. As shown above, certain items attributable to oil and gas activities, such as intangible drilling costs and depletion, would be reported differently by an oil and gas partnership and its partners if the partnership does not elect to be treated as a large partnership for reporting purposes. This makes matching impossible, but would cause the IRS and taxpayers to spend time and money to reconcile these differences. The additional systems and administration cost needed to implement the magnetic media reporting should not be required when it cannot be shown that the desired result would be achieved.

Matching might be more feasible for partnerships treated as large partnerships for reporting purposes since the number of separately stated items would be reduced, but the existence of "excluded partners" would continue to cause difficulties in matching and in administration.

If this provision is adopted, Oryx urges that it be limited to partnerships that are treated as large partnerships for reporting purposes.

- **MARCH 15TH DUE DATE FOR LARGE PARTNERSHIP K-1'S (Act § 107)**

Under current law, calendar year partnerships are required to file their tax returns and furnish Forms K-1 to their partners by April 15th. The Act proposes advancing to March 15th the due date by which large partnerships (including large oil and gas partnerships) with a calendar year-end must furnish tax return information (Forms K-1) to their partners. Act § 107, proposed I.R.C. § 6031(b).

Oryx opposes this provision because it allows insufficient time to prepare the information necessary to report accurately to the partners of large partnerships. Almost by definition, large partnership returns and the partners' tax information statements are voluminous and complex. Sun Energy must prepare approximately 13,000 Forms K-1. The printing, stuffing, and mailing alone of the Forms K-1 takes about two weeks to complete. More time, not less time, is needed to complete this material accurately. Further, the completion of these statements within a shortened timeframe would require the allocation of additional resources to this project in contravention of a stated criteria for including proposals in the Act: "whether the proposal would reduce significantly compliance and administrative costs." Statement of Chairman Rostenkowski at 1.

This proposal is not necessary because the market for interests in master limited partnerships and other large partnerships effectively imposes a March 31st deadline for this information. Sun Energy and, to the best of Oryx's knowledge, almost all other master limited partnerships now mail Forms K-1 to their partners by March 31st and thus essentially comply with the proposed deadline. Oryx opposes making March 15th a statutory deadline, however, because it could be difficult to meet in a given year due to unusual circumstances. Attempting to meet the deadline (which cannot be extended) in such a year would erode the accuracy of the partnership's tax return and the information reported to partners and cause needless errors for the IRS and taxpayers to correct through later adjustments. This is not simplification, and it is certainly not cost effective.

Finally, a rule that would cause greater inaccuracy in return preparation would compound the unfairness of the proposed audit rules since partners in later years would be required to pay the increased tax liability caused by later adjustments. This highlights the inequity of both provisions.

Mr. Shashy testified before this Subcommittee that the IRS supports this proposal only to the extent that it applies to partnerships treated as large partnerships for reporting purposes. The IRS does not support a March 15th due date for the furnishing of information other than simplified reporting information to partners. Tax Simplification Proposals: Hearings on H.R. 2777 Before the Select Revenues Subcommittee of the House Ways and Means Committee, 101st Cong., 1st Sess. (1991) (Statement of Abraham N.M. Shashy, Jr., Chief Counsel, Internal Revenue). Oryx agrees that current law should be retained for partnerships that are not treated as large partnerships for reporting purposes, but in the interests of accurate reporting of detailed information to partners of all large partnerships, Oryx submits that the entire provision should be deleted from the Act.

- **PROPOSAL: SIMPLIFY DEFINITION OF INTEGRATED OIL COMPANY**

Independent producers receive more favorable tax treatment under the Code than integrated oil companies. For example, independent producers (but not integrated oil companies) are permitted to calculate depletion using the percentage depletion method and are not required to reduce the amount allowable as a deduction for intangible drilling and development costs. I.R.C. §§ 291(b)(1), 613A(c)(1). A producer that either directly or through a related party engages in certain retailing or refining activities (an "integrated oil company") is not treated as an independent producer. Id. § 613A(d)(2),(4); see Id. § 291(b)(4). A person is considered to be related to the taxpayer if either (i) such person holds a significant ownership interest in the taxpayer, (ii) the taxpayer holds a significant ownership interest in such person, or (iii) a third person holds a significant ownership interest in both the taxpayer and such person. Id. § 613A(d)(3). A significant ownership interest means 5% or more in value of the outstanding stock of a corporation, 5% or more of the profits or capital interests of a partnership, or 5% or more of the beneficial interests in an estate or trust. Id.

The "third person" related party rule together with the low percentage (5%) that is used in the definition of "significant ownership interest" presents tax compliance and administration problems. If any investor acquires a 5% interest in a producer while also holding a 5% interest in a refiner or retailer, the producer will be deemed to be an integrated oil company and will lose the favorable tax benefits available to an independent producer. An independent producer likely will not know whether an investor also owns 5% or more of a refiner or retailer and an investor likely will be unwilling to disclose its other investments to the producer. These rules put the independent producer in the position of being deemed an integrated oil company without any action or knowledge on its part and make the independent producer completely subject to the investment decisions of unrelated third party investors over whom it has no control. These rules clearly are unfair. Further, these rules are not simple. They are difficult and sometimes impossible to apply or administer because the information necessary for application or administration is unknown to the taxpayer or to the IRS.

These problems could be eliminated as a practical matter by raising the percentage used in the definition of "significant ownership interest" to a higher percentage. Oryx proposes that the percentage be increased to an amount (such as "more than 20%") that more clearly reflects a "significant ownership interest" and indicates that the investor may exercise control over the producer and cause it to act like an integrated oil company. This simple change would alleviate the unfairness of the "third party" related party rule and, by decreasing the potential for unintended application of the rule, make compliance and administration of the rule more feasible.

Increasing the percentage to "more than 20%" would also harmonize another limitation in the Code which is applicable to Oryx and to many other large organizations that have tax-exempt shareholders. Federal tax law encourages tax-exempt investors to maximize their return on investment within stated limits. For example, a private foundation is not taxed on investment income, such as dividends paid on the stock of an oil and gas corporation, but effectively is prohibited from owning more than 20% of a business enterprise. I.R.C. §§ 512(b)(1), 4943. A private foundation is permitted to hold up to 20% of the stock of both an oil and gas producer and a refiner or retailer. Yet these stockholdings will cause the oil and gas producer to be classified as an integrated oil company and to lose favorable tax benefits, thereby decreasing the value of the private foundation's investment in that company. The 5% test thus seems inconsistent with other provisions regarding tax-exempt investments. Simply changing the percentage used in the definition of "significant ownership interest" to "more than 20%" would ease the tax compliance and administration problems with respect to taxable investors and remove inconsistencies with respect to tax-exempt investors. Accordingly, at a minimum, Oryx proposes that the tax rules relating to tax-exempt investors and integrated oil companies be harmonized in this manner.

STATEMENT OF THE PUBLIC SECURITIES ASSOCIATION

The Public Securities Association (PSA) welcomes the opportunity to comment on the tax-exempt bond provisions contained in S. 1394, the Tax Simplification Act of 1991. PSA is the international trade organization of banks, brokerage firms and related firms that underwrite and deal in municipal securities, U.S. Government and agency securities, mortgage-related securities and money-market instruments. PSA's member firms account for approximately 95 percent of the nation's municipal securities market activity.

PSA strongly supports the tax-exempt bond provisions in S. 1394. These provisions would address significant problems experienced by bond issuers in raising capital while maintaining the spirit and intentions of those sections of the Tax Code that regulate the municipal bond market. We applaud the leadership of Chairman Bentsen in this needed simplification effort. Naturally, S. 1394 does not address all the areas of the Tax Code related to tax-exempt bonds that need simplification. Moreover, a provision of S. 1394 related to income reporting by large partnerships would inadvertently have a negative effect on demand for tax-exempt bonds and would especially affect broker-dealers in municipal securities that themselves are large partnerships. The testimony presented by other groups in relation to today's hearing will comment in detail on proposals contained in the simplification bill that pertain directly to tax-exempt bonds. This statement will focus on the partnership reporting provision as well as additional provisions that would go even further towards simplifying the Code as it relates to tax-exempt securities.

Simplification of partnership income reporting

One provision of S. 1394 would significantly alter the taxation of municipal bond broker-dealers that are partnerships, and would reduce demand for tax-exempt securities by other large partnerships.

S. 1394 simplifies the way in which large partnerships — those with 250 or more partners — report income to their partners.[1] Under current law, partnership income received from investment in tax-exempt securities is reported as tax-exempt, and partners may treat it as tax-exempt in filing tax returns. Under the proposed change, if less than 50 percent of the total income received by a partnership is tax-exempt interest, the partnership would report all income, taxable and tax-exempt, to its partners as taxable. Partners would then incur a tax liability on otherwise tax-exempt interest.

Large partnerships sometimes invest in tax-exempt securities for cash management purposes. Since in these cases relatively little of the partnership's income is tax-exempt interest, partners would be forced to treat the income as taxable. Under these circumstances, most would simply shift their cash into taxable instruments. Even though partnerships that would be affected by the proposed change account for only a small portion of all investors in tax-exempt securities, any loss of demand for tax-exempts could have some effect on tax-exempt interest rates. Moreover, a rule that forces investors to treat tax-exempt interest as taxable creates a dangerous statutory precedent.

The change in partnership reporting rules would have a significant effect on broker-dealers in tax-exempt bonds that happen to be organized as partnerships, including at least two very large, nationally recognized dealers. In the course of underwriting and trading tax-exempt securities, dealers earn significant tax-exempt interest. The proposed rule change would result in tax liabilities that do

[1] Large partnerships themselves do not incur tax liabilities. Rather, partnerships report income to individual partners, who then include the income along with their own personal income.

not exist under current law. The rule could affect liquidity in the municipal market, since dealers would be marginally less willing to take positions in securities.

PSA recommends that large partnerships that choose to report income under the new, simplified rules not be required to report tax-exempt interest if it is less than 50 percent of total income. Partnerships that currently invest in tax-exempt securities for cash management could continue to do so without fear of additional tax liability. Moreover, given that the proposed rules represent a sweeping change in the way in which partnership income is reported, PSA recommends allowing large partnerships, especially broker-dealers, to elect to continue reporting income under current rules. The partners of firms that so elected would not incur tax liabilities for tax-exempt interest. Such a change would be especially important if the Subcommittee chose not exempt altogether tax-exempt interest from partnership reporting under the provision in S. 1394.

Provisions contained in H.R. 2775 related to additional tax simplification

A companion bill to S. 1394, H.R. 2777, was introduced recently in the House. In addition, Ways and Means Committee Chairman Rostenkowski introduced an additional bill, H.R. 2775, that goes even further to simplify the tax-exempt bond provisions of the Tax Code. The bill would accomplish the following additional changes:

1) Repeal the five-percent unrelated and disproportionate private use rule. In addition to the ten-percent private use and five-percent private loan limitations on tax-exempt bond issuance, current law imposes a five-percent limit on the amount of proceeds of a governmental-use bond issue that may be used by private parties in a manner unrelated to the project being financed. It is often difficult to determine whether a private business use is really unrelated to a government use also being financed. In addition, other restrictions on private-activity bond issuance, such as use restrictions and volume caps, are adequate to satisfy the federal goal of limiting the use of tax-exempt bonds by private parties.

2) Increase the annual issuance limitation for exemption from arbitrage rules from $5 million to $10 million. Small communities, in particular, have difficulty in complying with complicated yield restriction and rebate requirements. Raising the exemption limit would free many small issuers from the complex regulations while adequately protecting the federal government from arbitrage-driven transactions.

3) Repeal the 150-percent of debt service limit. In addition to yield restriction and arbitrage rebate requirements, current law limits the amount of private-activity bond proceeds that may be invested in instruments with materially higher yields to 150 percent of annual debt service. This restriction was adopted before the enactment of other arbitrage restrictions, and is basically duplicative.

4) Exempts from arbitrage rebate requirements issuers who choose to restrict the yield on their bond-proceeds investments. The proposed change would free issuers from a duplicative and complicated set of regulations, since yield restriction already prevents issuers from earning material arbitrage profits.

PSA urges the Subcommittee to include all of the provisions of H.R. 2775 in its final tax simplification proposal.

Recommendations by the Committee on Ways and Means and the Joint Committee on Taxation

In February, 1990 Ways and Means Chairman Chairman Rostenkowski instructed the majority staff of the House Ways and Means Committee and the staff of the Joint

Tax Committee to prepare recommendations on tax simplification. The staffs of both committees made a number of recommendations related to tax-exempt bonds, including several of the provisions included in S. 1394 and H.R. 2775. Staff recommendations also included the following:

Ways and Means Recommendations:

1) Establish a statutory definition of "proceeds". According to the staff report, the lack of a statutory definition of bond "proceeds", combined with the varying use of the word in different sections of the Code, has resulted in confusion and misinterpretation.

2) Mandate that the Treasury Department significantly amend its arbitrage tracking and rebate regulations. In the mean time, the majority staff said, the May, 1989 regulations should be suspended.

3) Establish an incentive system for arbitrage regulation. In order to avoid violating yield restriction regulations, issuers often invest bond proceeds in inefficient investment instruments that ultimately are not in their or the federal government's interests, a practice known as yield-burning. The Ways and Means staff recommended that in order to give issuers an incentive to maximize investment yields while still discouraging arbitrage-motivated transactions, issuers be permitted to keep a small percentage of their arbitrage earnings.

4) Revise the Treasury's State and Local Government Series (SLGS) program to make it more useful for bond-issuers, especially with respect to the combined investment of yield-restricted and non-yield-restricted funds.

Joint Tax Committee Recommendations:

1) Mandate significant revision of the Treasury Department's arbitrage tracking and rebate regulations, including the enactment of of a statutory safe harbor for comingled investment funds.

2) Establish penalty alternatives to the loss of tax exemption for violations of tax-exempt statutes or regulations. The loss of tax exemption is in general the only sanction available to the Internal Revenue Service for violations of tax-exempt bond rules. The Joint Tax Committee staff recognized that in many cases, the party hurt most by this sanction is the bondholder, generally the one who is furthest removed from the violation. Moreover, the loss of tax exemption is often not an appropriate penalty for minor violations.

3) Provide a statutory definition of "proceeds".

The additional tax-exempt bond simplification proposals recommended by the Ways and Means and Joint Committee staffs would go far towards easing needlessly complicated provisions of the Code which have created substantial burdens for bond-issuers. PSA urges the Subcommittee to consider these additional simplification provisions during its review of S. 1394.

Anthony Commission Recommendations

The 1989 report by the Anthony Commission on Public Finance contained a number of recommendations related to the treatment of tax-exempt bonds that fall under the definition of simplification. Several of these recommendations are included in legislation introduced in 1990 and again in 1991 Senator Max Baucus, S. 913. Some of the provisions of S. 913 have been included in modified form in H.R. 2775. Another provision of S. 913, not included in either of this year's simplification bills, would implement the Ways and Means staff recommendation regarding establishing an incentive system for arbitrage regulation by allowing

issuers to keep up to 10 percent of their arbitrage earnings. Yet another provision of Senator Baucus's bill would make the exemption from arbitrage regulations for construction bonds spent down within two years retroactive to the effective date of the Tax Reform Act of 1986.

One final provision of S. 913 would raise from $10 million to $25 million the annual issuance limitation for exemption from restrictions on bank deductibility of interest costs associated with purchasing or carrying tax-exempt bonds.

The most profound effect of the tax-exempt bond provisions of the Tax Reform Act of 1986 has been the radical shift in sources of demand for municipal bonds, especially the reduction in demand by commercial banks. In 1985, banks held $232 billion in tax-exempt bonds, or 35 percent of the market. By the end of 1990, banks had reduced their holdings of tax-exempt bonds by $115 billion, a reduction of nearly 50 percent. At the end of last year, banks held approximately $117 billion in tax-exempts, just 14 percent of the market.

The reason for commercial banks' withdrawal as investors from the municipal market has to do with a Tax Reform Act provision that removed an important incentive for bank purchases of tax-exempt bonds. Before 1986, banks could deduct 80 percent of the interest cost associated with buying or carrying tax-exempt bonds. The 1986 Act disallowed that deduction for all but a small class of tax-exempt securities. The result has been that rather than supporting the market as investors, banks have actually increased the supply of tax-exempt securities on the market by being net sellers of tax-exempt securities in every year since 1985.

The loss of bank demand has left the municipal market dangerously dependent on one major source of demand for tax-exempt bonds, individuals and households. Since 1985, households, either directly or through their proxies, money market and mutual funds, have increased their holdings of municipal bonds from $289 billion to $536 billion. Today, retail investors hold approximately 64 percent of all outstanding tax-exempt securities. Without continued strong demand by retail investors, state and local governments would have difficulty finding buyers for their securities. Interest rates for states and localities would almost surely increase. A market so dependent on one source of demand carries the risk of instability.

In 1986, Congress recognized the importance of bank participation in the municipal market by allowing bank deductibility of interest costs associated with holding tax-exempt bonds issued by small communities that issue $10 million or less annually, known as bank-qualified bonds. Consequently, banks have been active participants in the "small issue" market. The benefits of bank deductibility can be seen in the difference between interest rates on bank-qualified bonds and non-bank-qualified bonds of comparable risk. The bank-qualified/non-bank-qualified spread is in the neighborhood of 20 basis points[2] and has been as high as 35 basis points, depending on market conditions.

Raising the small issuer exemption for bank deductibility from $10 million to $25 million annually would extend the benefits of bank deductibility to a larger group of small communities. It would also preserve the intent of Congress to limit bank deductibility to small communities most in need of borrowing assistance. We recognize that this proposal involves more than pure simplification. However, raising the small issuer limit would make tax-exempt financing easier for a large number of communities, while affecting a relatively small overall volume of bonds. PSA urges the Subcommittee to consider including all of the S. 913 provisions in its review of tax simplification proposals.

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[2] A basis point is 1/100th of a percentage point.

Alternative Minimum Tax (AMT) Provisions

The AMT was imposed by Congress in 1986 to ensure that individuals and corporations pay a minimum tax on earnings, regardless of the tax preferences used in a given year. The AMT is applied differently to private-activity bonds[3] and government-purpose bonds. All interest on tax-exempt private-activity bonds is subject to both the corporate and individual AMTs. For government purpose bonds, 75 percent of interest is subject to the corporate AMT.

Bonds subject to the individual AMT, known as AMT bonds, generally carry an interest rate 20 to 30 basis points higher than non-AMT bonds. Ostensibly, this additional yield compensates investors in AMT bonds for the risk that they could have to pay a tax on their tax-exempt interest earnings. However, it is unlikely that very many investors in AMT bonds actually pay tax on their interest earnings. Rather, investors who might be subject to the AMT simply do not buy AMT bonds. Investors who do buy AMT bonds — usually those who likely will not be subject to the AMT — receive an unearned yield premium. Moreover, subjecting tax-exempt interest to the individual AMT likely raises very little federal revenue, since AMT taxpayers rarely buy AMT bonds. The losers in this scenario are bond issuers, who are forced to pay higher interest rates on their borrowing.

PSA recommends removing private-activity bond interest from the individual AMT calculation, thus reducing interest costs for bond-issuers at relatively little cost to the Treasury. Other restrictions on private-activity bonds would not be affected by this amendment. We again urge the Subcommittee to consider this proposal during its review of S. 1394.

Conclusion

PSA strongly supports the tax-exempt bond simplification provisions in S. 1394, and we applaud the Subcommittee for its consideration of simplification proposals. However, we recommend changes to the partnership income-reporting provision to prevent partners from incurring tax liabilities on tax-exempt interest income. Moreover, in order to address all areas of the Code truly in need of simplification, we urge the Subcommittee to consider a number of other simplification proposals, including those in H.R. 2775, those recommended by the staffs of the Ways and Means and Joint Tax Committees and those contained in Senator Baucus's bill, S. 913. In addition, we urge the Subcommittee to consider changes to the individual AMT that could result in substantial debt service savings to issuers at relatively little cost to the federal government.

PSA appreciates the opportunity to submit this statement, and we look forward to working with the Ways and Means Committee as it continues its deliberations.

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[3] Private activity bonds are those issues where 10 percent or more of bond proceeds are used by a private party and 10 percent or more of the debt service is secured by a private party.

STATEMENT OF THE ROMAN CATHOLIC DIOCESE OF BUFFALO, NY

Introduction and Summary

This is a statement on behalf of the Roman Catholic Diocese of Buffalo, New York, requesting enactment of pension simplification legislation to provide a single definition of church plan for purposes of the tax rules applicable to pension plans. At present a broad definition of a church plan (including plans for church affiliated hospitals and universities) applies to exclude church plans from almost all of the ERISA rules applicable to qualification under the Code. Instead the pre-ERISA nondiscrimination rules apply. The one exception, introduced in 1988, is based on the definition of a church for purposes of the social security system, resulting in the exclusion of church affiliated hospitals and universities from the definition of a church so as to require compliance with the post-ERISA minimum distribution rules that must be in a plan as a condition of qualification. It is the fact of two different definitions of church plan that we find objectionable and complicating. One plan may be subject to two different sets of rules, ERISA and pre-ERISA, in determining qualification of the plan, depending on the issue involved. Our position is that one set of qualification rules, whichever Congress chooses, ought to apply to employees of church affiliated hospitals and universities. To subject plan administration to qualification rules selected from different regimes, depending upon the particular qualification requirement, makes no sense. No one has been able to construct any possible reason the social security definition of a church plan should be appropriate for the minimum distribution rules.

The result of a single set of plan qualification rules can be accomplished in one of two ways:

1. Repeal the 1988 amendment that added the last sentence of Sec. 401(a)(9)(C) referring to Sec. 3121(w) and simply state that the term "church plan" means a church plan as defined in Sec. 414(e).

2. Amend Sec. 414(e) to state that a church plan means a church plan under the social security definition by incorporating the Sec. 401(a)(9)(C) language into Sec. 414(e).

Background

The original definition of a church plan for the rules applicable to employee benefits is contained in Sec. 414(e). The Sec. 414(e) definition is broad and includes plans maintained by a church inclusive of church employees who work in a church affiliated hospital and a church affiliated university. The Sec. 414(e) definition exempts church plans from the major ERISA specific qualification refinements applicable to vesting (Sec. 411), joint and survivor annuities (Sec. 401(a)(11)), anti-alienation (Sec. 401(a)(13)), minimum coverage (Sec. 410(b)), and minimum funding (Sec. 412). Church plans are left generally to the pre-ERISA (more flexible) nondiscrimination requirements. Finding what provisions apply to church plans and what ones do not is like a treasure hunt -- it takes ingenuity to find them -- see, for example, the flush language hidden right after Sec. 401(a)(30) that exempts church plans by way of the vesting exemption in Sec. 411(e) that in turn brings in Sec. 414(e).

Beginning with 1984 a new definition of a church was introduced as Sec. 3121(w) for social security purposes to make sure that social security employment included coverage for employees of church affiliated hospitals and universities.

The 1986 Act tightened the distribution rules for pension plans to require commencement of distribution of benefits for all employees who had attained age 70 1/2, even if they had not retired. The purpose was to prevent what was regarded as unwarranted deferral for as much as an entire lifetime.

In 1988 the amended version of Sec. 89 used the narrower definition of a Sec. 3121(w) church for purposes of restricting the church plan exemption from the health insurance welfare benefit non-discrimination rules. Thus, church affiliated hospitals and universities would have been subject to the non-repealed Sec. 89.

TAMRA 1988 restored, as a technical correction, the pre-1986 rule permitting commencement of distributions to be deferred to actual retirement (even after age 70 1/2) for government and church plans. The definition of a church selected here was the narrower definition of a church in Sec. 89 -- the Sec. 3121(w) definition. When Sec. 89 was repealed, the definitional reference was amended to refer directly to Sec. 3121(w). The inclusion of these employees for social security purposes or for purposes of the now repealed Sec. 89 has absolutely no bearing on the qualified plan minimum distribution rules. Note the 1988 "technical correction" did not fully correct, because it used the narrower definition of a church than the original pre-1986 definition.

In summary, in 1988 for the first time in the pension area a second definition of a church was introduced in one specific qualification requirement for pension plans. The Sec. 414(e) definition applies everywhere else in the pension area but Sec. 401(a)(9).

The resulting statute clearly is an overreaching and needless complication. There should be only one definition for a church, be it the broader one of Sec. 414(e) or the narrower one of Sec. 3121(w). Until Congress is prepared to enact a narrower definition for all the pension requirements applicable to church plans, it is the height of technical complexity and not sensible to have a separate definition applicable to the minimum distribution rules of Sec. 401(a)(9).

Some staff members familiar with the issue have said that the 1988 adoption of a second definition was a technical error. Others have said, however, that it was a deliberate effort to move the law in the direction of a narrower definition, recognizing the burden on taxpayers in the interim transition period until the narrower definition is applied across the board. It has been stated that to modify Sec. 401(a)(9) to apply the general definition would be a retrogressive step. When it was suggested that the appropriate proposal is application of the narrower test across the board, the reply was that such a proposal would require extensive analysis of the adverse effects that might occur from the change. Yet no analysis was ever made of the adverse effects of the TAMRA 1988 change.

Informal discussions with Treasury and Senate Finance staff elicited agreement with the view that a single definition is all that makes sense.

Consequences of a second definition.

The Diocese of Buffalo plan is a defined benefit plan with 4100 participants, of whom 828 are hospital employees. Of the 4100, 50 have attained age 70 1/2, but only 5 of these are hospital employees. No one over 70 1/2 is a highly compensated employee under the Code definition. Many Diocese employees are hired at a late age after other careers. Even if their benefits must commence at age 70 1/2, the law also requires continued accruals for service after age 70 1/2. The plan actuary must then compute the value of the benefit paid and offset it against future benefit accruals. Because of the relatively small amount of benefit accrued, the actuarial expense to perform the calculations in many cases exceeds the additional benefit payable.

The two definitions now present in the law raise many difficult construction problems. If there are any hospital employees under a plan, for example, is it a church plan and can the employees benefit from the church plan exception? Or must there be two rules -- one for employees of a church defined in Sec. 3121(w) and one for employees of a church as defined in Sec. 414(e) but not in Sec. 3121(w)? Do the church plan rules apply to both sets of employees for all the requirements other than the minimum distribution rules? If the latter, what happens to employees who shift categories (but not plans) during the course of their employment? What happens to employees who perform services for both the hospital and non-hospital functions of the Diocese? Do we have two different required beginning date distribution rules for the same employee?

The additional recordkeeping and administrative functions the 1988 amendment requires make it mischievous since it accomplishes nothing today other than an unstudied foot in the door toward what some staff members hope is a long range change. A uniform definition of church should be restored as a technical correction or at least included in pension simplification legislation.

Statement of the Shriners Hospitals for Crippled Children

I. CORPORATE INTEREST OF WITNESS AND DESCRIPTION OF ITS PUBLIC SERVICE

Shriners Hospitals for Crippled Children is a public charity providing wholly free hospital and medical treatment for children in twenty specialty hospitals located in the United States, including three burn units and 17 orthopaedic hospitals. All of our facilities are available to any child whose parents cannot meet the costs of treatment without substantial hardship regardless of the child's race, color, creed, sex or sect. There is never a charge to a patient, a parent of a patient or a third party (such as a government or a private or public welfare plan) for any inpatient or outpatient care. Shriners Hospitals meets its operating, research and capital expenditures' budget from earnings on its substantial endowment and from charitable contributions from the general public. Shriners Hospitals' annual budget is fast approaching $1 million a day.

Shriners Hospitals is the beneficiary of over 1800 estates per year. Eighty-five percent are outright bequests; fifteen percent are partial interest bequests. In 1990, we estimate that about $135 million was received from decedents' estates, as partial or final distributions, or as distributions from fully matured charitable remainder trusts. Income from investments in 1990 was $195 million. Fund-raising costs approximate 2% of contributions; they are less than 1% of total revenue.

II. SUMMARY OF SHRINERS HOSPITALS SIMPLIFICATION PROPOSAL

We urge the Committee to include within S. 1394, the Tax Simplification Act of 1991, H.R. 2645, a bill that Congressman Sam Gibbons introduced on June 13. It has no Senate counterpart.

The primary purpose of H.R. 2645 is to ensure that charitable beneficiaries of charitable remainder trusts are made aware of their financial stake in these trusts. The proposal has several notice requirements, applicable to executors of estates with such trusts, and an annual reporting requirement to the charitable beneficiaries, imposed on the trustee of a funded charitable remainder trust. The bill also directs the IRS to use one combined information and tax return as a substitute for four Federal tax returns which charitable remainder trusts are now required to file. (See Rev. Proc. 83-32, C.B. 1983-1, 723). There is no revenue loss; it promotes accountability by fiduciaries; it reduces possible IRS audit burdens and allows charities to oversee tax subsidized charitable gifts.

We are aware of and have been involved in numerous cases where charities have failed to receive notice of their stake in an estate which passes to a charitable remainder trust, resulting in financial losses to the charities during probate administration and thereafter. Often a charity is informed of its interest in a remainder trust only after the last life beneficiary dies, years after its funding. Absent any notice preliminary or continue of a trust's financial condition, a charitable remainderman cannot hold a fiduciary accountable for non-feasance, misfeasance or malfeasance during the years and years of secret administration.

Attached is a list of twenty-two national charities which expressed concern about the problem of lack of timely or continuous notice to a charitable remainderman. These institutions joined us, as _amici curiae_, in petitioning the United States Supreme Court last year to overturn a Wyoming decision which effectively held that a charitable remainderman of a testamentary charitable

remainder trust had no constitutional right, under the due process clause of the Fourteenth Amendment, to notice of its financial stake in a decedent's estate. In that case, we alleged the executor sold the estate's principal asset, destined for a remainder trust, at well below its fair market value. We believe these institutions support the principles of H.R. 2645 and the notion that federal legislation is an apt and efficient way to make the tax subsidy for remainder gifts congruent with the desirability for oversight of fiduciaries, as recognized under the common law of the states.

III. REASONS FOR ENACTMENT OF SIMPLIFIED NOTICE AND REPORTING RULE

Charitable remainder trusts and other "split-interest" trusts represent a major source of funding for all charities. The National Audubon Society estimates that charitable remainder and other deferred gifts represent about 25% of the total contributions it receives. Many of Independent Sector's members -- especially universities, hospitals, social welfare organizations and religious groups -- derive a substantial part of their endowments from split interest gifts.

Charitable remainder trusts ("CRTs") owe their popularity to their convenience and tax advantages. It enables a donor, in a single instrument, to make a sizeable charitable contribution, and at the same time, provide for the support of family members during their lifetime.

The IRS had advised in response to a FOIA request, that more than 35,000 CRTs filed federal tax returns on IRS Form 5227 during 1988 - 1989. Ex. 2. We estimate that about 1,000 new CRTs are created and funded annually. Although the aggregate value of assets held in all funded trusts is impossible to determine from IRS records, it is safe to assume that this figure is well in excess of $8 billion, including pooled income funds. A recent sampling of 15 bank and trust companies revealed that they serve as trustees for 3,125 CRTs with aggregate assets in excess of $725 million.[1] In 1986, colleges and universities alone were reportedly beneficiaries of CRTs with assets in the range of $1.6 billion;[2] that figure can be expected to have grown to $2.7 billion by now through subsequent gifts and market-value appreciation. The Council for Aid to Education estimates that the amount of deferred gifts (principally CRTs) to some 1,100 private educational institutions totaled $425 million -- about 11% of all gifts by individuals to such institutions during 1987-1988.[3] As charities place increased emphasis on "planned giving," the rapid growth in assets held by CRTs will likely continue.

Despite the importance of CRTs to charities, <u>most states</u> do not require the charitable remaindermen to be notified of the commencement of probate proceedings or of trust transactions (such as asset sales) that may vitally affect charities' interests.

Only two states have statutes specifically requiring notice to charities in circumstances like those in the Shriners' Wyoming case -- California and New York.[4] A few states have no relevant notice provision or provide expressly that notice is not required.[5] But most state laws do not specifically address the question of notice to CRT beneficiaries. Rather, they provide generally that the executor or probate court must furnish notice of probate proceedings to "devisees" or "devisees and legatees,"[6] to beneficiaries "named in the will,"[7] or to "interested persons."[8] As is clear from the Wyoming Supreme Court's decision,[9] it is anybody's guess whether a state court would construe the latter terms to include charitable remaindermen. Some states require that the attorney general[10] or other governmental agency[11] be notified of transactions affecting CRTs, but such officials, in practice, rarely communicate notice to charities directly.

Shriners Hospitals for Crippled Children, and other charitable institutions, believe that providing notice to charitable remainder beneficiaries of their interests in trusts, and in decedent's estates -- particularly at the commencement of probate proceedings -- would materially increase the value of property that charities ultimately receive from CRTs. In their experience, it is common for trustees of CRTs also to serve as executors of the corresponding estates, making potential conflicts of interest less the exception than the rule. Under the current patchwork of state-law notice provisions, such CRTs are often administered for years -- even decades -- without the charitable remaindermans' even knowing of the trust's existence. Only after all income beneficiaries die, do trustees of CRTs typically inform charitable remaindermen of their vested remainder interest. By then, the passage of time will often have made it impracticable for charities to challenge trustee investment actions or certain discretionary payments made transactions that may have affected them adversely.[12]

There is strong Federal interest. It is not uncommon for agencies of the Federal Government, such as National Parks Service and the Forest Service, to receive remainder interests in CRTs funded with farmland or other realty. The American National Red Cross, a Congressionally-chartered charity that is also a federal instrumentality, receives charitable remainders and other deferred gifts in the range of $30 million annually. In such instances, the United States had a direct pecuniary interest in receiving notice of relevant probate proceedings and trust interests.

The failure of any notice requirement under existing law also affects the United States in its regulatory capacity. Congress has expressed a sharply defined policy that charities receive the full value of property destined to them through trust arrangements. The Government has an interest in maintaining the integrity, not only of the charitable contribution deduction, but also of the regulatory scheme that Congress has adopted to hold fiduciaries accountable for misfeasance in connection with CRTs.

Prior to 1969, there were manifold opportunities for abuse in making split-interest gifts to charity, enabling donors unjustly to claim tax deductions vastly in excess of the amounts charities ultimately realized. The Treasury Department accordingly recommended enactment of specific requirements which will ensure that the charity will actually receive that portion of the property for which a deduction is allowed. Congress responded by enacting Code sections 664 and 2055(e)(2), restricting charitable deductions for remainder interests to statutorily-defined types of trusts: annuity trusts and unitrusts. (Testamentary gifts of pooled income funds described in section 642(c)(5) would be covered by the notice legislation.)

These provisions are designed to ensure that there is a direct relationship between the contribution deduction claimed and the charitable benefit received. They preclude charitable deductions where "it is not probable that the gift will be ultimately received by the charity," for example, where the charity "has only a contingent remainder interest." H.R. Rep. 91-413 (Pt. 1), 91st Cong., 1st Sess. 58-59 (1969). They also prevent donors from "obtain[ing] a charitable contribution deduction for a gift of a remainder interest in trust to a charity * * * substantially in excess of the amount the charity may ultimately receive," e.g., where the trustee has discretionary power to invade corpus for the life tenant's benefit. S. Rep. 91-552, 91st Cong., 1st Sess. 87 (1969).

Besides mandating changes to the form of governing trust instruments, Congress in 1969 enacted new penalty taxes aimed at deterring misfeasance by (among others) fiduciaries of CRTs. Under Code Section 4947(a)(2), the actuarial share of a charitable remainderman is subject to the same protections against self-

dealing (IRC Section 4941), jeopardizing investments (IRC Section 4944), and taxable expenditures (IRC Section 4945) that apply to private foundations. Transactions in an estate destined for charity are also subject to penalty taxes if the fiduciary fails to comply with the Code's regulatory requirements. Rockefeller v. United States, 718 F.2d 290 (8th Cir. 1983).

IRC Chapter 42 reflects Congress' strong policy that gifts destined to charity through CRTs not be frittered away through improper actions by fiduciaries. Wholly apart from cases of fiduciary malfeasance, moreover, Congress' objectives will be frustrated whenever the value of a CRT's assets is needlessly reduced below its value when the trust was created. The donor's estate tax deduction is keyed to the value of property transferred to the CRT. If the value of a CRT's property subsequently declines -- e.g., because trust assets are sold at improvidently low prices -- the amount ultimately received by charity will be reduced, and the legislative subsidy represented by the tax deduction is concomitantly wasted.

The resources of the IRS are limited, and charitable remainder trusts (or private foundations) are not the top of the Commissioner's list of enforcement priorities. There are no IRS audits planned in FY 91 for charitable remainder trusts (about 36,000) and only 720 for FY 91 for private foundations (about 43,000), providing an audit coverage of less than 1% of returns filed for entities subject to chapter 42 of the Code. Sec. Ex. 2 and 3. We believe IRS supports our notice proposal. See Ex. 1. Even it they were able to do so, the IRS could not possibly detect all cases of abuse. Given these facts, the best prophylactic against devaluation of a charity's interest is oversight by the charity itself. If interested charities are immediately and constantly involved in monitoring monies held for them in trust - the enforcement burden of the IRS will be lightened and the objectives of Congress more fully realized.

IV. COMMON LAW REQUIRES FULL FINANCIAL DISCLOSURE; NO INVASION OF INCOME BENEFICIARY'S RIGHT TO PRIVACY

Shriners Hospitals has surveyed the common of trusts and found no compelling authority preventing a vested remainderman from receiving an accounting from a fiduciary respecting assets under its care.

> "* * * prevailing American jurisprudence holds that a vested remainderman has standing to compel a trustee to account for his management of trust assets." Shriners Hospitals for Crippled Children v. Smith, 385 S.E.2d 617 at 618 (Va. 1989).

In support for its conclusion, the Virginia Supreme Court cited Restatement (Second) of Trusts, Sec. 172; Bogert, Trusts and Trustees, (2d Ed.) §142; Scott and Fratcher, Law of Trusts, §143 (4th ed. 1987).

Although there may be some burden attached to filing an accounting with both an income beneficiary and a vested remainderman, there is no justification for excluding the remainderman so long as its share is vested, though not possessory. 385 S.E.2d. at 619.

Giving the donor his tax benefits implicitly gives the charitable remainderman the interest in assuring that the qualified trust is operated consistent with the subsidies derived by the private parties from the status of the remainderman. A trustee which attempts secrecy violates his trust; a donor that wants secrecy is equally abusive when he purports to serve the objects of the trust:

> "That the settlor has created a trust and thus required that the beneficiary enjoy his property interest indirectly does not imply that the beneficiary is to be kept in ignorance of the trust, the nature of the trust property and the details of its administration. If the beneficiary is to hold the trustee to proper standards of care and honesty and to obtain the benefits to which the instrument and doctrines of equity entitle him, he must know of what the trust property consists and how it is being managed." Bogert, Trusts and Trustees, 2d Ed., § 961.

What does the common law require the trustee to disclose to the beneficiaries: Texts or cases approve or require disclosure of -

1. Opinions of counsel (Scott, §173);

2. Papers relating to any possible self dealing by the fiduciaries or entities under their control before, during or after funding of the trust (Scott, §170); Matter of Green Charitable Trust, 431 N.W.2d 492 (Mich. 1988).

3. Papers relating to all amounts and sources of trust earnings, and allocation of income, expenditures, asset gains, asset losses, to individual beneficiaries and remaindermen (Bogert, §961).

4. Papers relating to tracing title to property administered by the Trustee (Bogert, §961).

5. Papers relating to the source and status of all trust investments (Marcellus v. First Trust and Deposit Co., 52 N.E.2d 907 (N.Y. 1942);

6. Papers relating to compensation paid the fiduciaries, their lawyers and their agents (Cosden v. Mercantile Safe Deposit, 398 A.2d 460 (Md. 1979); Shriners Hospitals v. Robbins, 450 So.2d 798 (Ala. 1984).

7. The visitation and touching of the physical property (tangible or intangible, real or personal) (Bogert, §961).

8. All books of account (Bogert, §961, Scott, §173, Restatement (Second) Law of Trust, §173).

We have found no explicit authority in the enforcement of civil trusts, or charitable trusts, that a trustee must turn over the trust's tax return to a beneficiary.[13] However, there is really no need for that document per se since all the working papers used by the trustee, including its ledgers and opinions of counsel, must be disclosed. Except for contingent beneficiaries, there is simply no case law approving a fiduciary keeping any secrets from a beneficiary, even in the face of a trust clause which relieve's a trustee of disclosure, since it may be contrary to public policy to allow enforcement of a no-disclosure clause absent very special circumstances. Matter of Estate of Hearst, 67 Cal. App. 2d. 777 (Calif. 1977).

The governing instrument of a qualified remainder trust contains numerous duties owed by the fiduciary to the remainderman, implicitly granting the remainderman the right to ascertain the fiduciary's faithful discharge of his duties. Parenthetically, the use of the charitable deduction, the income tax exemption, and the implicit shield from the grantor trust rules create a substantial

debt owed by the donor to the charity. For these tax opportunities, even the most opportunistic (or selfish) donor must realize he must pay that debt in different ways.

Existing regulations require the trustee to pay out the correct annuity or unitrust amounts to the income beneficiary and underpayments and overpayments must be corrected.[14] They require catch-up payments to be paid arising out of deferrals of the payment of the unitrust or annuity amount.[14] They require payments to be made for fixed intervals,[14] valuation of assets to be made,[14] and also imposed within the governing instrument are limits on transactions with donors, fiduciaries and other disqualified persons. In addition, there may be contingencies which, if certain acts or events occur, can accelerate the remainder, and cause the income beneficiary to forfeit its interest. Cf. IRC Sec. 664(f). If a fiduciary fails to adhere to the various governing instrument rules, the exempt status of the trust is jeopardized, putting remainder income and assets at risk.[15]

We would be remiss in not recognizing the role of state courts in authorizing and enhancing the rights of trust beneficiaries. However, a beneficiary needs to know about a trust before it can begin to use its state statutory or common law rights and a federal law giving notice is an inexpensive enforcement opportunity justified by the initial and continuing federal tax subsidies. The proposed legislation grants no new rights; provides no new rules on what is due a trust beneficiary; and burdens the trustee in only a de minimus, but compensable, way to accomplish a salutary result. We find no weight of state law, nor any well articulated reason, to preclude timely and complete disclosure of the information called for by H.R. 2645.

V. CONFORMITY OF H.R. 2645 TO SIMPLIFICATION CRITERIA

H.R. 2645 also satisfies appropriate tests for simplification.

1. The proposal would significantly reduce mechanical complexity or record keeping requirements. Our proposed legislation would simplify the filing of information and tax returns by the 36,000 charitable remainder trusts in the United States. Such trusts now file a confusing set of four returns, mandated by several different statutes. The bill would require the Internal Revenue Service to substitute the filing of one single uniform return for all charitable remainder trusts.

2. The proposal would significantly reduce compliance and administrative costs. The proposed legislation will make available to charitable remainder beneficiaries, on a timely basis, the information they need to monitor and audit the administration of such trusts for charitable purposes. As a result, audit and review by the Internal Revenue Service will only be required to find Chapter 42 violations. Moreover, by substituting the filing of one uniform return for the four that must now be filed, the legislation should reduce IRS administrative costs.

3. The proposal would preserve underlying policy objectives of current law and not create or reopen opportunities for abusive tax planning. The proposed legislation would dramatically further the basic purpose of the charitable remainder regulatory provisions of IRC Sec. 4947(a)(2), viz, to ensure that charities receive the full financial benefits of the subsidized charitable remainder gift. Keeping the administration of such trusts secret from the charitable beneficiaries does not help any interested party, especially the fiduciary.

4. The proposal would avoid significant dislocations of tax burdens among taxpayers. It would not cause any dislocations whatsoever because no new burden is involved. The fiduciary must now prepare two tax returns and two information returns for the IRS

filing and by furnishing an extra copy of one return to the beneficiaries is a de minimus, and compensable, chore.

5. The simplification our proposal would achieve outweighs the instability resulting from making any statutory changes, as opposed to permitting statutory repose. The proposed legislation is necessary to maintain the basic integrity of the charitable remainder deduction scheme in the federal tax code. Without the legislation, a portion of the over $8 billion in assets in such trusts may never be received by the beneficiaries because of fiduciary misfeasance or nonfeasance, acting without any oversight or accountability whatsoever.

6. Revenue effects of the proposal would comport with current revenue and budgetary constraints. The proposed legislation would have no effect on federal tax revenue.

Shriners Hospitals for Crippled Children earnestly supports tax simplification and provisions directly affecting charitable institutions. H.R. 2645, either as written, or as modified, furthers the Finance Committee's simplification desires and authorizes charitable institutions to be watchdogs of gifts and bequests held by fiduciaries for them. Mr. Gibbons' bill is efficient, since it costs Government nothing; it is simple because it reduces paperwork, and it is an effective way for beneficiaries to patrol and protect tax subsidized monies.

NATIONAL CHARITIES SUPPORTING TIMELY NOTICE PRINCIPLES

American Red Cross; United Way of America; Salvation Army; National Audubon Society; Association of Catholic Colleges and Universities; Baptist Joint Committee on Public Affairs; Christian College Coalition; Evangelical Council for Financial Accountability; General Conference of Seventh-Day Adventists; National Association of Homes for Children; United Church of Christ; Independent Sector; American Hospital Association; Association of American Universities; Association of Jesuit Colleges and Universities; Council for Advancement and Support of Education; National Association for Hospital Development; National Committee on Planned Giving; National Institute of Independent Colleges and Universities; National Masonic Foundation for Prevention of Drug and Alcohol Abuse Among Children; National Society of Fundraising Executives; American Council on Education.

FOOTNOTES

1. Estes, Managing Charitable Assets, Fund Raising Management 26-36 (February 1990). The Shriners estimate they alone are the beneficiary of more than 900 CRTs both pre and post 1969 versions.

2. National Center for Education Statistics, Financial Statistics of Institutions of Higher Education, Table 5 (1986).

3. Council for Aid to Education, Voluntary Support of Education 1987-1988, at 7 (June 1989).

4. See Cal. Prob. Code Section 1208 (1990) (requiring notice to trust beneficiaries where trustee also serves as executor); N.Y. Surr. Ct. Prac. Act Section 1904 (1967) (requiring notice to remainderman concerning disposition of trust property). See also Ohio Rev. Code Ann. Section 5303.22 (1989) requiring notice to "persons interested" in sale of an estate's property).

5. E.g., Fla. Stat. Ann. Section 733.613 (1976) (executor not required to provide notice of sale of trust property); Ind. Code Ann. Section 29-1-15-15 (1989) (same); Ill. Ann. Stat. ch. 110 1/2, 6-10 (1989)(executor not required to notify trust beneficiaries that probate has commenced.). Cf. Utah. Code Ann. Section 57-1-25 (1989) (requiring notice by publication of proposed sale of trust property).

6. E.g., Ariz. Rev. Stat. Ann. Section 14-3705 (1989); Kan. Stat. Ann. Sections 59-2209, 59-222 (1983); Mass. Gen. Laws Ann. ch. 192, Section 12 (1958); Nev. Rev. Stat. Ann. Section 136.100 (1986); Or. Rev. Stat. Ann. Section 113.145 (1984); S.C. Code Ann. Section 62-403 (1987); S.D. Codified Laws Ann. Section 30-6-8 (1984); Wash. Rev. Code Ann. Section 11.28.237 (1987). Cf. Tex. Prob. Code Ann. Section 128A (1990) (notice inter alia to a "charitable organization * * * named as devisee").

7. E.g., Wyo. Stat. Ann. Section 2-7-205 (1989).

8. E.g., Neb. Rev. Stat. Section 30-222 (1985); Va. Code Ann. Section 64-1-82 (1986); W. Va. Code Section 41-5-5 (1982); Wis. Stat. Ann. Section 879.03 (1989).

9. Shriners Hospitals for Crippled Children v. First Security bank of Utah, et. al., 770 P.2d 1100 (Wyo. 1989), on rehearing 782 P.2d 229 (Wyo. 1989), cert. den. 100 S. Ct. 2587 (June 4, 1990).

10. E.g., N.J. Civ. Prac. Rule 4:80-8 (1989); Or. Rev. Stat. Ann. Section 128.720 (1984); R.I. Gen. Laws Section 18-9-13 (1988); Tex. Prob. Code Ann. Section 123.001 (1987).

11. E.g., Va. Code Ann. Section 55-29 (1986) (trustee of CRT must make annual accounting to county or city commissioner): Va. Stat. Ann. Tit. 14, Section 2501 (1974) (same to probate court). But see, Shriners Hospitals for Crippled Children v. Smith, 385 S.E.2d 617 (Va. 1989) where the Shriners (as a remainderman) had to sue a trustee for accounting information, incurring substantial legal fees.

12. On March 31, 1982, the Tax Court decided Boeshore v. Comm'r, 78 T.C. 523. Until our tax counsel read the decision in a commercial tax service, we had no idea that we were a remainder beneficiary of the decedent's estate or that estate (and trust) funds were being expended in tax litigation. The decedent died May 28, 1976 and we learned of our financial interest from a person other than the fiduciary.

13. Under existing law, a charitable remainderman, if it knows of its interest in an estate or charitable remainder trust, is authorized to obtain the federal tax return and tax return information from the Internal Revenue Service. See, IRC Section 6103(e)(1)(E)(ii) and (F). Despite this authorization, IRS has no published procedures explaining how affected persons should attempt access.

14. See, Rev. Rul. 72-395, C.B. 1972-2, 340 and Rev. Rul. 88-81, C.B. 1988-2, 127.

15. Because Congress allows reformation of unqualified transfers, early notice to charity by an estate may assist it in achieving certain tax savings. See, IRC Sec. 2055(e)(3).

Internal Revenue Service | **Department of the Treasury**

Washington, DC 20224

Mr. William Lehrfeld
Lehrfeld, Canter & Henzke
Suite 403
1101 Connecticut Avenue NW
Washington, DC 20036

Person to Contact:
Michael Siegerist
Telephone Number:
(202) 566-2247
Refer Reply to:
T:FP:F:CD
Date:
21 AUG 19[illegible]

Dear Mr. Lehrfeld:

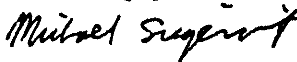
Thank you for your letter of July 13 regarding Form 5227, Split-Interest Trust Information Return. As John Nelson of my staff mentioned to you on the phone on August 13, IRS shares your concern that trustees may be making questionable investments that benefit income beneficiaries at the expense of, and without the knowledge of, charitable remainder beneficiaries. Such investments may prevent charitable organizations from receiving the full dollar value claimed as a charitable contribution upon creation of the trust.

As you pointed out, under Code section 6103(e), Form 5227 may be disclosed to a charitable remainder beneficiary. Any sales or dispositions of assets would be shown on Schedule D, and the fair market value of the trust's assets for unitrusts would be shown in Part V. The answer given to Question 5 in Part VI would indicate whether there had been any investments made that would jeopardize the charitable purpose. As Mr. Nelson mentioned, legislative action would be needed to require the trustee to send a copy of Form 5227 to the remainder beneficiary, as you suggested. Therefore, it's appropriate that you are pursuing a change in the law in this area.

We appreciate having all your suggestions for improving the form. As Mr. Nelson explained, the form is scheduled to be revised in 1992, unless legislation is enacted that would require us to revise it sooner. When the revision takes place, we will consider your suggestions carefully in light of the existing law and regulations.

Thank you for taking the time to write and share your thoughts with us.

Sincerely yours,



for/ John J. Dopkin
Chief, Tax Forms
De[illegible]

— EXHIBIT 1

Internal Revenue Service | **Department of the Treasury**

Washington, DC 20224

Person to Contact:
Edward J. Kulich
Telephone Number:
(202) 566-3570
Refer Reply to:
E:O:S
Date:
MAY 24 1991

Mr. William J. Lehrfeld
Lehrfeld, Canter & Henzke
Suite 403
1101 Connecticut Avenue, N. W.
Washington, D. C. 20036

Dear Mr. Lehrfeld:

This is in response to your letter of April 24, 1991 wherein you requested the number of returns filed by certain charitable organizations and certain trusts for several years.

Our response is provided in the following chart:

	YEAR			
	1986	1987	1988	1989
1) Forms 990-PF filed during process year	39,970*	42,071*	42,420*	43,338*
1) Forms 5227 filed during process year	27,650	31,864	36,030	35,011
3) Forms 1041 filed during process year	18,434	21,723	26,308	26,179

* Includes Section 4947(a)(1) nonexempt charitable trusts that are treated as private foundations (section 6033(d).

We hope this information is helpful to you.

Sincerely yours,

Barbara Reilly
Chief, Employee Plans and
Exempt Organizations
Support and Services Branch

* EXAMINATIONS COMPLETED/PLANNED

	COMPLETED					PLANNED
	FY-1985	FY-1986	FY-1987	FY-1988	FY-1989	FY-1990
FORM 5227 RETURNS						
** OCEP	8	134	2	0	1	0
FIELD	204	92	15	3	1	0
TOTAL	212	226	17	3	2	0
ADDITIONAL TAX & PENALTIES ASSESSED	$0	$0	$2	$0	$0	$0
*** FORM 990-PF RETURNS						
** OCEP	1,306	1,114	803	400	145	0
FIELD	2,948	3,843	3,167	1,908	1,253	1,143
TOTAL	4,254	4,957	3,970	2,308	1,398	1,143
ADDITIONAL EXCISE TAX & PENALTIES ASSESSED	$2,864,761	$55,344,591	$122,315,185	$17,500,667	$19,118,076	N/A
ADDITIONAL INCOME TAX & PENALTIES ASSESED	$477,985	$40,459	$110,567	$2,539,495	$112,818	N/A

* NUMBER OF RETURNS EXAMINED

** CORRESPONDENCE/OFFICE EXAMINATION PROGRAM

*** Includes Forms 990-PF, 4720, 1041/1041-A, and Form 1120 filed by Revoked Private Foundations.

EXHIBIT 2 - CHART

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Person to Contact:
Ms. J. Miner
Telephone Number:
(202) 566-3359
Refer Reply to:
EX:D:F:1/91-F-682
Date:
JUN 6 1991

Mr. William J. Lehrfeld
Lehrfeld, Canter & Henzke
Suite 403
1101 Connecticut Ave., N.W.
Washington, DC 20036

Dear Mr. Lehrfeld:

This is in response to your letter dated March 12, 1991, addressed to Howard Schoenfield. We are responding to item 2, since it pertains to the disclosure of information.

The information concerning the number of Forms 990-PF examined in FY 1990 and proposed for FY 1991, broken down by region, is provided below. The FY 1992 information is not yet available.

Region	FY 1990	FY 1991
North Atlantic Region	320	154
Mid-Atlantic Region	45	59
Southeast Region	113	101
Central Region	411	200
Midwest Region	120	100
Southwest Region	122	48
Western Region	147	60
Total	1278	722

Since we do not maintain information concerning the assessment of penalties by code section, we are providing information on the total proposed additional tax and penalties for Form 4720.

FY 1990 - $5,256,535 (Private Foundations and Self-Dealers)
FY 1989 - $18,778,875 (Private Foundations and Self-Dealers).

We hope you find this information useful. If you should have any questions, please contact Janet Miner at 566-3369.

Sincerely yours,

Arthur Perretta
Team Manager I
FOI/Privacy Section

— EXHIBIT 3

August 5, 1991

The Honorable Max Baucus
United States Senate
SH-706 Hart Senate Office Building
Washington, DC 20510

Dear Senator Baucus:

On behalf of the Small Business Legislative Council (SBLC), I wish to express our strong support for your efforts to simplify the payroll tax deposit system. Relief is long overdue.

There is no doubt in our minds that the payroll tax deposit system is the single largest source of inadvertent tax compliance errors for small business. The use of arbitrary filing dates, unrealistically low thresholds that trigger different deposit requirements, and a "dynamic" deposit requirement that forces changes "as you go," have made the payroll tax deposit system a small business owner's nightmare.

Your bill, S. 1610, addresses these concerns in a positive way. Enactment would constitute a significant breakthrough in tax simplification.

The SBLC is a permanent, independent coalition of over one hundred trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. While our policies are developed through consensus among our membership, we respect the right of individual associations to express their own views. For your information, a list of our members is enclosed.

Sincerely,

Phillip R. Chisholm
Chairman

PRC/S1836
Enclosure

bcc: Jeanne Saddler/Wall Street Journal

1156 15th Street, N.W. - Suite 510 Washington, DC 20005 (202) 639-8500 / FAX (202) 296-5333

Members of the Small Business Legislative Council

Air Conditioning Contractors of America
Alliance for Affordable Health Care
Alliance of Independent Store Owners and Professionals
American Animal Hospital Association
American Association of Nurserymen
American Bus Association
American Consulting Engineers Council
American Council of Independent Laboratories
American Floorcovering Association
American Machine Tool Distributors Association
American Road & Transportation Builders Association
American Society of Travel Agents, Inc.
American Sod Producers Association
American Subcontractors Association
American Textile Machinery Association
American Trucking Associations, Inc.
American Warehousemen's Association
Architectural Precast Association
Associated Builders & Contractors
Associated Equipment Distributors
Associated Landscape Contractors of America
Association of Small Business Development Centers
Association of the Wall and Ceiling Industries-International
Automotive Service Association
Automotive Warehouse Distributors Association
Bowling Proprietors Association of America
Building Service Contractors Association International
Business Advertising Council
C-PORT
Christian Booksellers Association
Council of Fleet Specialists
Electronics Representatives Association
Florists' Transworld Delivery Association
Helicopter Association International
Independent Bakers Association
Independent Bankers Association of America
Independent Medical Distributors Association
Independent Sewing Machine Dealers Association
International Association of Refrigerated Warehouses
International Bottled Water Association
International Communications Industries Association
International Formalwear Association
International Franchise Association
Jewelers of America, Inc.
Machinery Dealers National Association
Manufacturers Agents National Association
Manufacturers Representatives of America, Inc.
Mechanical Contractors Association of America, Inc.
Menswear Retailers of America
NMTBA-The Association for Manufacturing Technology
National Association for the Self-Employed
National Association of Brick Distributors
National Association of Catalog Showroom Merchandisers
National Association of Chemical Distributors
National Association of Home Builders
National Association of Investment Companies
National Association of Passenger Vessel Owners
National Association of Personnel Consultants
National Association of Plumbing-Heating-Cooling Contractors
National Association of Realtors®
National Association of Retail Druggists
National Association of Small Business Investment Companies
National Association of the Remodeling Industry
National Association of Truck Stop Operators
National Campground Owners Association
National Candy Wholesalers Association
National Chimney Sweep Guild
National Coffee Service Association
National Electrical Contractors Association
National Electrical Manufacturers Representatives Association
National Fastener Distributors Association
National Food Brokers Association
National Grocers Association
National Independent Dairy-Foods Association
National Knitwear & Sportswear Association
National Limousine Association
National Lumber & Building Material Dealers Association
National Moving and Storage Association
National Ornamental & Miscellaneous Metals Association
National Paperbox & Packaging Association
National Parking Association
National Precast Concrete Association
National Shoe Retailers Association
National Society of Public Accountants
National Tire Dealers & Retreaders Association
National Tooling and Machining Association
National Tour Association
National Venture Capital Association
Opticians Association of America
Organization for the Protection and Advancement of Small Telephone Companies
Petroleum Marketers Association of America
Printing Industries of America, Inc.
Professional Plant Growers Association
Retail Bakers of America
SMC/Pennsylvania Small Business
Small Business Council of America, Inc.
Society of American Florists
Specialty Advertising Association International
United Bus Owners of America

1156 15th Street, N.W. · Suite 510 Washington, DC 20005 (202) 639-8500 / FAX (202) 296-5333

STATEMENT OF SPECIAL COMMITTEE ON PENSION SIMPLIFICATION OF NEW YORK STATE BAR ASSOCIATION

The Special Committee on Pension Simplification was formed by the New York State Bar Association in 1986 for the explicit purpose of developing a program to achieve a major overhaul of the federal pension laws, with the object of simplifying the regulation of private pension plans. This Special Committee achieved its initial goal with the publication, in 1988, of its report on pension simplification entitled "A Process Awry: Call for Simplification and Rationalization of the Federal Pension Laws". The report, though widely circulated in government circles and generally favorably received, fell largely on deaf ears. Pension simplification was then on few lips and on essentially no one's mind. "For tax simplification there are no cheering multitudes," we wrote then, quoting a well-known tax scholar. That has all changed. Suddenly, pension simplification is very much in the air, with significant legislative initiatives having been launched in the Senate and House in the past six months. The Administration, too, has now joined the effort with the recent publication of its POWER proposals.

We enthusiastically applaud the recent efforts of many individual Congressmen, and hope that their ardor will prove contagious on the floors of the Houses of Congress. We particularly welcome introduction of such legislation by the Chairmen of the Senate Finance Committee and the House Ways & Means Committee, as well as the significant contributions by such Congressmen as Senator Pryor and Representative Chandler; and we are heartened by the calling of a hearing on pension simplification by the Senate Finance Subcommittee on Taxation, on September 10 and 12, 1991. In announcing that hearing, your Subcommittee invited the submission of materials discussing tax simplification proposals generally; and this statement is meant to be responsive.

The task for Congress now is to sort out the pending proposals, and to draw from them and from other sources a course of action that will lead to the goal that very many now seem to agree is urgently needed. We must note at the outset, though, that none of the pending legislative proposals goes far enough, at least not as far as our Committee stated in its report was necessary: i.e., a total overhaul of the pension laws by means of the establishment of a national commission charged with the complete reform and simplification of the laws, against the backdrop of a clearly enunciated national retirement policy.

While total, simplifying reformation continues to be the desideratum, it would be naive to hope that such an ambitious program can be accomplished within a time frame sufficiently rapid to provide timely relief or, indeed, that it can be accomplished at all within the current economic and budgetary rules. It is the very budgetary exigencies of the Eighties that have forced the private pension system to pay such a large price in cost and complexity; and winning back some of that lost ground, while devoutly to be wished, is not a consummation that realistically can be anticipated early in this decade of deficits.

Therefore, we subscribe to the view that even much less than half a loaf now is much better than none. We do this with some reluctance, however, because we are fearful that once the subject of pension simplification is addressed by this Congress, even in a limited way, the Legislature will have scant appetite for continuing the effort at future sessions. That we would count as a disappointing outcome.

High on our list of items in need of immediate and outright repeal are the top-heavy rules, section 415 complexities (now rendered largely superfluous, we might observe, by enactment of the 4980A excise tax on excess distributions), and minimum participation rules. Regrettably, none of the pending bills include such repealers. Additional areas of urgently needed simplification are integration, matching contributions (the "multiple use" test cries out for revision), coverage tests geared to benefit levels, 415(e) as regards combinations of defined benefit and defined contribution limits (assuming 415 is to be retained notwithstanding its redundancy), distributions and roll-overs, and line-of-business testing (now more than ever in need of additional Congressional input in the wake of the recently proposed and largely unsatisfactory 414(r) regulations). The current bills do not address these needs adequately, but Congress could do so at this Session, and in a completely "revenue neutral" manner. We hope to provide to the Congress a fuller expression of our views in this regard at a later time.

We also wish to reiterate one other portion of the recommendations in our report that could be enacted immediately by the Congress, as part of and complementary to the pending proposals, to preclude their swift undoing by subsequent legislative or regulatory action:

- prescribe moratorium on additional pension-related legislation (except legitimate technical corrections) until recommended by the law revision commission we have proposed (or elapse of stated number of years, if sooner)
- enactment of general effective date rule preventing any significant, substantive rule change enacted after stated date from becoming effective until plan years beginning after issuance of final regulations relating to the change (with certain exceptions spelled out in our report)
- revision and amelioration of existing penalty provisions where complexity, not neglect, of law was major factor
- directions to I.R.S., D.O.L. or P.B.G.C., as the case may be, as follows: (i) prohibiting, for stated number of years, promulgation of new regulations, pending legislative recommendations of the law revision commission, except if required by statute or clearly providing relief to plan sponsors or participants; (ii) mandating internal review of all regulations with a view to the actual (not just cosmetic) reduction of burdens; and (iii) barring regulations and rules which would overturn long-settled positions without prior review by Joint Committee on Taxation or adequate advance public notice.

All would concede that the system today is shot through with complexity. As the Joint Committee Staff in its Comparative Description of Proposals, etc. (hereafter "JCT Comparative Description") illustrates very well, however, the complexity has its defenders, as a necessary concomitant of preventing isolated instances of abuse, howsoever uncommon (e.g., resistance to use of a lookback period in testing for "highly compensated" to prevent "a newly hired employee who otherwise would be considered highly compensated (from receiving)...very large accruals in that first year"). Id. at p. 36. We oppose most strongly such micro-management, given all the burden and cost imposed on the many to avoid relatively minor distortions. Of course simplification involves some compromise of pure nondiscrimination. That, we submit, is far the lesser evil than a system so overladen with protections that it is itself an abuse of the regulatory function.

The JCT Comparative Description, in its overview, says very well:

> "The purpose of the tax benefits provided with respect to qualified plans is to encourage employers to establish broad-based retirement plans for their employees. Employer-provided pension plans reduce the need for public assistance and reduce pressure on the social security system."

One need only ask oneself whether the present regulatory orientation encourages employers to establish broad-based retirement plans!

The attachment which follows this Statement (Appendix A) deals with an important feature of the pending proposals: a drastically simplified type of plan, as a discrete approach apart from the simplification of rules generally applicable to pension plans. We support a simplified plan for small business, not because we believe complexity is to be sanctioned for businesses of any size, but rather because for small businesses the very complexity is so likely to force termination of existing pension plans (as, indeed, has in fact occurred in growing numbers) and to inhibit the establishment of new ones that the national interest in retaining plan coverage greatly outweighs any rigorously orthodox commitment to nondiscrimination.

Hence, we have set forth, in Appendix A, our views as to a kind of plan, which we call a SUPER-SEP, that will free small business sponsors from the testing, calculations, traps and paperwork that are now inherent in so much of the pension law, while retaining the essential protections established by ERISA. This, in turn, would create a climate for greatly expanded pension coverage among small businesses, the goal expressed by the Administration in putting out the recent POWER proposal. It would, at the same time, give new impetus to savings, without the complexities of 401(k) and 401(m), and with greater opportunities than under IRAs.

It must be noted, however, that the SUPER-SEP is not explicitly designed for small business or small plans. It can be adopted by plans and taxpayers of any size. We believe, though, that it will prove particularly attractive to small business, because of the real cost savings and the lifting of much of the burden of plan maintenance; but those same attractions are not without their appeal to larger businesses, which would be free to adopt a SUPER-SEP as their sole form of retirement benefit or as a complement to their other plans.

A simplified pattern plan, let us be clear, is not meant as an alternative approach to simplification; both general simplification and a special simplified plan, whether or not limited to small business, are needed, although neither is dependent on the other for enactment. Thus, whatever simplified rules the Congress enacts will not be preclusive of a simplified benefit plan, and vice versa. Similarly, it would be possible for Congress to enact one without the other, but that would leave the glass half empty.

We conclude with the hope that, before your labors are finished, you will inscribe in your bill a commitment to continue the process, so that it may be a beginning, not an end, on the way to full simplification.

Appendix A

A Proposal for Radical Pension Reform:
The Simplified SUPER-SEP

I. INTRODUCTION

The following is an outline of a proposed alternative pension plan (the SUPER-SEP) based on an expansion of the SEP-IRA plan described in Section 408(k) which would not only substantially simplify the pension rules, but would also provide full portability of benefits, inflation protection and enhanced ability for employee funding of health insurance. This proposal could be applicable to employers of all sizes, but we feel it would be most attractive to the smaller employer.

II. SUPER-SEP PROVISIONS

1. Eligibility and Vesting

All employees must be eligible to participate not later than the first day of the month after completing one year of service. Non-resident aliens and collectively bargained employees could be excluded, as under current law. Collectively bargained employees could be covered under a separate plan.

The SUPER-SEP (IRA) must be extended to all eligible employees in the sponsor's controlled group or in a separate line of business.

All participants must be immediately fully vested.

2. Employer Contributions

Each participant would have a separate SUPER-SEP (IRA) account. An employer may choose either of the following plan designs:

ALTERNATIVE A

Contributions to the SUPER-SEP (IRA) could be expressed either as a uniform percentage of compensation, which could be integrated with Social Security benefits, as under Section 401(l)(2), or, alternatively, on an age-weighted basis (similar to a target benefit plan) so that contributions at any age would accumulate to a uniform amount at age [65], which would be the normal retirement age. The IRS would furnish factors for each age so that a sponsor could select any uniform age-weighted level of contribution at age [65] with appropriate scale-downs at other ages. For simplicity, Social Security integration would not be permitted if age-weighted contributions are made.

Employer matching contributions would not be permitted.

A sponsor could adopt both a uniform contribution plan and age-weighted contribution plan covering the same employees.

ALTERNATIVE B

A sponsor that makes a base contribution of not less than [2%] of the compensation of each participant may make matching contributions up to the same percentage of compensation as the base contribution. The matching contribution may be no less than [50%] nor more than 100% of the participant's contribution, provided that the matching contributions do not exceed the base contributions.

Thus, if a sponsor makes a base contribution of 3% of compensation, it could provide matching contributions of 50% of the participant's contribution up to 6% of compensation or 100% of the participant's contribution up to 3% of compensation.

No antidiscrimination test would be imposed under this Alternative B.

3. Employee Participant Contributions

Individuals who establish SUPER-SEP (IRA) accounts could make deductible contributions of up to [6%] of compensation with a maximum approximately equal to the current [$8,475] Section 401(k) maximum, subject to cost of living increases. This portion of the arrangement is a personal IRA. Therefore, these contributions would be deductible by the employee - not by the employer (who would, of course, be permitted to deduct the employee's unreduced compensation). Such employee contributions would be permitted even if no employer contributions are made. No contribution deferral percentage ratios would have to be met. Participants could not be simultaneously covered under a Section 401(k) plan.

4. Maximum Limits on Employer Contributions

Employers could contribute a maximum of [25%] of a participant's compensation not to exceed [$200,000], adjusted for increases in the cost of living as under current law. Employers' deductible contributions would be subject to the same Section 404 limits as under current law.

5. Maximum Limits on Tax Deferred Accumulations

In order to limit tax deferred accumulations, participants would be limited to a maximum deferral of [$1,000,000] at age [65] adjusted for increases in the cost of living. The maximum account balance would be reduced in the case of employees below age [55] by being discounted at an appropriate interest rate, and above age [70] so that accumulations are phased out over a participant's life expectancy.

If a participant accumulates more than the maximum permissible amount in his account at his age (regardless of whether the excess results from favorable investment experience, generous employer or participant contributions, or lowering of the ceiling), the excess must be distributed in the following taxable year in order to avoid any excess accumulations penalty.

A participant [must] [may] select a single IRA custodian which will be responsible for policing the limits on accumulations by reporting required distributions to the participant and the IRS. A participant would be permitted to self-direct the investment of plan assets, as is the case with IRA's under current law.

It is not required that the SUPER-SEP (IRA) replace existing qualified plans. Therefore, existing conventional plans and the SUPER-SEP (IRA) could be correlated in the following manner:

A. The participant's account balance under a conventional defined contribution plan will reduce the maximum account limit under the SUPER-SEP (IRA).

B. The participant's interest in a defined benefit plan would not reduce the maximum account limit under the SUPER-SEP (IRA) until it is distributed. Existing defined benefit plans would have to be amended to permit lump sum distributions. Any participant in a SUPER-SEP (IRA) who is entitled to a benefit from a defined benefit plan must receive a lump sum distribution of his or her accrued benefit, which may be rolled over on a tax-free basis into the participant's SUPER-SEP (IRA) account.

6. Spousal Rights

In order to protect the non-working spouse while avoiding the complexities of spousal consent, a SUPER-SEP (IRA) could provide that [1/3] of each contribution made in respect of a year during which an employee is married would be allocated to a spousal account. Rollovers from other plans could also be allocated in this proportion.

7. Distributions

All SUPER-SEP (IRA) distributions would be taxed as ordinary income with no income averaging. On the death of a SUPER-SEP (IRA) holder, the balance in the account would be subject to estate tax except to the extent the surviving spouse is the beneficiary. There would be no penalty tax on excess distributions, but a penalty would be imposed on accounts whose assets exceed the maximum account limit. There would be a 10% penalty tax on distributions prior to age [55] except for the purchase of a principal residence, or for the uninsured medical or college tuition expenses of the participant, spouse and children.

Unlimited tax-free rollovers or direct transfers to or from a SUPER-SEP (IRA) would be permitted. Upon the death of a SUPER-SEP (IRA) holder the beneficiary could roll over his or her share of the distribution into the beneficiary's own SUPER-SEP (IRA), subject to the maximum account limit.

8. Portability

Each individual would maintain his or her own permanent lifetime IRA as the funding vehicle for SUPER-SEP (IRA) employer and participant contributions, thus ensuring full portability of accumulated benefits.

9. Inflation Protection

Each SUPER-SEP (IRA) account holder would be eligible to purchase individual retirement bonds (up to a prescribed limit) issued by the Treasury Department that would pay a fixed interest rate [2% or 3%] plus a COLA increase. Thus, if inflation is at a 5% rate, the bond would pay [7% or 8%]. Alternatively, the bond could be issued in annuity form so that it would pay a fixed amount based on the individual's age (and sex?) calculated at a [2% or 3%] interest rate, plus a COLA supplement.

10. Health Insurance

A SUPER-SEP (IRA) holder, whether or not employed, and regardless of age, could withdraw from his or her account a prescribed amount each year to pay health insurance premiums. Such withdrawals would be non-taxable.

11. Bankruptcy

We believe that the SUPER-SEP (IRA) should be free of creditor's claims in bankruptcy, although this need not be an integral feature of this program.

III. SUMMARY OF PRINCIPAL ADVANTAGES

The most practical method of reducing complexity is to adopt a defined contribution approach. At the same time, the advantages of a defined benefit plan - providing age-weighted benefits, and PBGC insurance - can be effectively accomplished by age-weighted contributions, and the purchase of a special class of inflation-linked U.S. retirement bonds.

The complexities attendant on deferred vesting and matching contributions would be eliminated. Similarly, the complexities of maximum limitations on contributions, minimum required distributions, salary reduction contributions and spousal rights would be substantially ameliorated.

Two glaring faults of the present pension structure - lack of portability and inflation protection - would be overcome by this proposal.

The proposal would encourage thrift, while minimizing discrimination by adopting a uniform maximum deferral amount.

Finally, depending on budgetary constraints, the proposal would alleviate health insurance costs by allowing premiums to be paid on a pre-tax basis.

[Note: Numbers in brackets are for illustrative purposes. The actual numbers would depend on their revenue effect.]

STATEMENT OF THE TAX EXECUTIVES INSTITUTE

Tax Executives Institute (TEI) is the principal association of corporate tax executives in North America, whose approximately 4,700 members represent more than 2,000 of the leading corporations in the United States and Canada. TEI represents a cross-section of the business community, and is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. As a professional association, TEI is firmly committed to maintaining a tax system that works one that is consistent with sound tax policy, one that taxpayers can comply with, and one in which the Internal Revenue Service can effectively perform its audit function. TEI is pleased to submit the following comments on S. 1394, the Tax Simplification Act of 1991 (introduced by Senators Bentsen and Packwood); S. 936, the Foreign Tax Simplification Act of 1991 (introduced by Senator Baucus); S. 1654, the Passive Foreign Investment Company Simplification Act of 1991 (introduced by Senator Moynihan), and other tax simplification measures.

I. OVERVIEW

Tax Executives Institute commends the Senate Finance Committee for recognizing that the tax laws are in desperate need of simplification. The Institute shares the Committee's commitment to developing and maintaining an administrable tax system. For far too long, a sincere but sometimes misguided desire to close "loopholes" or even "pinholes" in the Internal Revenue Code has led to the enactment of mind-numbingly complex "band-aids" on an already too complex tax law. For far too long, concerns about the substantive, transactional, and transitional complexity spawned by tax law changes have been given short shrift even where the concerns are voiced by taxpayers and IRS alike. For far too long, administrability and simplicity have been little more than an afterthought.

The Committee's focus on simplification, together with the IRS's related initiatives, is testimony to a desire to build a "new tax order." The Committee is to be commended for acknowledging Congress's role in creating complexity and in recognizing its obligation to reduce the heavy compliance burden imposed by unduly complex tax laws. These hearings clearly represent a step in the right direction.

Several provisions of S. 1394 will significantly reduce mechanical complexity, recordkeeping requirements, and compliance and administrative costs. For example, the provisions relating to the treatment of built-in losses for purposes of the corporate alternative minimum tax (AMT), the modification to the look-back method for long-term contracts, and the treatment of gain on certain stock sales by controlled foreign corporations (CFCs) under section 1248 of the Code would all further the goal of simplification.

There are, however, some notable omissions from S. 1394. For example, we urge inclusion of the proposal for creation of a single foreign tax credit (FTC) limitation "basket" for section 902 noncontrolled companies (so-called 10-to-50 companies). Even the Treasury Department has singled out the treatment of dividends from such companies as an area in need of simplification. Absent such relief, large multinational corporations will be forced to continue grappling with hundreds of separate FTC calculations. We thus commend the provisions in S. 936 which would provide a single FTC basket for companies that do not elect look-through treatment. S. 1394 also neglects the tremendous (and unnecessary) complexity spawned by the application of the uniform capitalization rules to foreign corporations—complexity that, again, S. 936 would end and at nominal cost to the fisc.

Certain proposals in S. 1394 would make substantive changes in the tax law and might actually increase the taxpayer's burden. For example, in the international tax area, S. 1394 would consolidate several anti-deferral regimes, which would at first blush provide some small measure of simplification. Upon analysis, however, the promise of simplification evaporates, for S. 1394 would supplant the existing rules with an expansive hybrid of the existing CFC, foreign personal holding company, and passive foreign investment company rules, as well as add a new "mark-to-market" provision. In other words, the good intentions of the drafters notwithstanding, the proposed passive foreign corporation (PFC) scheme is anything but simple. As discussed below, we believe a better, more targeted measure of simplification is available in S. 936.

On the domestic side, S. 1394 endeavors to mitigate the appalling complexity of the AMT and adjusted current earnings (ACE) provisions. Rather than recognizing that the mere existence of two separate and independent taxing schemes breeds inordinate complexity, however, S. 1394 provides only limited relief in calculating de-

preciation under the AMT/ACE rules for *newly acquired assets.* It thus completely ignores the requirement that taxpayers comply with the ACE requirements beginning in 1990 and that, even under the bill, they must continue to "track" the various depreciation regimes for assets acquired before the effective date of the proposed simplified method. This complexity can be meaningfully tempered by according taxpayers an election to apply the new rules to all years to which the ACE rules are relevant.

Moreover, in several instances S. 1394 eschews Congress's responsibility to effect meaningful simplification by simply delegating authority to the Department of the Treasury. For example, S. 1394 would grant the Secretary authority to issue regulations under section 986 that would allow foreign tax payments made by a foreign corporation to be translated into U.S. dollar amounts using an average exchange rate for a specified period. Although we commend the drafters for recognizing that something must be done to ease the burdens engendered by the Tax Reform Act of 1986, the approach taken in S. 1394 does not make sense. Rather than ceding the authority to correct the problem, Congress should forthrightly acknowledge that section 986 was misguided and amend the statute to provide a statutory rule that taxpayers can comply with and that the IRS can audit. S. 936 would provide a substantial statutory simplification by requiring foreign taxes to be translated at the same exchange rate as the income to which the tax relates. Another approach would be to adopt a year-of-accrual rule which translates the taxes at an average rate for the year in which the liability for foreign tax first arises. TEI would support either approach over the current year-of-payment rule.

A similar flaw underlies the provision in S. 1394 establishing a "simplified method" for applying the uniform capitalization rules. The proposal acknowledges the need for a simplified method for determining the cost of each administrative, service, or support function or department that is allocable to production or resale activities. Rather than establishing such a method, S.1394 would simply delegate authority to the Treasury Department to issue regulations allowing the use of a simplified method—the details of which would be "fleshed out" later. The simplified method, moreover, could not be used until such regulations were promulgated. Simplification deferred, however, is simplification denied: even if coupled with the injunction that the Treasury act with "all deliberate speed," S. 1394 not only denies taxpayers an opportunity to comment on the specifics of a proposed statutory change (because there are no specifics), but would also effectively sentence taxpayers to regulatory limbo, requiring them to wait months (or possibly years) to avail themselves of any such method. What's more, there is no guarantee that any regulations issued by the Treasury Department would truly promote the goal of simplification.[1]

TEI believes that the most effective safeguard against complexity is the allotment of ample time in which to analyze the administrability of specific proposals. To this end, we commend the Committee for providing taxpayers with a meaningful opportunity to review S. 1394, and we trust that the public will be given ample time to consider proposed revisions throughout the legislative process. In this way, Congress and the public can evaluate not only the policy underlying the proposals, but also whether that policy would be served by the legislative language. They will also be able to gauge whether the proffered scheme is not only wise but administrable.[2]

II. INTERNATIONAL PROVISIONS

A. *The Passive Foreign Corporation (PFC) Regime.* The passive foreign investment company (PFIC) provisions of the Code were enacted as part of the Tax Reform Act of 1986. Almost from the date of enactment, TEI and others have pointed to the PFIC provisions as a prime example of legislative overkill. The goals of the PFIC provisions—to remove the economic benefit of tax deferral in certain perceived

[1] Indeed, in a statement filed with the House Committee on Ways and Means in connection with a hearing on H.R. 2777 (which is identical to S. 1394), the Treasury intimated that it would not issue any regulations under this provision.

[2] S. 1394 contains provisions that will benefit from taxpayer scrutiny. For example, section 302 sets forth new Code section 1292(a), the last sentence of which would read, "Except as provided in regulations, stock in the preceding sentence shall also apply for purposes of section 904(d)." We are uncertain about the reference to "stock" in this sentence. Is it intended to provide a look-through rule for purposes of section 904? The sentence could even be read to classify PFC income as entirely passive for purposes of section 904. The Technical Explanation of the bill provides no guidance on the meaning or purpose of the garbled provision. *See Technical Explanation of S. 1394 and H.R. 2777,* at 56 (June 26, 1991) (hereinafter referred to as "Technical Explanation").

abuse situations and to prevent conversion of ordinary passive income into capital gain—were compromised by their excessive breadth. The definition of a PFIC is so broad that it has resulted in the classification of many corporations with active businesses (but substantial passive income or assets) as PFICs, even in situations where the foreign corporation is subject to high rates of foreign tax. Thus, whereas the target of the PFIC provisions was traditional investment companies, many other companies have become ensnared in the PFIC trap—one replete with tremendous administrative burdens.

TEI's proposed solution to this problem is simplicity embodied: exclude controlled foreign corporations (CFCs) from the reach of the PFIC provisions. A U.S. shareholder owning 10 percent or more of a CFC (*i.e.*, a foreign corporation that is more than 50-percent owned by U.S. shareholders) is already subject to immediate tax on passive income under Subpart F of the Code.[3] Within the context of the Committee's simplification initiative, TEI does not quarrel with the basic concept of Subpart F. We do, however, dispute the need to overlay another regime on top of Subpart F. The beauty of the Institute's proposal to exempt CFCs from the PFIC rules lies in its operational clarity: taxpayers could deal with an established set of rules, and need not undertake to unravel and comply with another regime that, in terms of tax policy, is wholly redundant and, indeed, never intended to apply to CFCs.

Regrettably, sections 301 to 304 of S. 1394 reflect a different approach to the Code's overlapping anti-deferral regimes. Under the proposed "unified" anti-deferral scheme, a passive foreign corporation (PFC) will still include a U.S. controlled corporation. In fact, the PFC regime is broader in scope—and more complicated—than the PFIC provisions it would supplant.

Under S. 1394, the PFIC 50-percent assets test would be retained for PFC purposes and the threshold 75-percent gross income test would be reduced to 60 percent. The high-tax exception to current inclusion of passive income under Subpart F would not carry over to the PFC rules because, according to the Technical Explanation (at page 50), that exception does not apply to PFICs and, hence, the bill's "modification to the application of a controlled foreign corporation rule [*i.e.*, elimination of the high-tax exception of section 954(b)(4) to passive income] preserves present law."[4] S. 1394 would subject a U.S. person holding 25 percent or more of the shares in a PFC that is not U.S. controlled to the same mandatory inclusion rule. In addition, U.S. persons with less than 25-percent ownership in PFCs could elect current, full inclusion; in the absence of such an election, the less than 25-percent shareholders are subject to tax under either a new "mark-to-market" regime or an interest-charge method adapted from the present PFIC rules.[5]

TEI objects to changes in the law that subject a greater proportion of non-"tainted," active business income to current taxation. The Technical Explanation is silent on why the PFC rules ought to apply to CFCs governed by current Subpart F rules. The 60-percent passive gross income threshold is proposed for PFCs apparently because such a threshold is contained in the foreign personal holding company (FPHC) rules, which are targeted at ending tax deferral by individuals. Such a gross income test, however, will in some circumstances cause CFCs with active operating businesses to be subject to the PFC rules. (The same is true under the 75-percent PFIC gross income test.) Assuming the absence of an explicit CFC exemption, TEI believes that the better, more targeted way of removing the effective penalty on active subsidiaries without vitiating the policy goals of the FPHC rules is to adopt a gross *receipts* test. We note that S. 936 adopts this approach. Although the need for such a test would not be as pronounced upon enactment of S. 1394 as under current law given the concomitant proposal in S. 1394 to repeal the generally applicable "once a PFIC, always a PFIC" rule, we nonetheless urge the Committee's careful consideration of a provision such as that in section 3 of S. 936 adopting a gross receipts test.

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[3] Continued deferral of U.S. tax on passive income under Subpart F is limited to either *de minimis* amounts or income highly taxed in the foreign country (such that residual U.S. tax after the foreign tax credit is negligible).

[4] Unfortunately, the Technical Explanation glosses over the fact that, under present law, a shareholder in a PFIC (that is also a CFC) making the Qualified Electing Fund (QEF) election is provided a high-tax exception, Thus, making the QEF election prevents the full inclusion of highly taxed passive income.

[5] S. 1394 would eliminate the option of CFC shareholders subject to the current PFIC scheme to continue deferral under the current law interest-charge method for excess distributions. Such a modification would constitute a substantive, adverse change for those taxpayers that rely on the alternative excess distribution method to cope with the complexity of the PFIC and CFC overlap. In addition, those taxpayers would have to deal with the transitional complexity engendered by the change.

The current Subpart F rules require full inclusion of a CFC's income by U.S. shareholders where Subpart F income comprises 70 percent or more of gross income. FPHC income is one category of Subpart F income and, with modifications, serves as the definition of passive income for the PFC provisions. Under S. 1394, however, the threshold for full inclusion of CFC income would be reduced to 60 percent when a single category of Subpart F income— passive income—is involved. Reducing the threshold would not only increase the number of U.S. shareholders of CFCs subject to full inclusion of both tainted and non-tainted income, but would also create a dichotomy between the groups of tainted Subpart F income triggering a mandatory full inclusion. Thus, by reducing the PFIC gross income test from 75 percent—a figure greater than Subpart F's 70-percent full inclusion rule—to a 60-percent gross income threshold with mandatory full inclusion, the PFC provisions would broaden the tax base of U.S. corporations with CFCs. Such a result cannot be justified as "simplification."

Finally, S. 1394 would retain the 50-percent average passive assets test contained in the PFIC provisions. Such a test could unfairly trap foreign sales or distribution subsidiaries with high ratios of working capital to total assets. We believe this result would be improper where virtually all of the CFC's gross income arises from active business activities. Thus, absent a CFC exemption, the PFC assets test should be eliminated or the threshold percentage substantially increased. In this regard, we note that S. 1654 would eliminate the assets test for CFCs.

By retaining the assets test, lowering the gross-income test's threshold, eliminating the high-tax exception for passive income, and reducing the percentage of "tainted" income to total gross income triggering full inclusion, the PFC provisions in S. 1394 would increase the number of U.S. corporate shareholders operating active business CFCs subject to current taxation. Subjecting active operating earnings (or an even greater percentage of such earnings) to potential current taxation is at odds with longstanding tax policy to defer current taxation of active foreign-earned income. Doing so under the guise of simplification is inconsistent with, and undermines the credibility of, a simplification initiative.

One positive aspect of the new PFC provisions is the elimination of the permanent stain of PFIC status for CFCs (or PFCs deemed to be CFCs under proposed section 1292).[6] Under S. 1394, the "once a PFIC, always a PFIC" rule would be replaced by an annually applied test. Thus, even if a CFC became a PFC in one year (thereby subjecting both active and passive income to full inclusion by the U.S. shareholder), the subsequent year's *active* income would not necessarily be taxed under the PFC regime (though the passive income would be currently taxed under the Subpart F rules). Another positive feature, though too limited to provide relief to a substantial number of taxpayers, is the provision that would allow leased facilities to be included in the base for determining the existence of 50-percent average passive assets.

Although the PFC regime arguably better integrates the Code's anti-deferral provisions than current law, the simplifying nature of the proposal should not be exaggerated, especially in light of the substantive (on balance, taxpayer-adverse) changes the proposals would work, as well as the complexity inherent in the proposed new mark-to-market rules. True simplification could be accomplished by adding a single sentence to the Code that eliminates the overlap of PFIC and Subpart F rules.[7]

B. *Treatment of Foreign Sales Corporations.* It is unclear whether the current PFIC rules apply to foreign sales corporations (FSCs) whose passive income is already subject to current U.S. taxation. Section 302 of S. 1394 clarifies that the passive income of a PFC does not include a FSC's foreign trade income. Although the IRS has informally suggested that the PFIC rules do not apply to FSCs, the proposed change would bring certainty to this area.

S. 1394 fails, however, to provide FSCs with an exemption from the 50-percent assets test for purposes of the PFC provisions. Thus, FSCs that invest their foreign trade income might become subject to the PFC rules because the earnings on that income would be treated as passive income. Because the FSC provisions already subject a FSC's passive income to current U.S. taxation, this oversight could result in double taxation. Therefore, we recommend that a specific exemption from the PFC rules be provided for FSCs. At a minimum, an exemption from the assets test (if it is retained) should be included in S. 1394.

C. *Repeal of Sections 960(a)(3) and (b).* Section 312 of S. 1394 would repeal sections 960(a)(3) and (b) of the Code, which permit an indirect foreign tax credit (FTC) and

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[6] The "once a PFIC, always a PFIC" rule would remain in effect for a limited category of U.S. shareholders of PFCs.

[7] See, for example, section 13 of H.R. 2948, which was introduced in the House of Representative Gradison.

an increased FTC limitation upon certain distributions by a CFC of previously taxed income (PTI). Under the bill, foreign taxes paid by a foreign corporation on a distribution of PTI would be added to the pool of indirect FTCs.

When the Joint Committee staff first advanced this proposal in its simplification recommendations, it averred that no real substantive change would be effected by its enactment because most taxpayers are in an excess credit position and could not use the credits that would be lost by the repeal of the statute. Staff of Committee on Ways and Means, 101st Cong., 2d Sess., *Written Proposals on Tax Simplification*, WMCP 101-27, at 33 (May 25, 1990) (recommendations of staff of the Joint Committee on Taxation). We suggest, however, that the Joint Committee staff misapprehended the effect of its proposal, since many taxpayers continue to rely on the mitigating provisions of section 960 to avoid double taxation of earnings. Distributions of PTI are frequently subject to foreign withholding taxes when they are remitted to the U.S. shareholder and, without sections 960(a)(3) and (b), there would be no specific mechanism to credit the additional taxes.

TEI believes that the tax policy against double taxation far outweighs any nominal simplification that may be achieved through the repeal of the statute. Thus, sections 960(a)(3) and (b) should be retained.

D. *Translation of the Deemed-Paid Foreign Tax Credit.* Section 321 of S. 1394 would grant the Secretary of the Treasury authority to issue regulations permitting foreign tax payments to be translated into U.S. dollar amounts using an average U.S. dollar exchange rate for a specified period. The bill thus adheres to section 986's requirement that foreign taxes be translated at a rate in effect during the year the taxes were paid.

Although the approach taken in S. 1394 represents a minor simplification of the translation of foreign tax payments, the proposal still fails to address directly the tremendous administrative burdens engendered by the Tax Reform Act of 1986's year-of-payment rule; the proposal would still require taxpayers to "track" the year in which myriad tax payments are made. TEI submits that the compliance burdens associated with section 986 are totally disproportionate to any practical or policy purpose that may be served by the provision.

Stated simply, the Code's foreign tax translation rules are in desperate need of simplification. Fortunately, administrable alternatives are clearly available. One is to return to pre-1987 law, which was relatively simple for both taxpayers and the IRS to administer. This approach is effectively embodied in section 5 of S. 936. Another alternative is to translate foreign taxes at a rate in effect in the year in which the taxes are accrued, perhaps averaging the rates in effect on the first and last days of the corporation's taxable year. Such a rule would substantially reduce the administrative burdens on taxpayers without sacrificing any sound tax policy or revenue goal.

E. *Simplified Method for FTC/AMT Calculation.* In computing its FTC limitation, a taxpayer is required to allocate and apportion deductions between U.S. and foreign sources. This limitation must be separately computed for both regular tax and alternative minimum tax (AMT) purposes. In essence, taxpayers that have allocated and apportioned deductions for regular tax purposes must re-allocate and re-apportion those same deductions for AMT-FTC purposes, using assets and income that reflect the AMT adjustments made in computing alternative minimum taxable income.

Section 322 of S. 1394 would accord taxpayers an election to use as their AMT-FTC limitation the ratio of foreign-source regular taxable income (rather than foreign-source AMT income) to their entire AMT income. The proposed election, however, would clearly operate to the taxpayer's detriment because foreign-source regular taxable income will invariably be less than foreign-source AMT income.

TEI questions the rationale set forth in the Technical Explanation (at page 69) that "the differences between regular taxable income and alternative minimum taxable income are often relevant primarily to U.S. source income." Indeed, any section 56 or 57 expense (such as depreciation) that is apportionable under Treas. Reg. §1.861-8 will reduce foreign-source income. We believe that an alternative exists that is not skewed toward benefiting either the government or the taxpayer. Specifically, we recommend that taxpayers be permitted to elect to use their regular section 904(a) limitation fraction, i.e., the ratio of foreign-source regular taxable income to their entire regular taxable income. This is the approach adopted by Congress in former section 59(a)(1)(C), regarding the allocation and apportionment of the book income preference.

F. *Treatment of Gain on Certain Stock Sales.* Section 311 of S. 1394 would provide that gain from the sale of stock of a foreign corporation by a CFC will be treated as a dividend to the same extent it would be under section 1248(a) of the Code if the

CFC were a U.S. person. The modification clearly satisfies the simplification criteria, and TEI endorses it. We question, however, the rationale underlying the proposal to exclude such deemed dividends from the scope of the same-country exception that the Code provides for actual dividends.

III. DOMESTIC PROVISIONS

A. *Simplified Method for Applying Uniform Cost Capitalization Rules.* Section 412 of S. 1394 would grant the Treasury Department the authority to issue regulations that allow taxpayers to use a base-period percentage in determining the costs of any administrative, service, or support function or department that are allocable to production or resale activities.

The Institute finds it difficult to comment on this proposal because the particulars of the simplified method are for the most part left for Treasury to determine. The Technical Explanation (at page 86) does state that the base period would begin no earlier than four years prior to the taxable year, but it leaves many questions unanswered. For example, the explanation does not address the length of the base period. Will it be a four-year rolling period? A one-year period that would be used for the four succeeding years? If the base period is a four-year rolling period, simplification will be achieved only in the first year. Moreover, the proposed statutory requirement that the costs be capitalized on a department-by-department, function-by-function basis is far from simple. A better method would be to permit taxpayers an election to use a specific percentage based on an average capitalization rate determined from a four-year base period.

In addition, we note that the Technical Explanation (at page 85) states that S. 1394 "authorizes (but does not require)" the Treasury Department to issue regulations providing for the simplified allocation method. The proposed statutory language, however, would clearly require the Treasury to issue such regulations. The obligatory nature of the grant of authority should be confirmed in the committee report, especially in light of the Treasury's testimony before the Ways and Means Committee intimating that such regulations might never be promulgated.

B. *Depreciation for AMT/ACE Purposes.* Section 421 of S. 1394 would apply a 120-percent declining balance method (switching to straight-line at a point maximizing depreciation deductions) for personal property (other than transition property to which the ACRS system in effect before the Tax Reform Act of 1986 applies) for determining the alternative minimum taxable income of a corporation. No further adjustment for this property would be required for purposes of the adjusted current earnings (ACE) provision.

The proposal would provide a simpler method of determining depreciation for newly acquired property. It would not, however, permit taxpayers to use the same method with respect to assets acquired prior to 1991. Thus, the provision may actually increase a taxpayer's compliance burden by forcing it to maintain one more depreciation system (for property placed in service after December 31, 1990). TEI recommends that taxpayers be accorded an election to apply the simplified method retroactively for all years to which ACE applies.

C. *Built-In Losses for Purposes of the Corporate Alternative Minimum Tax.* Section 422 of S. 1394 would repeal the ACE rule relating to the treatment of built-in losses after a change in ownership (current section 56(g)(4)(G) of the Code). Thus, under the bill, the treatment of built-in losses would be the same for ACE, AMT, and regular tax purposes—a significant simplification of current law. TEI endorses enactment of this provision.

IV. OTHER SIMPLIFICATION MEASURES

A. *Exempt Controlled Foreign Corporations from Uniform Capitalization Rules.* One area that significantly increases the compliance burdens of all U.S. corporations is the uniform capitalization rules under section 263A of the Code, which require the capitalization of costs incurred in manufacturing or constructing tangible property. These accounting rules, which were enacted in 1986, are the most comprehensive costing provisions ever approved by Congress, and the price taxpayers have had to pay—not in additional tax but in compliance costs—has been staggering. The uniform capitalization rules—especially those relating to interest expense—create tremendous administrative and compliance burdens for U.S. companies operating abroad, principally in the computation of indirect foreign tax credits under section 902 of the Code. In addition, because all post-1986 earnings are pooled for purposes of this section—and capitalization only postpones the deduction—the section 263A amount becomes increasingly insignificant over time. The existence of excess foreign tax credits (FTCs) has a further averaging effect. Thus, the application of the rules

to foreign operations produces relatively little revenue, certainly not enough to justify the astounding cost of compliance on taxpayers.[8]

TEI believes that the extension of section 263A to foreign subsidiaries is unwarranted. For these reasons, we recommend that the statute be amended to specifically exempt controlled foreign corporations from its reach. Section 2 of S. 936 will achieve this result.

B. *Use of U.S. GAAP for Computing Earnings and Profits.* The concept of "earnings and profits" (E&P) has relevance in the foreign tax area for several reasons. For example, E&P is used in measuring the amount of subpart F inclusions, the portion of a distribution from a foreign corporation that is taxable as a dividend, the amount of foreign taxes deemed paid for purposes of the deemed paid foreign tax credit under section 902, and the amount of section 1248 gain taxable as a dividend.

Under section 964, the E&P of a foreign corporation is to be computed in accordance with rules substantially similar to those applicable to domestic corporations. As a practical matter, however, a foreign corporation is frequently unable to compute E&P in the same manner as a domestic corporation. Although a domestic corporation generally calculates E&P by making adjustments to U.S. taxable income, a foreign corporation necessarily uses foreign book income as its base. The ensuing adjustments become especially difficult in the case of noncontrolled foreign corporations since the U.S. shareholder of such companies may encounter difficulty in obtaining all the information required to compute E&P.

Although foreign corporations do not compute U.S. taxable income, they frequently do adjust foreign book income to conform with U.S. generally accepted accounting principles (GAAP) for financial reporting purposes. There are numerous differences between GAAP and E&P, but most relate to timing differences and have at most a nominal effect on a company's U.S. tax liability, especially in light of the requirement of the Tax Reform Act of 1986 that taxpayers compute their section 902 FTC credit on the basis of a pool of post-1986 undistributed earnings.

Under current regulations, taxpayers need only make "material" adjustments between GAAP and E&P. Because the definition of materiality is a fluid one (with which IRS examining agents can take issue), taxpayers may feel compelled to make complicated and time-consuming—but essentially inconsequential—adjustments. If, however, taxpayers were permitted to use U.S. GAAP as a measure of E&P, the heavy compliance burden could be tempered, especially for depreciation, inventory capitalization, and foreign currency translation adjustments.

Accordingly, TEI recommends that taxpayers be generally permitted to use U.S. GAAP in computing the E&P of foreign corporations. Although the Institute believes section 964(a) provides the Treasury Department and IRS with adequate authority to prescribe such rules, we suggest that Congress clarify such authority and, indeed, expressly direct the Treasury Department and IRS to promulgate regulations implementing this change.

C. *Interest Rate under Section 6621(c).* Section 321 of H.R. 2775 (introduced by Representative Rostenkowski) would provide that, for purposes of determining the period to which the large corporate underpayment rate applies under section 6621(c) of the Code, any letter or notice will be disregarded if the amount of the deficiency, proposed deficiency, assessment, or proposed assessment set forth in the letter or notice is not greater than $100,000 (without regard to any interest, penalty, or addition to tax). The proposal would thus clarify that a notice relating to a minor mathematical error by the taxpayer will not be sufficient to trigger the higher interest rate imposed by section 6621(c).

Although TEI continues to disagree with the policy underlying the so-called hot interest provision, we recommend that S. 1394 be revised to incorporate section 321 of H.R. 2775. Indeed, the bill should go even further to make the "hot interest" provision more administrable and fair. Specifically, Congress should provide for the mandatory abatement of "hot interest" during the period attributable to a delay by the IRS in considering a taxpayer's administrative appeal of proposed adjustments. In addition, the bill should provide for Tax Court review of adjustments paid by taxpayers to stop the running of interest. Finally, Congress should reaffirm its unequivocal instruction to the Treasury Department to implement a comprehensive netting procedure to ameliorate the unfair effects of section 6621(c). No such procedure has been forthcoming from the Treasury or IRS even though the congressional mandate dates back to 1986.

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[8] Indeed, for some corporations the application of the uniform capitalization rules in the foreign context may actually *reduce* their tax liability, even without regard to the deductibility of the cost of compliance.

V. CONCLUSION

Tax Executives Institute appreciates this opportunity to present its views on S. 1394, S. 936, and other tax simplification measures and would be pleased to answer any questions you may have about its positions. In this regard, please do not hesitate to call either Robert H. Perlman, the Institute's Senior Vice President, who will testify on the Institute's behalf at the Committee's September 10 hearing, at (408) 765-1202 or Timothy J. McCormally of the Institute's professional tax staff at (202) 638-5601.

Statement of the Texas and Southwestern Cattle Raisers Association

My name is James B. Owen of Tyler, Texas. I am submitting the following testimony as president of the Texas and Southwestern Cattle Raisers Association, a livestock trade group of more than 20,000 working cattlemen operating primarily in Texas and Oklahoma.

I am pleased to provide members of the Senate Finance subcommittee on taxation with specific comments regarding S. 1394, the tax simplification legislation.

Today we would like to share with you the need to amend current estate law and a provision of S. 1394. The provision at Section 505 addresses the election of special use valuation of farm property for estate tax purposes. As it is currently drafted, this provision applies only to decedents dying after the date of enactment. We respectfully request that you amend this section, appropriately titled "Opportunity to Correct Certain Failures under Section 2032A", to make the effective date retroactive to 1986.

Such action would alleviate an inequity in the administration of the special use valuation rules so important to farmers and ranchers everywhere.

An unfortunate and arbritrary interpretation of existing regulatory guidelines by an individual examining agent has denied the family of a TSCRA member the advantage of framing 2032A as Congress intended. In fact, it may be necessary for the family to liquidate a significant portion of its productive ranch land; land which has been in the family for several generations.

This family's dilemma is not unique. Rather, we suspect that many other families whose members are engaged in the production of food and fiber find themselves in this fix. Amending the effective date of this proposed section 505 to make it retroactive to 1986 will do much to correct this inequity. We see no logic in penalizing those occurrences prior to the enactment of this correction, simply because of the date that they occurred. The passage of this correction, on the surface, indicates that the law was incorrectly administered. It would seem only fair and proper that all those who were victims of the misinterpretation should get relief. This we will feel is a reasonable accommodation.

Texas and Southwestern Cattle Raisers Association urges your adoption of this proposed modification of estate tax law.

Statement of Thompson & Mitchell

This statement is submitted on behalf of Thompson & Mitchell, a St. Louis-based law firm, and our numerous clients who, like countless other taxpayers nationwide, have been injured by the operation of what is now recognized as a flawed estate tax provision. While we are pleased with the apparent widespread acceptance of section 502 of S. 1394, the tax simplification bill, one further task must be undertaken: this section of the bill must be made to apply retroactively. Retroactive application of this amendment is a critical step in effectuating Congress' objective of preventing section 2035 from working hardships on the nation's taxpayers.

Present Law and S. 1394:

The current operation of Section 2035(d)(2) arbitrarily penalizes gifts made from revocable trusts by including in the decedent's estate the value of an interest transferred from a revocable trust if made within 3 years of decedent's death. However, direct gifts of less than $10,000 per year are non-taxable and are not included in the decedent's estate. This creates an oddity whereby a $10,000 gift made directly by the decedent as a donor is not includable in the estate, while a $10,000 gift made by the decedent as the trustee of a revocable trust is includable in the estate. As currently drafted, section 502 of the bill would correct this problem prospectively.

Retroactive Amendment:

Since 1981, section 2035 has created a minefield in both tax planning and IRS enforcement. In that year, Congress enacted the Economic Recovery Act of 1981 (P.L. 97-34, Sec. 424), (as amended by the Technical Corrections Act of 1982 (P.L. 97-448, Sec. 104)) which amended 2035 to its present form. The policy of the 1981 Act was that small gifts made within three years of the decedent's death generally should not be included in the decedent's estate; thus, the estate tax law would be consistent with the income tax law under which gifts up to $10,000 are not taxable. In addition, the amendment was intended to eliminate inconsistent rulings regarding gifts made in contemplation of death. In fact, the legislative history of the Economic Recovery Tax Act of 1981 reflects the congressional policy of promoting the use of bright line rules and minimizing speculation on the parts of both tax planners and the IRS with respect to this provision. See generally S. Rep. No. 97-144, 97th Cong., 1st Sess. 230-39 (1981). An additional goal articulated was modification of the tax system to promote greater personal savings. Id. at 120.

Section 2035 has been a trap for estate planners. In spite of the general policy in favor of excluding small gifts from the estate, a minor and narrow exception exists for gifts made from a common estate-planning device, the revocable trust. To overcome this narrow exception, estate planners and taxpayers must perform somewhat contorted transactions to make a small gift that is not includable in the estate. A deviation from these unnecessary requirements generally renders the gift, otherwise untaxable, taxable.

The widespread support for section 502 of S. 1394 illustrates that Section 2035(d)(2) is appropriately viewed as a provision yielding inconsistent and seemingly arbitrary interpretations and consequences. For example, the IRS has held that gifts from revocable trusts are not included in the

gross estate and not taxable where the trustee transfers the gift back to the grantor and the grantor then makes the gift. Priv. Ltr. Rul. 90-10-005 (Nov. 17, 1989) The IRS has also ruled that some gifts from revocable trusts are not includable in the estate if the trust instrument only authorizes transfers to the grantor, yet a transfer is made directly to third persons in contravention of the instrument. Priv. Ltr. Rul. 90-10-004 (Nov. 17, 1989). One can only speculate as to the mental gymnastics plaguing estate tax planners and taxpayers in their concerted efforts to comply with murky Section 2035 rules. Added to this are the inequitable tax consequences resulting from this provision. Such considerations, taken together, have undoubtedly fueled the decision to amend Section 2035.

Clearly, this amendment is corrective in nature, and, fortunately, will operate to prevent future inequities. However, as with many amendments, correction can only be complete by retroactive application. While the effect upon the federal budget of such retroactive application will likely be de minimis, the effect upon taxpayers nationwide who have been impacted in the past will be quite substantial.

STATEMENT OF THE UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

On June 27, 1991, H.R. 2777 and S. 1394 (the Tax Simplification Act of 1991, hereinafter "the Bill") were introduced in Congress. H.R. 2777 and S. 1394 are the culmination of a process that dates back to February, 1990, when Chairman Rostenkowski requested that the interested public, Treasury, IRS and staffs of the House Ways and Means and Joint Committee develop tax simplification proposals for review by the full House Ways and Means Committee.

For the members of the U.S. Council for International Business, who have devoted substantial time and effort on suggestions for simplifying the foreign provisions of the Code, the Tax Simplification Bill is a disappointment. While the Bill introduces some helpful changes in the rules dealing with controlled foreign corporations (CFCs) and the alternative minimum foreign tax credit computation, it actually simplifies very little. Its proposal for replacing the numerous anti-deferral regimes with a single regime is an exceedingly complex set of rules in its own right; it eschews responsibilities for an important foreign tax translation issue by delegating regulatory authority to the IRS; and it makes no changes at all in the foreign tax credit area for corporate taxpayers (except to eliminate a taxpayer elective provision). Even more disappointing is the fact that, at every opportunity, it seems that the Committee chose the most restrictive (to taxpayers) option available. Our detailed comments follow.

The United States Council for International Business represents American business positions before the Executive and Legislative branches of the U.S. Government and in the major international economic fora. A membership organization comprised of over 250 international corporations, law firms, and accounting firms, it seeks to promote an open international system of trade, investment and finance. The Council is the U.S. business group that officially consults with key international bodies influencing international business. It is the U.S. affiliate of the International Chamber of Commerce (ICC), the Business and Industry Advisory Committee (BIAC) to the OECD, and the International Organisation of Employers (IOE).

ANTI-DEFERRAL REGIMES

Under current law, there are at least six different, but related regimes for taxing otherwise deferred income of a foreign corporation: the controlled foreign corporation (or "subpart F") rules (§§ 951-964), the foreign personal holding company ("FPHC") rules (§§ 551-558), the passive foreign investment company ("PFIC") rules (§§ 1291-1297), the personal holding company ("PHC") rules (§§ 541-547), the accumulated earnings tax ("ACT") (§§ 531-537), and the foreign investment company ("FIC") rules (§§ 1246-1247).

In our simplification submission of June 29, 1990, a copy of which is attached, the U.S. Council suggested that the concerns of the multiple anti-deferral regimes could be adequately addressed by just two: one to tax income of foreign corporations controlled by U.S. shareholders (subpart F) and another to tax income of foreign corporations with predominately passive income (an expanded PFIC). The Bill adopts this approach, by creating a new creature -- the Passive Foreign Company ("PFC") -- to replace the PFIC, FIC and the majority of the FPHC rules; the rest of the FPHC rules are folded into the existing subpart F regime, and the ACT and PHC tax are eliminated in their entirety (at least as they apply to foreign corporations).

The overall approach adopted by the Bill is, therefore, sound. Furthermore, some useful changes are proposed for the CFC rules. The expanded PFIC concept, however, adds so many nuances and alternatives that little simplification is really achieved. Moreover, the simplification

that is achieved is borne on the backs of taxpayers. The foreign provisions of the Bill are estimated to raise $87 million over five years, and the bulk of the revenue is certainly attributable to the anti-deferral proposals.

CFC Changes

While the rules for taxing shareholders of CFCs are retained, significant changes are proposed. Most of these changes are indeed simplification.

First, the Bill adds to subpart F income, under section 954(c), amounts received under a personal service contract to be performed by the CFC if the recipient of the services or some other third party has a right to designate the individual who is to perform the services and such individual owns, directly or indirectly, 25 percent or more of the value of the CFC. This rule is lifted from the FPHC regime. It applies, however, without regard to whether the CFC is controlled by five or fewer individuals. The extension of the rule is difficult to understand other than as a means of tightening deferral. It would therefore be preferable to restrict application of this personal service contract rule to situations where the "5 or fewer" ownership is present.

The Bill states that income earned on such a personal service contract, while FPHC income for subpart F, is not treated as passive income for foreign tax credit purposes. Nevertheless, this income can have an effect on the classification of a foreign corporation as a PFC (see PFC discussion below).

Second, under existing law, when the stock of lower- tier CFCs is sold, the income is treated as passive, subpart F income to the U.S. shareholders of the upper-tier CFC seller. Under the Bill, such lower-tier sales would be taxed to the CFC seller in the same manner as if a U.S. shareholder sold section 1248 stock. Thus, to the extent of the lower-tier's earnings and profits earned while the stock was held by the upper-tier, the gain is recharacterized as a dividend with only the excess treated as gain from the sale of stock. Curiously, however, the same country dividend exclusion of section 954(c)(3)(A) does not apply to the portion of the sale recharacterized as a dividend. As a separate matter, the Bill also provides for adjustments to the basis of lower-tier CFC stock in the hands of its upper-tier CFC parent for subpart F inclusions and distributions.

The Council supports the extension of section 1248 to sales of stock in lower-tier CFCs and providing stock adjustments for subpart F inclusions attributable to lower-tier CFCs. These proposals will eliminate unnecessary restructuring required under current law to avoid passive income treatment. The lower-tier stock sale proposal, however, would be more rational -- and thus simpler -- if any resulting deemed dividends were treated as actual dividends for all purposes of the Code, including the "same country exclusion" of section 954(c)(3)(A). Where lower-tier earnings would not result in subpart F income if actually distributed, the same earnings should not create subpart F income when included as part of a section 1248 dividend.

Third, the Bill provides a number of useful rules to assure that on the sale of CFCs certain earnings previously taxed are properly excluded. For one, the Treasury is given the authority to exclude deemed section 304 dividends (which typically arise on cross-chain sales of CFC stock) to the extent of the previously taxed earnings and profits out of which the stock is deemed to be distributed. The Bill also provides a reduction to the subpart F income of a U.S. shareholder for the year the shareholder acquires the stock of a CFC from another U.S. shareholder by the shareholder's portion of the seller's section 1248 dividend attributable to current year earnings and profits. Under existing law, the subpart F income of a CFC is taxed only to the U.S. shareholders that hold stock on the last day of the taxable year. To account for this year-

end holder rule, the Code provides an adjustment for dividends that are paid out of current year earnings and profits prior to the acquisition. No such adjustment is currently provided, however, for the portion of the deemed dividend under section 1248 to the seller that is composed of current year earnings and profits. These proposed rules are a welcome addition.

Finally, the Bill addresses the foreign tax credit rules for previously taxed income ("PTI"). Under current law, section 960(a)(3) allows an indirect credit for foreign taxes paid by the distributing or lower-tier CFC on PTI, and section 960(b) allows any excess foreign tax limitation from the year in which the PTI was originally taxed to be recaptured for use in the year of distribution. The Bill repeals these sections on the grounds that they involve complex recordkeeping and tracing requirements and normally do not result in substantial tax savings. Thus, indirect taxes on PTI would remain in the post-86 pool of foreign taxes, potentially creditable in future years, and any excess credits that result when the taxes become creditable are subject to the normal two year carryback and five year carryforward rules.

The U.S. Council agrees that section 960(b), in conjunction with section 960(a)(3), even though essentially a taxpayer elective provision, involves complex recordkeeping and tracing requirements. In our simplification submission, we suggested that consideration be given to alternative rules. We do not believe that simplification is well served by eliminating provisions that are beneficial to taxpayers without appropriate substitute provisions. The U.S. Council would therefore suggest retaining section 960(a)(3), which has not proven overly complex in practice, and replacing section 960(b) (ie. carryforward of excess limitation), which has proven complex in practice, with a provision allowing a lengthy (e.g. 10 years) carryback period for excess credits arising from taxes attributable to PTI. We continue to believe that this is the preferable alternative, because it reduces administrative complexities but still allows taxpayers a more liberal rule for the use of prior year excess limitations to credit taxes resulting from distributions of PTI -- a right which is particularly important if U.S. rates increase.

Proposed PFC Regime

As mentioned above, the Bill replaces the PFIC, FIC and FPHC income rules with a new creature -- the passive foreign company ("PFC"), which continues to impact U.S. shareholders of CFC's. The U.S. Council believes a simpler approach would have been to eliminate U.S. shareholders of CFC's from PFC coverage.

PFC is defined as any foreign corporation that satisfies one of the following three tests: (1) a gross income test, 60 percent or more of its gross income is passive; (2) an asset test, 50 percent or more of its assets produce passive income or are held for the production of passive income; or, (3) a registration test, the foreign corporation is registered under the Investment Company Act of 1940 as a management company or unit investment trust.

The three-pronged alternative PFC definition represents a blending of the various passive anti-deferral regimes; but, in many ways, it is a blending of the worst sort. The gross income test adopts the 60 percent FPHC threshold rather than the higher 75 percent PFIC or 70 percent CFC thresholds. Given that the PFC rules do not carve out CFCs from their reach, additional simplification would be achieved if the 70 percent rule of subpart F were adopted instead. The asset test, except for the addition of certain leased assets, is lifted from the PFIC rules. The retention of an asset test as a touchstone for passive characterization is regrettable. As explained in our simplification submission, the asset test creates tremendous compliance and administrative burdens. Because in practice taxpayers are forced to use

adjusted tax basis (rather than fair market value) to value assets, the asset test also discriminates among industries. The registration test is lifted from the FIC definition and seems appropriate.

The Bill makes no attempt to reconcile the various definitions of passive income under subpart F, PFIC and the foreign tax credit rules. Passive income for the gross income and asset tests is the PFIC definition under current law, including the exceptions for banking and insurance income and the look-through rules for related parties, but with additional modifications and two clarifications.

The inclusion of income to U.S. shareholders of a PFC can occur in any one of a number of different ways and on either a current tax basis or on a deferred tax basis with an interest charge. Current inclusion is required if (1) the PFC is a CFC, (2) more than 50 percent of the vote or value of the PFC's stock is held by 5 or fewer persons, or (3) more than 25 percent of the PFC's stock is owned by a U.S. shareholder. Current inclusion also essentially applies if (4) the PFC would qualify as a Regulated Investment Company if it were a domestic corporation, meets certain requirements to be set forth in regulations by the IRS, waives all treaty benefits, and elects to be taxed as a domestic corporation. Ownership is determined in situations (1) and (3) under section 958, but the ownership determination in situation (2) is set forth in the much broader rules applicable to domestic personal holding companies (section 544). The U.S. Council recommends that the use of section 544 ownership rules be entirely eliminated under the PFC regime, and that section 958 be used across the board, particularly since under situation (2) the 5 or fewer persons need not be individuals. The rules applicable to situation (1) are the straight PFIC rules applied to CFCs, but with a significant exception. The high-tax exception available to CFCs that make a qualified electing fund election under current law is repealed in favor of the FPHC regime. A high- tax exception was not provided for FPHCs, because FPHCs were almost exclusively formed in low-tax jurisdictions. Since this is not true for CFCs, it is difficult to understand why the high-tax exception is not retained for CFCs that are also PFCs. The rules for situation (2) are lifted from the FPHC rules, but with the ownership change noted above that five or fewer persons need not be individuals. The rules for situation (3) have no origin that we can find in prior law. The election available for companies meeting the criteria of (4) to be taxed like a domestic corporation exist in only narrow contexts, such as section 953(d).

Current inclusion, except for the PFC that elects to be taxed as a domestic corporation, would be based on the existing CFC model, including the basis adjustments, treatment of previously taxed income, ordinary treatment of inclusions and foreign tax credits. Unlike subpart F, however, all inclusions would be treated as foreign personal holding company income, even if the PFC is also a CFC. The result is to increase the computations required under the high-tax kick out rules of section 904(d)(2)(F), an already burdensome provision. The full inclusion rule for PFCs is similar to the subpart F full inclusion rule for CFCs. Under that rule, items of income simply retain their character for foreign tax credit purposes as active foreign base company income, passive income, or non-subpart F income. In addition, under the existing rules for CFCs with qualified electing funds, the foreign tax credit look-through rules apply. The Council therefore recommends that the look-through rules for PFC inclusions should apply to all controlled PFC's.

Shareholders not covered by the rules discussed above may individually elect to be subject to the current inclusions based on the current qualified electing fund regime for PFICs. For electing shareholders, inclusions are treated for foreign tax credit purposes as dividends from non-controlled foreign corporations. If shareholders do not elect, they are taxed in one of two ways: (1) on the mark-to-market system, if the shares are "marketable"; or (2) if the shares are not marketable, under a deferred tax with interest charge regime similar to the current law section 1291. PFC stock is considered marketable if it is regularly traded on a qualified exchange, whether inside or outside the U.S. An exchange qualifies for this purpose if it is a national

securities exchange which is registered with the SEC or the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934, or if the Secretary is satisfied that the requirements for trading on an exchange ensure that the market price on that exchange represents a legitimate and sound fair market value for the stock. The Service is permitted to adopt a definition of the term "regularly traded" that differs from the definitions provided for other purposes of the Code, e.g., section 884(e)(4)(B)(i). Gain or loss under the mark-to-market regime is treated as ordinary and characterized for foreign tax credit purposes as if the stock had been actually disposed.

TRANSLATION OF FOREIGN TAXES

Under existing law, foreign taxes are translated at the spot rate on the date of payment. The Bill provides the IRS with regulatory authority to use an average rate for taxes paid within a prescribed period. The alternative taxpayers overwhelmingly requested -- and which is proposed in both Senator Baucus's and Congressman Gradison's recent bills -- is a return to the translation of taxes at the same rate as income (the so-called Bon Ami rule). This is a much simpler methodology because, among other things, it eliminates the need for annual translations and foreign tax redeterminations in a significant number of cases. In addition, as explained in detail in our simplification submission, this rule is at least as conceptually correct as the date of payment rule, because it would treat the translation of foreign taxes consistently with the translation of other functional currency expenses, and would maintain the effective rate of foreign tax.

ALTERNATIVE FOREIGN TAX CREDIT

The Bill provides a binding election to compute the alternative foreign tax credit by substituting regular foreign source income for alternative foreign source income in the numerator of the fraction. The U.S. Council supports this proposal.

IMPORTANT PROPOSALS LEFT OUT

The most discouraging aspect of the Bill is what it leaves out. The Bill does nothing at all to simplify the foreign tax credit complexities for corporate taxpayers -- nothing on the "10-50" basket problems; nothing on the "high tax kick out rule" for passive income; and nothing on the application of section 263A or section 404A to foreign corporations. In addition, no attempt is made to address the numerous obscurities and anomalies that add to complexity, such as conforming the definition of 10 percent shareholder in sections 902, 951(b), 960, and 245 or conforming the look-through rules for section 904(d) and (g).

CONCLUSION

The U.S. Council commends the drafters of the Tax Simplification Bill for their efforts to simplify the foreign provisions of the Code. In reality, however, other than changes in the rules dealing with controlled foreign corporations (CFCs) and the alternative minimum foreign tax credit computation, the Bill simplifies very little. If there is to be meaningful simplification in the foreign area, clearly more must be done. The U.S. Council encourages the members of both the House and Senate to consider carefully the simplification bills that have also been introduced by Senator Baucus and Congressman Gradison, as they offer many proposals that the Council believes could result in meaningful simplification. We are also resubmitting our original submission for simplifying the foreign provisions for your continued consideration.

United States Council for International Business Recommendations for Simplification of International Provisions of the Code

I. INCLUSION OF INCOME OF FOREIGN CORPORATIONS

A. Introduction

The complexity of the current system for taxing income of foreign corporations engaged in business outside the United States can be traced primarily to the need to separate income that is deferred from that which is not. A system that permitted complete deferral or required current taxation of all income would undoubtedly be much simpler. The pros and cons of such systems, however, have been debated for years, and it would seem unlikely that either is fully justifiable in and of itself. The real question, therefore, is what are the appropriate rules for inclusion of income of foreign corporations given that some income will be deferred until distribution.[1]

The current rules for taxing income of foreign corporations to U.S. shareholders can generally be classified into two regimes: (1) Passive anti-deferral provisions -- those provisions, which tax currently income of foreign corporations whose primary activities or income is passive in nature (i.e., the foreign personal holding company (FPHC), foreign investment company (FIC), and passive foreign investment company (PFIC)); and (2) Subpart F -- which taxes currently only certain types of income where U.S. shareholders or a group of U.S. shareholders control the foreign corporation. The Council believes that these two basic regimes should be retained but that substantial revisions to each are needed in order to avoid excess complexity. Suggestions for improving these two basic regimes are discussed separately below.

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[1] Despite the 1986 Act's affirmation of the corporate system of double taxation, there continues to be some interest in the integration of corporate and shareholder taxes. It appears highly unlikely, however, that if an integration system were adopted that it would result in full integration of the income of domestic corporations, let alone foreign corporations. Thus, there will undoubtedly be some income of foreign corporations that, absent a special provision, will be taxed only upon distribution.

B. Passive Anti-deferral Provisions

1. Unification of provisions

Perhaps the most compelling candidate for simplification is the unification of the multiple regimes that exist for taxing income of foreign corporations that are involved primarily in passive activities -- the foreign personal holding company (FPHC), the foreign investment company (FIC), and the passive foreign investment company (PFIC) provisions. The concerns addressed by these provisions are generally all adequately addressed by a single provision -- the PFIC provisions (or could be addressed with minor changes thereto). The primary difference in these provisions turns on the definition of passive income or assets or the level of U.S. ownership which triggers their application. The overlapping nature of these structures is evidenced by the comprehensive priority rules that are needed.[2]

2. Modification to PFIC rules

Along with the unification of the provisions dealing with foreign corporations operating primarily in passive activities, the Council also recommends that the PFIC provisions be amended so that they do not apply to U.S. shareholders[3] of controlled foreign corporations (CFCs); the income of such corporations is already subject to inclusion to these shareholders under subpart F. Not only would this simplify the operation of the anti-deferral regimes to CFCs, it would continue the longstanding tax policy that active business earnings of foreign corporation are taxable only upon repatriation and would be consistent with the intended scope of the PFIC provisions, which was to eliminate deferral on passive income earned in widely held foreign corporations.

3. Passive activities tests

Finally, the Council recommends that an asset test not be used to determine when a foreign corporation is engaged in sufficient passive activities to cause current taxation of its income under the PFIC rules.[4] Characterization of assets

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[2] E.G., sections 951(d) and (f) (subpart F trumps FPHC and PFIC); section 551(g) (FPHC trumps PFIC); section 1297(b)(7) (PFIC trumps FIC).

[3] U.S. shareholder is defined in section 951(b), generally as a U.S. person who owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote.

[4] See section 1296(a)(2).

is an extremely difficult process and has been a frequently litigated point of contention for taxpayers and the Service in numerous other areas of the Code for years. The difficulties this causes is compounded in the case of foreign corporations. The Treasury Department itself is well aware of the difficulties. In the recent interest allocation regulations under section 864(e), taxpayers have been permitted an election to characterize the stock of CFCs on the basis of the gross income, rather than assets, of the corporation (Treas. Reg. § 1.861-9T(j)).

C. Subpart F

1. Eliminate inter-affiliate dividends, interest, rents, and royalties

The subpart F provisions were originally enacted in 1962 in a vastly different economic environment than exist today. The underlying concept adopted in 1962, that income earned in a country other than the country of incorporation should be taxed currently, is subject to much criticism in the present worldwide economy in which taxpayers operate. Free flow of capital and technology is increasingly the norm and will undoubtedly continue to be so. Moreover, developments toward integration of the EEC continue to proceed.

The Council believes that a simpler system, and one much more reflective of the global nature of the business world, would be to permit all dividends, interest, rents, and royalties that are paid within the affiliated group to be exempt from the reach of subpart F, unless on a look-through basis the payments are attributable to subpart F income of the payor.[5] This would correspond the treatment of subpart F to section 904(d).

2. Currency gain or loss

a. Subpart F and section 904(d)

Under current law, currency gain or loss of a controlled foreign corporation (CFC) is treated as foreign personal holding company income (FPHCI) and passive income under section 904(d), unless incurred in a transaction directly related to the business needs of the CFC.[6] In order to satisfy the business needs exception, the corporation must meet detailed tracing, characterization and identifications

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[5] Affiliated group would be defined by reference to section 1504, but without regard to section 1504(b) and by reducing the ownership level from 80 to 50 percent.

[6] See sections 954(c)(1)(D), 904(d)(2)(A).

rules, which generally reflect the transaction-oriented nature of the statute (*see* Temp. Treas. Reg. § 1.954-2T(g)).[7]

Most taxpayers that operate worldwide enter into thousands of transactions in nonfunctional currencies. The currency exposures these transactions present are almost always hedged to some extent, to prevent unpredictable changes in profits or losses due to violent swings in exchange rates. Hedging, however, is almost never done on an individual basis, but rather on the net exposure of the corporation in a particular currency. Thus, the notion that currency gain or loss can be individually traced, characterized and identified creates enormous difficulties for even the most sophisticated taxpayer.

Simplification could be gained, with little or no revenue loss, if the rules were amended to permit taxpayers an election to apportion currency gains and losses among all the CFC's section 904(d) baskets on either the gross income or asset method used by the foreign corporation to allocate interest expense. Special rules, however, would be necessary for assets and liabilities that are denominated in hyperinflationary currencies to account for the currency gain or loss that is created by inflation. The simplest way to do this would be to currently recognize currency gain or loss on all indebtedness (or similar items) outstanding at year-end, under rules similar to section 988(a)(3)(C).

b. <u>Permit election to adopt mark-to-market method</u>

Under existing accounting principles (embodied in FASB 52) all current assets and liabilities in nonfunctional currency are generally marked-to-market at the end of each accounting period and currency gain or loss recognized.

A mark-to-market system would go far in eliminating timing concerns that remain in the taxation of currency, such as sections 1092 and 1256, and would permit taxpayers to generally conform their accounting treatment with tax. Moreover, as the accounting rules recognize, there is generally readily available data for determining the value of current assets and liabilities denominated in nonfunctional currency and, thus, a mark-to-market system limited to such assets and liabilities does not present the fair market value difficulties that broader mark-to-market systems do.

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[7] These rules also apply to determine the section 904(d) character of currency gains and losses of foreign branches and partnerships. <u>See</u> Treas. Reg. § 1.904-4(b)(1)(ii).

Accordingly, the Council recommends that an election be provided to adopt a mark-to-market system for current assets and liabilities in nonfunctional currency on a worldwide basis, provided the method is otherwise consistent with the taxpayer's financial accounting method.

3. Unified definition of passive income

The Council also believes that simplification would be achieved if the definition of passive income under subpart F and the PFIC provisions were conformed to the definition under the foreign tax credit rules of section 904(d), so that there would generally be only one definition of passive income.

The primary difference in the definitions of passive income is the treatment of rents and royalties under the regulations. The foreign tax credit regulations permit the determination of whether rents or royalties are active to be made on an affiliated group basis, while subpart F and PFIC limit the determination to a single entity.[8]

4. Foreign tax credit and subpart F loss recapture rules

The loss recapture rules of the Code apply to different categories of income for foreign tax credit and subpart F purposes. In order to compute a U.S. shareholder's foreign tax credit, a CFC's income and taxes must be characterized and grouped at the CFC level in accordance with sections 904(d) and (f). Because sections 904(d) and (f) operate with respect to the baskets defined in section 904(d), while sections 952 and 954 operate with respect to subpart F categories, a single section 904(d) basket can be composed of several subpart F categories. For example, subpart F sales, service, personal holding company, and foreign oil related income can all fall within the general limitation basket. Conversely, a single subpart F category can constitute several section 904(d) baskets. For example, FPHCI can be general limitation, noncontrolled section 902 dividends, passive, or high withholding tax income. Thus, there can be section 952(c)(2) recapture but no recapture under section 904(f) or vice-versa. The effect of these different rules is that the amount and character of income for subpart F may differ from that for foreign tax credit purposes. A simple example illustrates some of the problems that can occur.

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[8] Relaxing the definition of passive income for rents and royalties is not likely to erode the tax base, as there are more than adequate safeguards to assure that intangible or tangible property is not transferred outside the U.S. without adequate tax. See sections 367, 1491 and 482.

Example: In 1990, a CFC begins operations and has the following income and taxes.

	General limitation	FT	Noncontrolled § 902	FT
1990	($100) FBC sales	$20	$50 (nonsubpart re § 954(b)(4)	$50
	$100 FBC services	$10		
1991	$100 nonsubpart F	$20		

The current subpart F rules do not allow a loss in one category of subpart F income to reduce income in another category of income. Thus, the $100 sales loss in 1990 does not offset the $100 of service income.[9] Nevertheless, in 1990, only $50 of the CFC's foreign base company service income would be subpart F, because subpart F inclusions are limited to current earnings and profits, which in this case are $50 ($100 deficit in sales income plus $100 service income and $50 noncontrolled section 902 income).[10] For section 904 purposes, however, the $50 subpart F inclusion is presumably considered entirely from the noncontrolled section 902 basket that has $50 of associated taxes as that is the only section 904(d) basket with income (the general limitation basket is zero).[11]

In 1991, there will be subpart F recapture but no section 904(f) recapture. Thus, $50 of the $100 nonsubpart F general limitation income is recaptured as subpart F service income under section 952(c)(2) (but none of the $20 associated taxes). Since there is no section 904(f)(5) recapture because there was no section 904(f)(5) loss in 1990, presumably the income recaptured as subpart F income for section 904 purposes would be considered general limitation income with $25 of associated taxes.[12] That is the only income that exists for section 904(d) purposes. The noncontrolled section 902 basket has been depleted by the $50 1990 inclusion.

The complexity demonstrated by this example is obvious. The Council believes the best solution is to allow losses within a section 904(d) basket to offset other income in the basket for subpart F purposes as well as section 904,

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[9] See Temp. Reg. § 1.954-1T(c).

[10] See section 952(c)(1).

[11] See section 904(d)(3)(B).

[12] The $25 of taxes are determined under the multi-year pooling rules of section 960 as follows - - $50 of subpart F inclusion divided by $100 of general limitation income pool multiplied by $50 of general limitation tax pool ($30 from 1990 and $20 from 1991).

and to amend section 952 so that the subpart F recapture rules apply with respect to the section 904(d) baskets, rather than subpart F categories. Thus, in the example above, the 1990 foreign base company sales loss of $100 would reduce the foreign base company service gain of $100 for subpart F purposes as well as section 904, and no recapture would occur in 1991.

5. Earnings and Profits

Earnings and profits of a foreign corporation are important because they (1) determine if a distribution is a dividend; (2) determine the amount of foreign taxes "deemed paid" upon an actual or deemed dividend; and, (3) set the limit on the amount of subpart F income required to be included or PFIC income subject to taxed where a qualified electing fund election is made.

In addition, the foreign tax credit limitation look-through rules, the pooling concept for determining indirect credits, and the earnings and profits adjustment for allocating interest to the stock of a foreign corporation have made the annual calculation of a CFC's income more critical.

While "earnings and profits" is not specifically defined, after 1986 the earnings and profits of a foreign corporation are determined under the rules of section 964 and the foreign currency rules of sections 985-989. Section 964(a) provides that a foreign corporation's earnings and profits are to be determined under rules substantially similar to those applicable to U.S. corporations. The IRS requires the earnings and profits to be adjusted to conform to U.S. GAAP rules and to U.S. tax accounting rules.[13]

In recent years, Congress has added provisions in section 312 that help define earnings and profits for U.S. corporations. But there have also been new tax accounting provisions, such as section 263A. The IRS has generally extended these changes to foreign corporations. The adjustments required by section 263A are extremely time consuming and require detailed factual information. Thus, in order to make the adjustments, the U.S. multinational must request its foreign subsidiaries to provide information that may not be readily available, and must request it from personnel who may not be fluent in English let alone knowledgeable about the U.S. tax laws.

While the 1986 Act has made the annual determination of a foreign corporation's earnings and profits more critical, it has made the tax effects of any earnings and profits adjustment less significant. First, any increase in earnings

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[13] Treas. Reg. §§ 1.964-1(b), (c).

and profits resulting from an adjustment will only increase the size of the dividend, which will generally be covered by excess foreign tax credits. Further, the amounts capitalized under section 263A do not result in major timing differences, since the turnover rate for inventory of most corporations is high. Moreover, as the new "multi-year pooling concept" tends to average a CFC's effective foreign tax, the effects of any earnings and profits adjustment caused by section 263A are negated.

Accordingly, the Council requests that the computation of a foreign corporation's earnings and profits be simplified by excluding foreign corporations from section 263A.

The Council also recommends that section 404A(d) be eliminated as unnecessary in light of the pooling changes made to the indirect foreign tax credits. Section 404A(d)(1)(A) limits the deduction permitted for various payments to foreign pension plans to the lesser of (i) the cumulative United States amount or (ii) the cumulative foreign amount. The pre-1986 legislative history states that the additional earnings and profits limitation was imposed to respond to the "possibilities for distortion of a taxpayer's indirect credit which are presented by the annual system . . ." of computing foreign earnings and profits. The legislative history also states that the potential for distortion might be eliminated if accumulated foreign taxes and earnings were computed on a pooled basis.[14]

II. RELIEF FROM DOUBLE TAXATION

D. Introduction

Since 1918, the United States has provided relief from double taxation of international operations through some form of a credit mechanism. The primary alternatives are a deduction or exemption system. The Council strongly believes that a credit system is the preferable system.

The deduction system would be far simpler, but is a rather poor substitute for relief from double taxation. It would not allow dollar-for-dollar credits for taxes incurred in foreign countries; thus, the system would discriminate against industries that are highly taxed in foreign countries compared to those that are not. There might be some ways to jerry-rig the system to ameliorate this, but it is likely to result in as much complication as the present credit system.

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[14] S. Rep. No. 1039, 96th Cong., 2d Sess. 15 (1980).

An exemption system, on the other hand, has some appeal, but it would not necessarily be simpler than an overhauled credit system. A pure exemption system would exempt all foreign source income. It is hard to imagine an exemption system, however, that did not at least differentiate passive income from other income -- as an exemption of passive income would open the door for massive revenue losses. It would also be reasonable (and necessary from a revenue standpoint) to expect some assurance that the exempt income is being subject to substantial taxes in a foreign country. A foreign tax credit would also presumably be necessary for foreign income that is not exempt. Accordingly, there would be a need for rules to separate passive income, income that is taxed at low rates and U.S. sourced income from income more broadly and to allocate taxes and expenses to these categories. Look-through rules would also be necessary to at least preserve the integrity of the passive rules. Thus, at the minimum, an acceptable exemption system would raise many of the same problems associated with a credit system.

E. Reduce Number of Limitation Baskets[15]

Perhaps the easiest and most straight forward way to simplify the foreign tax credit is to reduce the number of limitation baskets. There may be strong policy reasons for not restricting cross-crediting in certain circumstances. Nevertheless, the degree of fragmentation in the current law creates tremendous complexities that outweigh many of the possible benefits of restricting cross-crediting.

1. Permit look-through for noncontrolled section 902 corporations

The requirement that dividends from each non-controlled section 902 foreign corporation creates a separate foreign tax credit limitation causes a number of problems. The most severe problems are felt in the growing area of joint venture activities. If the joint venture operation cannot be structured into CFC status or as a partnership, -- the result

[15] The discussion that follows also assumes that the most appropriate credit system is one based on an overall rather than per country limitation. The Council believes an overall limitation is generally simpler and more equitable than a per country system. The per country system, which at one time was a part of the Code, has the potential for creating many more baskets, since it is based on the number of countries in which a taxpayer operates. In addition, look-through rules would be necessary to determine geographic source. Moreover, due to the ability of taxpayers to create passive type income in countries where such geographic source would be beneficial, some sort of basket for passive income (and look-through rules) would also be necessary.

is a separate basket, as opposed to look-through treatment. From the stand point of simplification, however, the problem is the tremendous increase in baskets to which income and expenses must be apportioned.

The simplest solution would be to permit all noncontrolled section 902 dividends to be placed in a single basket. However, the most rational solution -- and one still simpler -- is to extend the look-through treatment of section 904(d)(3) to noncontrolled section 902 corporation'. Under this proposal, dividends as well as interest, rents and royalties from a noncontrolled section 902 foreign corporation would be afforded look-through treatment.

The legislative history to the Tax Reform Act of 1986 provides two reasons for denying look-through treatment: (1) that the minority shareholder lacks sufficient identity of interest with the corporation to justify allowing cross-crediting; and (2) that the minority shareholder may not be able to obtain sufficient information to make the computations.[16]

If there is sufficient identity of ownership to permit a U.S. corporation to claim a section 902 credit, it is difficult to understand why this identity is not also sufficient to permit cross-crediting, at the very least among other income received from the corporation. Moreover, if the U.S. corporation had the identical ownership interest in a CFC or nonincorporated joint venture, the look-through rules would apply. In addition, if the foreign corporation has foreign oil and gas extraction income (FOGEI), the U.S. shareholder would be required to apply look-through rules to determine its section 907 limitation on FOGEI.[17]

The concern expressed about shareholder information is also not very convincing, and, in any event, can be dealt with easily. Shareholders are already required to compute earnings and profits of foreign corporations to claim section 902 credits and, as mentioned above, look-through rules already apply to such taxpayers for section 907 purposes. Moreover, if the access to information is a concern, a rule could be adopted that permits the IRS to apply separate basket treatment for dividends or passive treatment for interest, rents, and royalties if the taxpayer did not provide adequate information.

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[16] , Staff of the Joint Committee on Taxation, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986 867-68 (Comm. Print. 1986) (hereinafter "Blue Book").

[17] Section 907(c)(3).

The Council also believes that consideration should be given to extending look-through treatment to pre-acquisition earnings and profits of foreign corporations.[18] Under present rules, pre-acquisition earnings are generally not afforded look-through treatment. Thus, each shareholder is forced to keep separate accounts of pre- and post-acquisition earnings and profits as well as any additional fragmentation necessary to apply the rules of sections 1248 and 367(b).

2. Eliminate high-tax kickout rule

Tremendous complexity is produced by the high-tax kickout rule of section 904(d). The rule kicks out of the passive basket income that has been subject to a rate of tax in excess of the highest U.S. tax rate. The complexity produced by the rule arises from the need to (1) determine the income item or group of income items to which the test applies; (2) make additional allocations of taxes within the passive basket to these groups; (3) adjust for timing differences that occur because of subpart F and the PFIC rules (e.g., withholding taxes on distributions of previously taxed income and reductions in foreign taxes as a result of integrated tax systems); and, (4) recompute expense allocations if the baskets change due to income that has been kicked out.

The Council believes the high-tax kickout rule is not necessary and should be eliminated. Passive income generally does not bear high taxes since it is easily movable. Moreover, taxpayers generally have no incentive to incur high taxes on passive income. It is true that some taxpayers will be stuck with having to pay substantial taxes on passive income. This will generally be the exception, however, and it is not clear why cross-crediting of the taxes in these situations should not be permitted anyway. Furthermore, the legislative history suggests that the purpose for the rules is the need to curb tax motivated transactions.[19] The only example in the legislative history is a taxpayer that enters into various back-to-back borrowing transactions with unrelated parties that have the effect of allocating most of the passive expenses created to active income, so that high-taxed passive income is produced that can be used to reduce U.S. tax on low-taxed passive income.[20]

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[18] Section 904(d)(2)(E)(i) provides regulatory authority to cure this problem in situations where the corporation was a CFC both before and after the acquisition.

[19] See 1986 Blue Book, supra, n. 11 at 879.

[20] Id.

Given that the only justifiable concern behind the high-tax kickout rule is to curb tax motivated transactions, the Council believes a better approach would be to grant the IRS authority to exclude any high taxed passive income from the passive basket if earned in a transaction lacking a substantial business purpose. While there will undoubtedly be uncertainty that arises from the grant of such authority to the IRS, the simplicity gained would far outweigh the uncertainty produced.

The elimination of the subpart F exception in section 954(b)(4) for passive income that is subject to foreign taxes in excess of ninety percent of the U.S. rate might also be justified. While there are different policy considerations involved in subpart F and section 904, the exception creates much of the same complexity as the high-tax kickout rule.[21] Since section 954(b)(4) is a taxpayer elective provision, however, the Council believes that the exception should remain. If the election is made, however, it would appear that any income that is excluded from subpart F should be treated as general limitation basket income for section 904(d) purposes.

3. <u>Consolidate DISC and FSC baskets into expanded passive basket</u>

There are currently separate limitations for distributions from a Domestic International Sales Corporation (DISC), distributions out of foreign trade income from a Foreign Sales Corporation (FSC) or former FSC, and foreign trade income derived by a FSC or former FSC.

It appears that these separate limitations were considered necessary because the income generally bears little or no foreign taxes. However, it is not so clear why these baskets could not be grouped in a single basket with other similarly low taxed income. It is hard to imagine taxpayers incurring high taxes in a DISC or FSC; the benefit for establishing these incentive corporations would generally be eliminated. Accordingly, the Council suggests that the separate basket treatment of DISC and FSC be eliminated and that the income be included in an expanded passive basket.

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21 *See* Temp. Reg. § 1.954-1T(d).

F. Indirect Foreign Tax Credit

1. Multi-year pooling

The Tax Reform Act of 1986 changed the computation of the indirect foreign tax credits (sections 902 and 960) so that earnings and profits and foreign taxes are computed on a pooled basis, consisting of all undistributed earnings and profits and taxes since 1987.

As time passes, the pools will become increasingly larger, and, thus, taxpayers will be required to verify undistributed earnings and profits and taxes since 1987 for section 902 or section 960 credits whenever there is subpart F income or a dividend distribution. Given the requirements section 904 imposes on categorizing earnings and profits and taxes, the administrative burdens created will be severe. Any adjustment required will affect all previous claimed credits, subject only to the statute of limitations. Moreover, the IRS can make adjustments to earnings and profits related to a taxable year not within the statute of limitations for purpose of determining foreign tax credits that are under current examination.[22]

The changes made by the Tax Reform Act of 1986 were targeted to two problems. The most serious (from the Government's standpoint) was the ability to time distributions to increase foreign tax credits (referred to as the "rhythm method"). The LIFO system also created potential problems where there was a deficit in earnings and profits as computed under U.S. principles but foreign taxes were paid.[23]

Both of the problems could be addressed in a less burdensome manner. The Council believes the best alternative would be to apply the pooling concept on a moving three to five year basis. For distributions in excess of the pool, there would be a reversion back to the LIFO rules of pre-1987 law. This would most certainly cure the abuses caused by the

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[22] There is generally no statute of limitations on earnings and profits.

[23] A major problem with losses was the lack of guidance on how deficits in earnings and profits affected the section 902 fraction (or section 960 fraction, in the case of a section 956 or 1248 transaction) and how accumulated profits were to be computed. Both of these issues were largely resolved by a 1987 revenue ruling (Rev. Rul. 87-72, 1987-2 C.B. 170) and by the recent Supreme Court decision in Goodyear Tire and Rubber Co. v. United States, U.S. S. Ct. No. 88-1474 (Dec. 11, 1989).

rhythm method and would lessen any remaining problems that might be caused by deficits.[24]

2. <u>Translation of Foreign Taxes</u>

The Tax Reform Act of 1986 alters the rules for translating foreign income taxes so that now all foreign taxes must be translated into U.S. dollars at the exchange rate existing at the date the taxes are paid.[25] Multinationals and their subsidiaries are often subject to income taxes in hundreds of jurisdictions, which result in numerous tax payments for estimated taxes, original and amended return filings and the payment of additional tax assessments. Moreover, foreign tax returns and receipts do not generally evidence the time of payment. It is, therefore, an enormous task to record all these payments at the date they occur.

The Tax Reform Act of 1986 for the first time also adopted a comprehensive set of rules for taxing currency gains and losses.[26] Under those rules foreign corporations and branches (QBUs) determine their income and expenses in functional currency. If functional currency is not the U.S. dollar, then the translation of income and expenses is generally at the "appropriate exchange rates" as defined in section 989(b) of the Code. The requirement that taxes be translated into dollars when paid is the primary exception to this regime.

It would greatly simplify the system if foreign taxes were translated at the appropriate exchange rates that are applicable to the inclusions of income to which the taxes relate. Thus, for actual dividends foreign taxes would be translated at the exchange rate existing on the date of the distribution (the old <u>Bon Ami</u> rule). For section 1248 inclusions, foreign taxes would be translated as of the date of the deemed dividend. Foreign taxes with respect to subpart F inclusions, PFIC inclusions, and branch income would be translated at the weighted average exchange rate for the taxable year of the CFC, PFIC or branch.

Since the appropriate exchange rates do not apply if functional currency is the U.S. dollar, taxes would be translated at the date of payment, which corresponds to the translation of the related income. Moreover, the translations of the taxes in the U.S. dollar context could be further simplified by permitting taxes to be translated at the monthly

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[24] <u>See</u> discussion at n. 16, <u>infra</u>.

[25] Section 986(a).

[26] <u>See generally</u> Subpart J (§§ 985-989).

rates generally permitted for other nonfunctional currency payables (see Temp. Treas. Reg. § 1.988-1T(d)(3)).

Adopting these rules would not only be simpler, but would be at least as conceptually correct as the current translation rules. The use of the appropriate exchange rate generally preserves the effective rate of the taxes, which, as noted, is more consistent with the concept of functional currency than the current rule. Moreover, the primary reason that has been given for the payment rate rule is that this is the date the taxes become fixed in U.S. dollars and, thus, no longer subject to fluctuation.[27] However, other expenses are not considered fixed when paid, but rather are computed in functional currency and translated only when there is some event that causes U.S. taxation.

Finally, using the appropriate exchange rate will generally curb the ability for planning, since no matter when taxes are paid or earnings remitted the same effective tax rate will be produced. Under the current rules, it is advantageous to pay taxes currently in depreciating currencies but to defer payment in appreciating currencies.

3. Eliminate separate section 907 limitation

The Council believes that section 907 should be repealed and that oil and gas income be subjected only to the normal limitations of section 904(d).[28]

Under current law, oil and gas income must be separated into foreign oil and gas extraction income (FOGEI) and foreign oil related income (FORI), and a special limitation applied to the FOGEI so that foreign taxes paid in excess of the U.S. rate are not treated as currently creditable taxes. Carryovers and carrybacks are permitted. After the separate limitation of section 907 is applied, oil and gas income is again subject to limitation under the normal section 904(d) rules.

Requiring that foreign oil and gas income be subject to two limitations creates tremendous complexity. Moreover, since the issuance of final regulations under section 901, the need for this added complexity seems highly questionable. Section 907 was enacted in 1975 because of a concern that high taxes that were generally paid on oil and gas extraction activities might actually represent in part a return for a royalty being paid to the foreign government which owned the natural resources.

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[27] 1986 Blue Book, supra, n. 19 at 1091.

[28] If section 907 were repealed, consideration should also be given to rewriting section 954(g).

Section 907 was enacted as a means of segregating these taxes from taxes on oil and gas income more broadly. Final regulations under section 901 (1983), however, now expressly deal with what (and how much) is an income tax in these situations. Thus, the justification for section 907 is hard to understand. This is especially true given that the general rules for other active businesses (such as manufacturing) permit cross-crediting of taxes imposed on income produced by the business.

4. Treatment of losses

There are currently three different rules that apply when a U.S. taxpayer experiences a foreign loss in a separate foreign tax credit basket.[29]

Under section 904(f)(5), foreign losses in a separate foreign tax basket reduce other foreign tax baskets before reducing U.S. source income. Any income subsequently produced in the basket that generated the loss is recaptured into the baskets that were reduced by the loss.

If the taxpayer has enough losses so that an overall foreign loss occurs (excess of foreign losses or expenses over foreign income), the loss reduces U.S. source income. As soon as foreign income is produced in a later year, however, it is recaptured as U.S. source income to the extent the previous loss offset U.S. source income.

Finally, if the U.S. taxpayer has a net operating loss (NOL) for the year that is composed in part or in whole of an overall foreign loss, when the NOL is carried forward or back, the foreign source component will reduce foreign source income in its own foreign tax credit basket first and then other foreign source income. If the loss exceeds foreign source taxable income, it reduces U.S. source income.

The need to allocate losses between foreign baskets and U.S. source income and then to apply the recapture rules produces tremendous complexity. The complexity cries out for some workable alternatives. The Council believes one alternative would be to allow a loss in a separate foreign tax credit basket to reduce U.S. taxable income, but, for foreign tax credit purposes, to simply carry forward the loss until it reduced positive income in the same basket. Under this rule,

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[29] See, generally, final regulations under section 904(f); Notice 89-3, 1989-1 C.B. 623.

there would generally be no need for the section 904(f) recapture rules.[30]

A separate basket loss would reduce U.S. source income and would be carried forward to eventually reduce foreign income within its own foreign tax credit basket. The effect of the rule would be to accomplish the goal of section 904(f) -- to deny taxpayers the ability to take current deductions against U.S. tax for foreign losses and then claim a foreign tax credit for taxes paid in a foreign country in a subsequent year in which profits are produced -- by reducing subsequent income in the limitation in which the loss occurred.[31]

5. Conform definition of ten percent shareholder

To claim a credit under section 902 or 960, to be a U.S. shareholder of a CFC under section 951(b), or to claim a dividend received deduction under section 245 for the portion of a foreign corporation's earnings that have been taxed in the U.S. as effectively connected income, a U.S. corporation must own ten percent or more of the stock of the foreign corporation. The determination of ten percent ownership, however, is different for each of these purposes.

Under section 902 and 960, the determination of ten percent ownership is made by taking into account only voting stock owned directly. Under section 951(b), however, attribution rules apply to determine voting stock. Finally,

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[30] The recapture rules of section 904(f) would presumably still be necessary in some form for CFCs. The anti-deferral policy behind the loss recapture rules of section 952(c) is arguably inconsistent with the deferred loss proposed for section 904(f) in situations where nonsubpart F losses reduces subpart F income by way of the earnings and profits limitation of section 952(c). Thus, were the deferred loss proposal applied to CFCs without alteration, there could be a lack of coordination between the foreign tax credit recapture rules and the subpart F recapture rules of section 952(c) - - an unacceptably complex system. For a discussion on recommendations for coordinating the current section 904(f) and section 952(c) recapture rules, see discussion in text, supra, at page 5.

[31] This rule would also ameliorate the inequity that exist in current law between the treatment of U.S. and foreign source losses, since both U.S. and foreign losses would reduce U.S. source income in the current year and, thus, neither would effect the current year foreign tax credit limitation formula.

under section 245, only direct ownership is apparently taken into account, but vote as well as value are considered.

The Council believes that there is no justification for subjecting taxpayers to these differing requirements since they are intended to serve the same function -- determine when a shareholder has a sufficient identify with the foreign corporation to permit application of the statute. The Council, therefore, recommends that the definitions under sections 245, 902 and 960 be conformed to the definition under section 951(b).

6. Conform look-through rules of section 904(d) and section 904(g)

Under the present rules, there is an incongruity between the look-through rules of section 904(d) (which determine the character of income) and those of section 904(g) (which determine the source). The primary differences are in the entities and shareholders to which the rules apply.

The look-through rules of section 904(d)(3) generally apply only to U.S. shareholders of CFCs. A U.S. shareholder is a shareholder owning ten percent or more of the stock of the CFC.[32] A CFC is a foreign corporation in which greater than fifty percent of vote or value is owned by U.S. shareholders (as defined above).[33] The look-through rules of section 904(g), on the other hand, apply to any U.S. shareholder that owns stock in a United States owned foreign corporation. A United States owned foreign corporation is a foreign corporation in which fifty percent or more of the vote or value of the corporation is owned by U.S. persons.[34] There are also some other minor differences.[35]

The Council believes the differences between these rules cannot be justified and, thus, add unwarranted complexity. We recommend that the section 904(g) look-through rules be amended to conform to those in section 904(d)(3).[36]

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[32] Section 904(d)(4)(B).

[33] Section 904(d)(4)(A).

[34] Section 904(g)(6).

[35] For example, the look-through rules of section 904(g) do not apply to rents or royalties.

[36] It should be noted that the current regulations interpreting section 904(g) are limited to circumstances where the section 904(d) and section 904(g) rules overlap. See Treas. Reg. § 1.904-5(m).

7. Section 960(b)

Section 960(b), in conjunction with section 960(a)(3), creates enormous complexity, because it requires that distributions of previously taxed income must be attributed to the year in which the income was originally taxed to the U.S. shareholder in order to determine the application of section 904. See Notice 88-71, 1988-2 C.B. 374.

The Council believes that consideration should be given to alternative rules. One possibility might be to eliminate section 960(b) and permit longer carrybacks for the excess credits produced by taxes on distributions of PTI -- such as 10 years. This could work for or against taxpayers, but would presumably be much simpler than the current system.

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